

The Case for a Monetary Rule in a Constitutional Democracy

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Constitutional democracy protects individual liberty. It does so by placing restraints on the arbitrary exercise of power by government. A primary restraint is the constitutional protection of property rights. The monetary arrangements of a country either promote or undermine that protection.

Money is unique in that its value in exchange far exceeds the cost of producing an additional unit. On the one hand, governments have an incentive to print additional money to gain “free” resources, or seigniorage revenues.¹ On the other hand, the central bank must limit the quantity of money in circulation to control prices.

Through its influence on seigniorage, money creation affects how government raises revenue. It can also affect who within government decides how that revenue is spent. Through its influence on fluctuations in the price level, money creation influences the extent of arbitrary redistributions of wealth among individuals. The institutional arrangements that govern the creation of money then bear on two aspects of the protection of property rights: the taking and disposition of wealth from the public and the distribution of wealth by government between individuals.

■ The opinions expressed herein are the author's and do not necessarily represent those of the Federal Reserve Bank of Richmond or the Federal Reserve System.

¹ Under a commodity standard, the Mint had a monopoly over coinage. It charged a fee called seigniorage for turning bullion into coins. Today, seigniorage is the general term for the revenues a government gains from its monopoly over the creation of fiat money. The resources commanded by a paper dollar (or its electronic equivalent bank reserves) far exceed the resources needed to create that dollar. The central bank varies the amount of revenue it raises for the government through seigniorage by varying the rate of money creation and, consequently, the rate of inflation. Up to a point, higher inflation yields more revenue. When a central bank allows high rates of money growth and inflation, seigniorage is commonly referred to as an “inflation tax.” The holders of cash, who must add to their cash balances to restore the purchasing power eroded by inflation, pay this tax.

A legislative mandate from Congress requiring the Federal Reserve (the Fed) to stabilize the price level and to hold only government securities in its portfolio would complement the rules in a constitutional democracy that protect property rights.

A *Financial Times* (1990) editorial made the case for rules in the conduct of monetary policy:²

The notion that money must fall within the domain of day-to-day politics is a 20th century heresy. . . . Painful experience with the modern manipulation of monetary policy suggests that money is more appropriately an element of the constitutional framework of democracy than an object of the political struggle. Monetary stability is a necessary condition for a working market economy, which is itself a basis for a stable democracy.

1. OVERVIEW

Sections 2 and 3 provide historical background showing that monetary arrangements in Britain and the United States have in the past raised issues basic to the design of a constitutional democracy. Early British experience influenced American thinking during the Revolutionary War, in which protection of property rights was a central issue. Section 3 reviews how during the period of the Articles of Confederation the states' discretionary control of money undermined property rights. The monetary abuses of this period contributed to the convening of the Constitutional Convention.

Section 4 reviews the more recent experience with discretionary control of inflation in the 1970s and argues that this experience produced the same arbitrary redistributions of wealth that characterized the earlier period. The earlier experience led the Founding Fathers to remove government discretion over money creation by putting the United States on a specie (gold or silver) standard. The later experience caused the Fed in practice to assign priority to maintaining a low rate of inflation. However, in this more recent period, the United States has not put in place institutional arrangements to ensure monetary stability in the future. Section 5 reviews fiscal transfers by the Fed made possible through seigniorage and discusses how they can circumvent the constitutionally mandated budget process. Section 6 offers concluding comments.

2. PRINCIPLES OF CONSTITUTIONAL DEMOCRACY

The following historical review provides examples of how monetary arrangements either reinforce or relax constitutional constraints on the exercise of power by government. Discretionary control over inflation can undermine the

² For an economic argument in favor of rules, see Friedman (1960) and Lucas (1983). For a constitutional argument, see Friedman (1962).

accountability provided for in a constitutional democracy. The power of a government to increase the revenue from seigniorage through inflation without explicit legislation lessens democratic accountability. Moreover, the ability to allocate seigniorage revenues discretionarily, that is, outside the constitutionally mandated budget process, lessens accountability.

British Constitutional Democracy

The germ of constitutional democracy appeared in 1215 when British nobles forced King John to sign the Magna Carta. The Magna Carta established the principle that no one is above the law. Moreover, it articulated two principles that bear on monetary arrangements. First, government should be divided into separate parts capable of counterbalancing each other. Second, taxation “shall be levied in our kingdom only by the common counsel of our kingdom.” The practical working out of these principles required decisions about which part of government would control and allocate seigniorage.

