Introduction

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On March 4, 1951, the Chairman of the Board of Governors of the Federal Reserve System, Thomas B. McCabe, and the Secretary of the Treasury, John W. Snyder, released a joint announcement of an understanding that has come to be known as the Treasury–Federal Reserve Accord.[1] That watershed agreement released the Federal Reserve from the obligation to support the market for U.S. government debt at pegged prices and laid the institutional foundation for the independent conduct of monetary policy in the postwar era. This special issue of the *Economic Quarterly* commemorates the 50th anniversary of the Treasury–Federal Reserve Accord.

The Federal Reserve's support for government debt prices during World War II kept yields from rising and reduced the direct cost to the Treasury of financing wartime deficits. Although this support effectively monetized the debt, price controls helped limit inflation. The policy of supporting government security prices was still in effect when hostilities broke out on the Korean peninsula in the middle of 1950. As inflationary pressures emerged later that year, the Federal Open Market Committee sought to raise short-term interest rates. The Treasury resisted, and the issue came to a head in the dramatic events of late January and early February of 1951, which set in motion the negotiations that produced the Accord.[2]

The central issue at stake was control of the Federal Reserve System's balance sheet. By committing to support government debt prices, the Federal Reserve in effect gave up control over the amount of government debt it held. When the Treasury sold new securities or the public became less willing to hold existing Treasury securities, the Fed was forced to purchase them on the open market to prevent yields from rising. Since Fed asset purchases required

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[1] The announcement read: "The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt" (*Federal Reserve Bulletin* 1951, p. 267).

[2] See articles by Hetzel and Leach in this issue or Stein (1969), Chapter 10.

increases in the Fed's monetary liabilities—either currency or reserve account balances—the Fed also effectively surrendered control over the monetary base. Without the understanding embodied in the Accord, the Fed would have been unable to pursue an independent monetary policy by varying the size of its balance sheet.

Nevertheless, since the Accord the Federal Reserve has relied on open market purchases and sales of U.S. Treasury securities to implement monetary policy. The supply of Treasury securities outstanding has always exceeded the amount necessary to satisfy the Federal Reserve's needs. In essence, the Fed has been able to limit itself to a policy of "Treasuries-only." Recently, however, the U.S. government has run budgetary surpluses that if continued will result in the supply of outstanding Treasury securities falling below the volume necessary to meet the Fed's needs.

In the lead article, "What Assets Should the Federal Reserve Buy?," J. Alfred Broaddus, Jr., and Marvin Goodfriend consider problems posed by the possibility of dwindling supplies of Treasury securities.[3] They argue that the Fed's asset acquisition practices should adhere to two closely related principles in order to preserve the Fed's independence and support monetary policy. First, asset acquisition should respect the integrity of fiscal policy. The Fed's balance sheet should not be used to circumvent constitutional safeguards on the fiscal policy process, for example, by channeling credit to favored constituencies. Second, asset acquisition should insulate the Fed from the politics of credit allocation. Exposing the Fed to pressure from groups seeking credit on favorable terms risks compromising sound monetary policy for the sake of resisting credit market distortions, or, conversely, yielding to interest group pressure in order to protect the integrity of monetary policy.

Broaddus and Goodfriend point out that the Treasuries-only policy conforms well to both principles. It prevents the Fed from holding private assets, from compromising the integrity of fiscal policy, and from becoming involved in credit allocation. The authors propose that the Treasury continue to issue sufficient debt for the Fed to buy, even as budgetary surpluses continue. Such a program would have no direct economic consequences since the interest cost of the incremental debt issued for the Fed to buy would be offset by the Federal Reserve's remittance to the Treasury of the interest earnings on that debt. The Treasury could invest the proceeds of the incremental debt issue in private assets and thereby benefit directly from the return on those assets. However, nothing would require the Treasury to acquire private assets; the proceeds could instead be used to reduce taxes or increase expenditures.