The Glorious Revolution in 1688 gave Britain its present parliamentary form of constitutional democracy. The competition between Crown and Parliament for political power, which Parliament won, was driven in part by religion and in part by Parliament’s desire to gain secure property rights. The desire by Parliament to stop the arbitrary seizure of property by the Crown led to the particular characteristics of British constitutional democracy that inspired Americans in their Revolution. The exclusive right of Parliament to levy taxes was especially important.

In the past, some English kings had debased the coinage as a way of obtaining revenue. Despite protests by Parliament, Henry VIII had regularly lowered the precious metal content of coins. Debasement of the currency gave the Crown a source of income independent of Parliament. After the Glorious Revolution, Parliament took over the Mint to foreclose debasement as a source of revenue. When Parliament incorporated the Bank of England in 1694, it prohibited the Bank from lending to the Crown without Parliament’s consent.

American Revolution

John Locke was the philosopher of the Glorious Revolution. He understood the two major incentives to the arbitrary exercise of power: the seizure of political power and the seizure of property. Locke ([1690] 1986, p. 180) wrote that men “join in society with others . . . for the mutual preservation of their lives, liberties, and . . . property.”

Locke included popular consent to taxes as a natural right. That principle, expressed in the phrase “No Taxation without Representation,” became the rallying cry of the American Revolution. The Declaration of Rights in the Virginia state constitution, written by George Mason and adopted in 1776, states that “men . . . cannot be taxed or deprived of their property for publick uses, without their own consent, or that of their representatives so elected” (Commager 1962,

p. 104). In the Declaration of Independence, Thomas Jefferson listed as one of the “repeated injuries and usurpations” of King George his assent to “imposing Taxes on us without our Consent.”

The arbitrary seizure of property by the British Crown became a major factor precipitating the American Revolution. James Otis denounced writs of assistance, which gave the Crown’s agents broad authority to search houses and confiscate smuggled goods not restricted by “probable ground” or particular “houses specially named” (Commager 1963, pp. 46–47). The Constitution provided for the protection of property rights in the Fourth Amendment, which guaranteed the right of “people to be secure in their persons, houses, papers, and effects against unreasonable searches and seizures,” and in the Fifth Amendment, which provided that no person shall “be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.” As explained below, the writers of the Constitution viewed monetary arrangements as part of the constitutional protection of property rights.

3. THE CONSTITUTIONAL PROTECTION OF PROPERTY RIGHTS

Abuse of Money Creation under the Articles of Confederation

In the period of the Confederation following the Revolutionary War, actual or threatened civil disorder in several states, especially Massachusetts, prompted calls for a convention to create an effective central government. The political difficulty of imposing the excise taxes necessary to pay debts inherited from the Revolutionary War caused many states to yield to pressure to repay debts through the issue of paper money. Rhode Island effected a general transfer of wealth from creditors to debtors through the inflationary issue of paper money combined with legal tender laws forcing creditors to accept paper money rather than specie. In a number of states, legislators used inflation in combination with price controls to transfer income from creditors, merchants, and large planters to farmers, debtors, and artisans. On August 7, 1786, James Madison (Rutland 1975, p. 89) wrote:

. . . the States are running mad after paper money, which among other evils disables them from all contributions of specie for paying public debts, particularly the foreign one. In Rhode Island a large sum has been struck and made a tender, and a severe penalty imposed on any attempt to discriminate between it and coin. The consequence is that provisions are withheld from the Market, the Shops shut up—a general distress and tumultuous meetings.

In a letter to Jefferson, Madison complained about the “warfare & retaliation” that arose among states due to laws allowing citizens of one state to pay out-of-state debts in depreciated paper money (Rutland 1975, pp. 94–95). In

Federalist essay 10 (Beloff 1987, p. 47), Madison expressed his famous idea that in a large republic “a greater variety of parties [would militate] against the event of any one party being able to outnumber and oppress the rest.” One reason was that in a large republic “a rage for paper money, for an abolition of debts, for an equal division of property, or for any other improper or wicked project, will be less apt to pervade the whole body of the union, than a particular member of it” (Beloff 1987, p. 47).

The 1786 disturbance in Massachusetts called Shay’s Rebellion acted as a catalyst for the convening of a Constitutional Convention. Armed farmers closed courts to prevent foreclosures on properties for tax delinquency and threatened to march on Boston to force passage of easy money legislation. Such threats prompted the Constitutional Convention to protect property rights by prohibiting states from issuing paper money, from making legal tender laws, and from impairing the obligation of contracts. In *Federalist* essay 44 (Beloff 1987, p. 227), Madison defended the Constitution’s prohibition of the issuance of paper money (then called bills of credit) by the states:

The extension of the prohibition to bills of credit must give pleasure to every citizen in proportion to his love of justice and his knowledge of the true springs of public prosperity. The loss which America has sustained since the peace from the pestilent effects of paper money on the necessary confidence between man and man; on the necessary confidence in the public councils; on the industry and morals of the people, and on the character of republican government, constitutes an enormous debt against the states.

Jefferson believed that the Constitution denied to Congress the “power of making paper money or anything else a legal tender” (Lipscomb 1903, p. 65). He wrote that paper money “is liable to be abused, has been, is, and forever will be abused, in every country in which it is permitted” (Ford 1898, p. 416). The historian Jack Rakove (1996, p. 44) argues that Madison formulated his views on constitutional government in response to the arbitrary redistributions of wealth caused by the paper money inflations and legal tender laws of the states in the Articles of Confederation period.

Limiting the Power of Government to Seize Property Arbitrarily

The Founding Fathers carefully balanced the need for government to raise revenue with the need to protect private property from arbitrary seizure. They did so by entrusting fiscal policy to Congress, which by design encourages open debate.³ That debate allows for the monitoring that gives substance to

³ Congress is composed of a large number of members. There are two houses of Congress, each with its own subcommittees, committees, and rules committee. In order to become law, a bill must pass through all these individual centers of power. Along the way, a bill can be killed by a filibuster. A bill must also go through a conference committee to reconcile differences between each house of Congress and then survive a possible presidential veto. This convoluted structure not only disperses power, but also enhances public discussion. The debate and controversy

the principle that sovereignty resides with the people. Tax legislation must originate in the House, whose members are elected every two years. No funds can be spent by the other branches of government without explicit authorization by Congress. Article I, Section 9, of the Constitution states, “No money shall be drawn from the Treasury, but in consequence of appropriations made by law; and a regular statement and account of the receipts and expenditures of all public money shall be published from time to time.” Article I, Section 8, enforces congressional control of fiscal policy by allowing only Congress “to borrow money on the credit of the United States.” To enforce the separation of powers, however, a different branch of government, the Executive Branch, spends the revenues raised by Congress.

In Article I, Section 8, of the Constitution, the Founding Fathers assigned to Congress the responsibility “to coin money, regulate the value thereof.” By assigning to Congress the responsibility to determine the metallic content of coins, they prevented the President from following the example of European kings and debasing the currency. Article I, Section 10, prohibited state governments from printing paper money. Taken together with Article I, Section 8, the Founding Fathers put the country on a specie standard. In this way, the authors of the Constitution sought to limit the ability of government to abrogate contracts by taking actions affecting the price level.

Monetary arrangements were part of the initial constitutional framework. By removing money creation and the determination of the price level from the political process, the Founders limited the ability of government to purposefully redistribute wealth through inflation and inflation combined with price controls. Those same restrictions also protected property rights by preventing recourse by the government to the unlegislated tax of inflation.

However, the specie standard ultimately did not survive as part of the constitutional framework. At times, the specie standard allowed for inflation or deflation and was itself a source of instability. A mandate from Congress to the Fed to stabilize the price level would possess the advantage of the specie standard of eliminating discretionary control over the price level. It would complement other protections afforded property rights. At the same time, such a mandate would avoid the instabilities of the specie standard.

The argument for a rule requiring the Fed to stabilize the price level is not one of original constitutional intent. And it is not a legal argument about the constitutionality of discretionary as opposed to rule-based monetary arrangements. The Constitution does not require government to stabilize the price level. Money is not a capital “C” constitutional issue involving a legal interpretation of the Constitution.

generated by the multistep procedure of requiring repeated majorities among groups with widely differing self-interests generates news and thus supplies the information citizens need to monitor government. It also reduces the possibility of precipitate action.