In effect, the proposal advanced by Broaddus and Goodfriend is the mirror image of the 1951 Accord. In 1951, the Treasury pledged not to *compel* the

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[3] Their article first appeared in the Federal Reserve Bank of Richmond *2000 Annual Report.*

Fed to purchase Treasury securities. Broaddus and Goodfriend propose that the Treasury pledge not to *deprive* the Fed of Treasury securities. In both cases, at issue is control over the Fed's balance sheet and the independence of monetary policy from fiscal policy. The 1951 Accord freed the Fed from the pressure to monetize government debt for fiscal purposes. The Broaddus and Goodfriend proposal would free the Fed from the pressure to allocate credit for fiscal purposes. Their new Accord would allow the regime initiated by the 1951 Accord to continue. It was under this regime that monetary policy "came of age," in the words of Goodfriend, and has now successfully maintained low inflation since the mid-1980s.[4] This experience suggests that we should be wary of drastic changes in our monetary institutions and that the Broaddus and Goodfriend proposal for retaining key features of the Accord regime deserves serious consideration.

The logic of Broaddus and Goodfriend's proposal was anticipated in Goodfriend's 1994 article "Why We Need an Accord for Federal Reserve Credit Policy: A Note," which discusses the distinction between credit policy and monetary policy and is reprinted as the second article in this issue.[5] *Monetary policy* refers to changes in the stock of central bank monetary liabilities, that is, currency and reserve account balances. *Credit policy* alters the composition of a central bank's assets, holding the stock of monetary liabilities fixed. Examples include liquidity assistance to particular institutions, sterilized foreign exchange operations, and transfers of Federal Reserve assets to the Treasury for the purpose of deficit reduction. Credit policy is a form of fiscal policy since it generally has distributional or public finance consequences.

The 1951 Accord freed the Federal Reserve to conduct monetary policy independently to stabilize the macroeconomy. Goodfriend's 1994 essay argues for a similar Accord to prevent fiscal misuse of central bank credit policies and to protect central bank independence. A fully independent central bank significantly enhances the effectiveness of macroeconomic stabilization policy. But stabilization policy requires independent central bank discretion only over the stock of monetary liabilities, that is, the size of the central bank's balance sheet. Credit policy is unnecessary for the conduct of monetary policy. It erodes the integrity of the fiscal policy appropriations process prescribed by the Constitution and jeopardizes the institutional independence on which monetary policy effectiveness relies.

Broaddus and Goodfriend's Treasuries-only proposal is a corollary of Goodfriend's 1994 proposed Credit Accord. Goodfriend did not anticipate that outstanding Treasury debt might fall low enough to necessitate Federal Reserve purchase of private assets. If the debt were to fall that low, the Fed would be forced to choose among private assets. This discretion is precisely

[4] See Goodfriend (1997).

[5] This article first appeared in the *Journal of Money, Credit, and Banking* in August 1994.

what Broaddus and Goodfriend are worried about. In an era of declining Treasury indebtedness, Goodfriend's proposed Credit Accord leads inevitably to the Broaddus-Goodfriend proposal.

The third article in our special issue, "The Treasury-Fed Accord: A New Narrative Account" by Robert L. Hetzel and Ralph F. Leach, presents a narrative account of the dramatic events that led to the 1951 Accord, including leaked memoranda, shrewd bond market maneuvers, and a disputed meeting with President Truman. This episode is as about as gripping and suspenseful as monetary policy gets. The reminiscences of Ralph Leach, a Board economist at the time, add previously unpublished details to the account. Leach was a witness to and at times a participant in the events as they unfolded; he attended many of the relevant FOMC meetings and worked closely with many of the principals. Leach later went on to a career on Wall Street.