However, the Constitution does provide broadly for the protection of property rights. A mandate from Congress to the Fed requiring price-level stabilization would buttress that broad constitutional protection. Such a rule is desirable for the same reason that rules in general are desirable in a constitutional democracy: to constrain the arbitrary exercise of power by government. In this sense, the sense used here, money is a small “c” constitutional issue referring to a form of government where rules limit government power. (See the Appendix for a brief history of money and the Constitution.)

4. THE MODERN EXPERIMENT

Although monetary arrangements have disappeared as part of the constitutional order, Congress remains constitutionally responsible for the value of the dollar. While it has delegated that responsibility to the Fed, it has done so without clear instructions on the desirable behavior of the price level.

The Inflation of the 1970s

In the 1960s and 1970s, the combination of pressures to make the economy grow rapidly and a belief that inflation arose from factors unrelated to money growth caused the Fed to pursue an inflationary monetary policy. Inflation generated an unlegislated transfer of resources to the government through an increase in seigniorage. More important than seigniorage, inflation generated government revenue through its interaction with a tax code not indexed for inflation. The arbitrary redistributions of wealth due to the inflation of this period recall the earlier experience of the Articles of Confederation period.

Prior to indexing of the personal income tax brackets and exemptions in 1985, inflation combined with progressive tax rates to push individuals into higher tax brackets. With inflation, capital gains taxes still fall not only on the real gains from selling an asset, but also on the paper gains that compensate for inflation. In addition, inflation raises corporate tax rates by lowering the real value of historical depreciation costs and by raising the measured, but not real, profits on holdings of inventories. Inflation also erodes the value of the estate tax exemption. (See Feldstein [1996] and the Appendix in Hetzel [1990].) The interaction of inflation and a tax code specified in current dollar terms created enormous uncertainty and distortions in the 1970s. Corporations favored short-term over long-term investment. Investors shifted capital out of the corporate sector and into real estate in response to the effective rise in corporate tax rates.

Inflation allowed a shadow fiscal system where the combination of inflation and price controls transferred income to politically influential groups. Such transfers were not subject to the safeguards provided by the public discussion that accompanies explicit legislation to impose a tax. The housing industry successfully lobbied for the use of Regulation Q to limit the interest rates

that depository institutions could pay on savings and small-denomination time deposits. As a result, when inflation rose above Regulation Q ceilings, savers of modest means received negative returns. Wealthy investors were unaffected as they could invest directly in money market assets whose yields incorporated an inflation premium. By not allowing the usury ceilings on the interest rates paid on loans to rise with inflation, state governments discriminated against savers. Rent controls, especially in New York and California, appropriated the wealth of apartment owners. Price controls on domestically produced oil, instituted as part of the Nixon price controls in early 1974 but kept until the early 1980s, rewarded small, politically influential refiners.

Inflation and Scapegoating

When discussing the costs of inflation, economists concentrate on economic costs, such as the increased number of trips individuals make to the bank to economize on the holding of cash balances. The actual experience with the inflation of the 1960s and 1970s, however, demonstrated that the problems created by inflation can extend beyond the purely economic.

Inflation threatened the dispersion of power characteristic of the U.S. political system. It did so by creating a demand for immediate action to deal with a problem that could only be solved through a long period of perseverance and patience. Moreover, inflation created an incentive for the political system to identify scapegoats and to deal peremptorily with them in ways that eroded institutional safeguards to individual liberty. The resulting divisiveness came on top of other divisive forces in American society arising from the Vietnam War and the Civil Rights Movement.

Maintenance of the effective dispersion of power called for in the Constitution requires avoidance of the politics of scapegoating. The reason is that the politics of scapegoating creates a demand for a strong leader who will loosen institutional constraints so as to be able to deal decisively with the offending minority. People tend to rationalize impersonal, threatening forces seemingly beyond their control by blaming them on the actions of identifiable minority groups. The rise of inflation in the late 1960s appeared as such a force. Inflation added to the forces in the early 1970s that caused the middle class to feel besieged by hostile forces beyond its control. The resulting appeal of the politics of wage and price controls encouraged a majority to blame a minority for inflation.

The origin of inflation lay in the high rate of growth money created by the Fed. The political system, however, desirous of using monetary policy to promote rapid growth, found it advantageous to exploit the public's presumption that private parties create inflation through the exploitation of monopoly power. That presumption led to a demand for wage and price controls. The controls, imposed on August 15, 1971, carried the message that to control inflation

government had to prevent organized groups from selfishly demanding unreasonable shares of national income. The controls allowed government to make scapegoats of organized labor, large corporations, and sectors of the economy with politically sensitive prices such as food processors.

The combination of inflation with a fixed exchange rate created an overvalued dollar, trade deficits, and a demand for protectionism. The political system then took advantage of worker resentment over imports and fears of job losses to scapegoat foreigners. In the early 1970s, criticism of Japan became a staple of the American political scene. To provide political balance for wage controls, which were unpopular with leaders of organized labor, the Nixon Administration imposed a surcharge on imports. Although popular with labor, the unilateral adoption by America of an openly protectionist trade measure threatened to precipitate a trade war and reversed the long-standing American support for a multilateral system of world trade.⁴

The price controls of the 1970s were an extreme manifestation of the social costs of inflation. However, any time there is inflation, there is a political

⁴ The complexity of economic activity made inevitable the exercise of discretion in applying the wage and price controls. That discretion allowed the arbitrary exercise of power by government bureaucracy over individuals. During the initial freeze following the announcement of controls, even individuals selling personal items in yard sales had to document the sale price of similar items to avoid transgressing the law.

Because of the difficulty of policing a large complex economy and because of the need to maintain political support, controls required widespread popular support. Popular support required the appearance of fairness. For this reason, the controls entailed all kinds of destructive intervention in the economy unrelated to the behavior of the price level. For example, unions demanded controls on interest and dividends. The general public demanded limitation on profit margins. The government used the threat of IRS audits of profit margins to influence the price setting behavior of corporations. The ideal in a constitutional democracy of limited government power enforced through due process disappeared in the populist clamor to deal with powerful corporations and unions.

Political pressures existed to make the controls permanent. The controls did not become permanent in part because of the hostility of the Ford Administration and in part because they did not work to prevent inflation. Without of course intending to, the Fed discredited them by pursuing an inflationary monetary policy. If it had not, however, the public could have seen the controls as working and they might have become a permanent feature of government control of large corporations. Price controls on oil, which lasted through 1981, almost became permanent. Those controls created an energy "shortage" and prevented America from producing the oil that would have broken the OPEC price cartel. The resulting artificially high price of oil exercised an important influence on international politics. American price controls meant that the Soviet Union, one of the largest world producers of oil, and the oil-producing countries in the Middle East gained the resources necessary to exercise significant power on the world scene.

Price controls criminalize socially useful activity. Inevitably, more and more individuals find themselves breaking the law and staying out of the criminal system only through the forbearance of a price control bureaucracy. The government can prosecute a large fraction of the population at will or in response to political pressures to deal with an unpopular group. Controls erode the general acceptance of law that allows a free society to function with a minimum of state coercion. The average citizen is law abiding because he assumes most other citizens are also law abiding. However, controls create the opposite presumption, that is, everyone else is breaking the law.

incentive to impose attenuated forms of controls through government price fixing. That incentive arises from pressures on the political system to find ways to redistribute wealth that do not require explicitly voted taxes. Although the effects of inflation interacting with price controls in individual markets are of a different magnitude from general controls, the corrosive effects are the same. Individual vice (circumventing the laws that fix prices) becomes public virtue. And respect for the rule of law erodes. (See Friedman in U.S. Congress, 6/21/73, p. 136.)

Bringing Monetary Arrangements into a Constitutional Framework

The contribution of inflation to the polarization of society and politics in the 1970s argues for bringing monetary policy into the constitutional framework in a way that limits the ability of the central bank to inflate. Congress has not established guidance for what constitutes desirable behavior of the price level. Although the *Federal Reserve Act* instructs the Fed to pursue “stable prices,” it also instructs the Fed to pursue “maximum employment” (*Federal Reserve Act*, Section 2A). In practice, the absence of any instruction on how to combine the pursuit of both these objectives has meant the lack of a meaningful mandate for the behavior of the price level. The rise in the price level by a factor greater than six between 1950 and 1995 amply demonstrates the ineffectiveness of the formal mandate.

A congressional mandate to the Fed for price stability would provide an institutional safeguard against a recurrence of the divisive experience with inflation in the 1960s and the 1970s. The more clearly stated the mandate, the more understandable it would be to the public. Also, public opinion rallies more easily behind a simple mandate. The clarity of a mandate to stabilize the price level as opposed to the vagueness of a mandate to target a “low” rate of inflation means that the former would be more likely than the latter to become a permanent part of U.S. institutional arrangements.