The authors' account makes clear that the Fed was anxious to assert a degree of institutional independence that would allow it to resist inflationary pressures then emerging by raising short-term interest rates. The Fed's opponents favored lower interest rates. The exchange in late January 1951, at the height of the crisis, between Governor Marriner Eccles (at that time no longer Chairman, thanks to President Truman) and Representative Wright Patman (the populist Texan) is instructive.[6] After suggesting that the Fed has an obligation to protect the public against high interest rates, Patman asks, "Who is master, the Federal Reserve or the Treasury?" to which Eccles replies, "How do you reconcile the Treasury's position of saying they want the interest rate low, with the Federal Reserve standing ready to peg the market, and at the same time expect to stop inflation?" Later Eccles declares, "Either the Federal Reserve should be recognized as having some independent status, or it should be considered as simply an agency or a bureau of the Treasury." The tension between pressure for lower interest rates and the need to stem inflation would repeatedly strain the Fed's independence in the postwar era.

The fourth article in this issue, "After the Accord: Reminiscences on the Birth of the Modern Fed," also by Hetzel and Leach, recounts how key facets of our contemporary monetary policy regime emerged in the years immediately following the Accord. For example, the government bond market, which now plays such a pivotal role in the formulation of monetary policy, was much less developed at the time of the Accord. Some policymakers doubted a robust free market in government debt would emerge if the Fed withdrew from active support, and yet a deep and liquid market was indeed established. The pullback from the bond market after the Accord also led to internal reorganization of Fed policymaking. The Federal Open Market Committee was given a strengthened role, shifting influence from the Trading Desk in New York to the FOMC in

[6] See Hetzel and Leach, "The Treasury-Fed Accord: A New Narrative Account," p. 44.

Washington. And a further challenge to Fed independence would arise in the form of "Operation Twist." The authors' account, building on Leach's recollections, reminds us that it took several years after the watershed events of 1951 to restore the Fed's monetary policy independence.

In the final article, "Monetary Policy Frameworks and Indicators for the Federal Reserve in the 1920s," Thomas M. Humphrey critiques the practice of monetary policy in the period before the Fed came to rely on Treasuries-only.[7] Monetary policy during the 1920s was guided by the needs-of-trade, or real bills, doctrine, which held that money created by loans to finance real production rather than speculation has no influence on prices, and that fluctuations in money are caused by fluctuations in prices and output, not vice versa. As a result, Fed officials focused on indicators—nominal interest rates, member bank borrowings, and the commercial paper available for rediscounting—that at the start of the Great Depression signaled easy monetary conditions and no need for correction. In contrast, indicators based on the quantity theoretic analysis of Irving Fisher and others—the money stock, the price level, and real interest rates—were readily available at the time and correctly signaled that money and credit conditions were contractionary and would worsen the slump. Evidently, the tools were available that would have allowed the Fed to avoid the depression, or at least mitigate its severity.

A reexamination of monetary policy during the 1920s is relevant to the anniversary of the Accord because of the contrast it provides with the policy framework that ensued after the Accord. As Humphrey points out, monetary policy under the needs-of-trade doctrine had the potential to destabilize the price level and the money stock. With the 1951 Accord, the Fed began to put in place policies to provide for the stability of money and prices. Although it would take four decades to achieve price-level stability, without the significant shift in monetary policy practice represented by the Accord, this achievement would not have been possible. Humphrey vividly describes the preceding regime and documents that the tools to implement the post-Accord approach were available more than 20 years earlier, had policymakers been interested.

Humphrey's article also touches on the question of what assets the Federal Reserve should buy. Policymakers in the 1920s believed that the type of assets the Fed held—whether those assets represented lending for "productive" uses—was critical to the efficacy of monetary policy. In essence, the needs-of-trade doctrine mistook credit policy for monetary policy. Ironically then, the Fed's preoccupation with non-Treasury assets may have hindered the evolution of monetary policy in the early years.

The 1951 Treasury–Federal Reserve Accord was a key turning point in the century-long evolutionary process by which American monetary policy

[7] Forthcoming in the *Cato Journal,* vol. 21 (Fall 2001), and printed here with permission.

has come of age. We take many aspects of our current monetary regime for granted, but as our lead article emphasizes, we should not overlook the critical institutional foundations of the Fed's success. The next century could well bring new and unforeseen challenges to American monetary arrangements. By way of preparation, now is an apt time to pause in appreciation of the dramatic events of 1951.

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