5. SEIGNIORAGE AND THE CONSTITUTIONALLY MANDATED BUDGET PROCESS

Seigniorage as a Nonlegislated Tax

Money creation possesses implications not only for inflation, but also for the level of taxation by transferring resources to the government.⁵ Moreover, money

⁵ For example, in 1974 (quarterly average CPI) inflation was 12.1 percent. Hetzel (1990, p. 53) estimates that federal government revenue was 17 percent higher than it would have been with price stability. Much of the increased government revenue derived from the lack of indexing of the tax code for inflation. The personal income part of the tax code was indexed for inflation in 1985. By reducing the incentive of government to inflate, that indexing constituted an important institutional arrangement protecting against future inflation.

creation allows government to obtain resources without imposing an explicit tax. Milton Friedman (1978, p. 27) wrote:

Since time immemorial, the major source of inflation has been the sovereign's attempt to acquire resources to wage war, to construct monuments, or for other purposes. Inflation has been irresistibly attractive to sovereigns because it is a hidden tax that at first appears painless or even pleasant, and, above all, because it is a tax that can be imposed without specific legislation. It is truly taxation without representation.

The seigniorage from money creation has implications for the U.S. constitutional system of limited government because of its potential for removing fiscal policy from the recorded budget voted on by Congress. The way the central bank handles seigniorage raises fundamental constitutional issues about openness and the separation of powers in government.

As part of the separation of powers, the Constitution assigns to Congress the power to tax and appropriate funds. As an institutional safeguard to keep fiscal policy in the hands of Congress, the Founding Fathers assigned control over the specie content of currency, and thus seigniorage, to Congress. Institutional arrangements legislated in the *Federal Reserve Act* also attempt to assure that the government will not use money creation to evade the constitutional requirement that Congress vote explicitly on taxes and appropriations.

These latter arrangements possess two aspects. One is to prevent the political system from making use of money creation as an unlegislated tax. The *Federal Reserve Act* (Section 14: Open Market Operations, (b)(1)) authorizes Fed banks "to buy and sell in the open market . . . any obligation . . . of the United States." The phrase "in the open market" implies that the monetization that occurs when the Fed purchases debt should be undertaken solely to advance monetary policy objectives rather than to alleviate the fiscal problems of the Treasury. Specifically, the Fed should not buy Treasury debt directly from the Treasury. It should not use the power of the printing press on request to turn government debt into money. This aspect of independence concerns the *size* of the Fed's asset portfolio, the quantity of money, and ultimately the price level.

The second aspect of institutional arrangements designed to assure the conduct of fiscal policy through the public acts of Congress concerns the Fed policy of transferring to the Treasury the income from the securities it holds (after meeting its operating expenses and paying the statutory dividend to member banks). In this way, the revenue from money creation appears as government revenue. Consequently, that revenue can only be spent as part of the regular appropriations process. Seigniorage revenue must be spent in ways that are voted on by Congress and that appear on budget. As explained below, this aspect of independence concerns the *composition* of the Fed's asset portfolio. (See also Goodfriend [1994].)

The Federal Reserve's Fiscal Powers

The Fed creates money by purchasing securities from the public. The seigniorage value to the government is measured by the reduction in the stock of securities held by the (nonFed) public or, equivalently, the increase in the stock of securities in the Fed's portfolio. For bookkeeping purposes, the value of this seigniorage is measured by the flow of interest payments paid on the securities in the Fed's portfolio. These bookkeeping arrangements are the heart of the institutional arrangements that support Fed independence. The Fed achieves budgetary autonomy from the political system by allocating to itself the amount of interest it needs to meet its expenses. The remainder counts as tax receipts of the government.

As part of the bookkeeping arrangements that buttress its independence, government accounts treat the Fed as a member of the public. In order to measure accurately the fiscal policy actions of the government, however, the balance sheets of both the Treasury and the Fed should be consolidated. The reason is that the Fed turns over to the Treasury the interest it receives on the government securities it holds (above its costs). As far as the government is concerned, interest paid on securities held by the Fed is essentially a wash. For the purposes of fiscal policy, the key implication is that it makes no difference whether the Treasury or the Fed sells a security. Either way, there is an increase in the debt on which the federal government must pay interest financed by some future increase in taxes or reduction in expenditure. In short, the Fed, like the Treasury, can take fiscal policy actions. Consider the following examples.

Examples of Federal Reserve Fiscal Policy

The Fed could make discount window loans to an insolvent bank. For example, in 1984 Fed loans to Continental Illinois Bank amounted to somewhat more than \$7 billion, 85 percent of the bank's uninsured deposits. In conjunction with such lending, the Fed sells government securities from its portfolio to keep money and the price level unchanged. That is, it engages in a pure fiscal policy action with no consequences for monetary policy. Government debt in the hands of the (nonFed) public rises. Control over the composition of its asset portfolio gives the Fed the ability to engage in fiscal policy; in this case, it is in the form of credit allocation.⁶ (See Goodfriend and King [1988] and Schwartz [1992].)

Consider next the direct monetization of Treasury assets that occurs when the Fed acquires assets from the Treasury's Exchange Stabilization Fund (ESF).

⁶ The credit allocation arises because of the nonmarket allocation of funds. In this example, the Fed also transfers the liability for the insolvency from the uninsured depositors to the FDIC. Because the premiums that banks pay to the FDIC go into general federal government revenues and because the disbursements of the FDIC are government expenditures, the Fed transfers the liability to the taxpayer.

These assets take the form either of SDRs or foreign exchange.⁷ When the Fed acquires assets from the ESF, it credits the Treasury's deposit account at the New York Fed. When the Treasury draws down its newly acquired deposits, the revenues of the banking system increase. The Fed then sells U.S. government securities out of its portfolio to offset that increase. The net result is to substitute either an SDR or an asset denominated in foreign exchange for a U.S. government security in the Fed's portfolio.⁸ Government securities held by the (nonFed) public rise, and the Fed finances the activities of the ESF—foreign exchange intervention and lending to foreign countries.

As a final example, consider a swap between the Fed and a foreign central bank. For example, in a swap with the central bank of Mexico, the Fed accepts peso deposits in exchange for dollar deposits. The Fed invests the pesos in a peso-denominated security. When Mexico spends the dollars it receives, bank reserves in the United States increase. The Fed then sells a U.S. government security out of its portfolio to offset that increase. The net result is to substitute a peso-denominated security for a U.S. government security in the Fed's portfolio. Government securities held by the (nonFed) public rise. And the Fed lends funds to Mexico.⁹

⁷ The International Monetary Fund periodically allocates to member countries special drawing rights (SDRs), which the ESF carries as assets.

⁸ In 1988 and 1989, the U.S. Treasury and the Fed engaged in coordinated sterilized foreign exchange intervention with other central banks to counter strength in the dollar. In December 1987, the mark/dollar exchange rate was 1.6. In May 1988, the yen/dollar exchange rate was 125. By September 1989, the value of the dollar had risen so that 1.95 marks exchanged for one dollar and the 145 yen for one dollar. In 1989, the administration became concerned about the appreciation of the dollar given a large U.S. current account deficit. As a consequence, the administration and the Fed began sterilized purchases of marks and yen.

The Fed and the ESF divided their purchases of yen and marks. When the ESF ran out of dollars to sell, it obtained additional dollars from the Fed both through warehousing and through monetizing the SDRs it held. In 1989, the Fed's foreign-exchange-related transactions added about \$23 billion to reserves. That was more than the additions to currency that year, and the Fed sold on net about \$10 billion in government securities.

The SDRs on the books of the Fed increased from \$5.0 billion at the end of 1988 to \$8.5 billion at the end of 1989. In 1989, Fed warehousing of foreign currencies for the Treasury rose from zero to \$7 billion. Fed monetization of the SDRs held by the ESF increases the ESF's assets permanently as the ESF uses the dollars it acquires to acquire interest-bearing assets. (See Schwartz [1997], especially Table 1.)

Figures on SDRs are from the Fed's balance sheet reported in the *Federal Reserve Bulletin*. Figures on Fed warehousing are from quarterly reports, "Treasury and Federal Reserve Foreign Exchange Operations," in the Federal Reserve Bank of New York *Quarterly Review*.

Broaddus and Goodfriend (1995) criticize such interventions for sending contradictory signals about the stance of monetary policy. In this case, the dollar was strengthening because the FOMC had raised its funds rate peg to almost 10 percent in May 1989 to contain a rise in inflation. By selling dollars to weaken the foreign exchange value of the dollar, the FOMC was sending an opposite message about the desired stance of monetary policy from what it was sending domestically by raising the funds rate. Kaminsky and Lewis (1996) make the same point.

⁹ For example, in September 1989, Mexico drew on its swap line with the Fed for \$784.1 million dollars. At the same time, it drew on an ESF swap line for \$384.1 million. Figures on

The Fed established swap lines with foreign central banks in 1962 to defend the fixed exchange rate system without raising interest rates (Hetzl 1996). The collapse of the fixed rate system in spring 1973 eliminated the original rationale for swaps. The Fed, however, put them to another use. For instance, in 1973, the administration asked the Fed to help Italy deal with the increase in its balance of payments deficit in the aftermath of the large rise in oil prices. "The Federal Reserve . . . came to the aid of Italy, whose chronic political instability prevented rapid response to the energy crisis. The central bank expanded its swap line with the Bank of Italy from \$2 billion to \$3 billion to help that country finance imports in the short run" (Wells 1994, p. 125).

The use of swaps to provide short-term assistance to foreign countries prompted a debate within the Federal Open Market Committee. In response to a question from a governor about whether the Fed might provide long-term assistance to Italy, Chairman Burns (Board of Governors 1974, p. 783) responded:

If the Federal Reserve were to abandon the principle that the swap lines were available only to meet short-term needs, there would be a natural tendency for other agencies of Government to look to the System, rather than to Congress, for the resources to deal with a broad variety of international financial and political problems. If the System were to provide those resources it would, in effect, be substituting its own authority for that of the Congress. A decisive case could then be made in support of the charge that the System was using Federal moneys without regard to the intent of the Congress.

Limiting the Federal Reserve's Ability to take Fiscal Actions

Congress has delegated to the Fed the right to exercise the public monopoly on the creation of money. Through creation of money, the Fed acquires a portfolio of government securities. Although this portfolio arises out of the conduct of monetary policy, it allows the Fed to undertake fiscal policy actions independent of Congress, as illustrated above.

Fiscal policy actions taken by the Fed are not subject to the open public debate generated by congressional actions. Therefore, they limit the government accountability that is encouraged by the free flow of information. The Fed should avoid fiscal policy actions not integrally related to its monetary responsibilities. A restriction that permitted the Fed to hold only government securities and to acquire them only in the open market would achieve this result.

swap line drawings are from quarterly reports, "Treasury and Federal Reserve Foreign Exchange Operations," in the Federal Reserve Bank of New York *Quarterly Review*.

The Fed does not lose interest on the assets in its portfolio as it receives interest on the peso-denominated assets. The basic point is that the Fed can engage in the loan transaction with Mexico because of its control over seigniorage. That is, the ability to create and extinguish fiat money allows it to purchase peso-denominated assets.

Fed independence would then complement the constitutional provision: “No money shall be drawn from the Treasury, but in consequence of appropriations made by law.”

On the most general level, the issue is preservation of the constitutional safeguards that give content to popular sovereignty. Those safeguards facilitate the monitoring of government by the public. Because inflation imposes an unlegislated tax, discretionary control of inflation reduces the monitoring ability of the public. Also, the use of seigniorage revenues by the central bank for purposes other than financing its own operation reduces the public’s ability to monitor government activities by limiting public discussion. If the use of the central bank’s seigniorage revenues is directed by the Executive Branch, it erodes the separation of powers provided for in the Constitution.

6. CONCLUDING COMMENTS

Balancing Independence and Accountability

Central bank independence can help to prevent monetary policy from becoming subservient to fiscal policy. Preventing that subservience is an important part of facilitating the monitoring of government by the public. A central bank ultimately controls only money creation. A legislative mandate for price stability would limit political pressure to use money creation to achieve goals that may be socially desirable but beyond the reach of a central bank. Although money creation does not create real resources, it can impose a tax. A price rule would help keep government finance honest.

An independent central bank also needs to be accountable. The Fed chairman does testify regularly before congressional committees. However, there is a tension between the accountability provided by congressional oversight and Fed independence. The budgetary benefits of a strong economy have, in the past, encouraged some congressmen to pressure the Fed for low interest rates and, in effect, inflationary money growth. A mandate requiring the Fed to stabilize the price level would minimize this pressure, enhance independence, and provide a clear standard with which Congress could assess the Fed’s performance.¹⁰

In a democracy, the legitimacy of central bank independence must rest on a public belief that the central bank is accountable. That belief derives from open debate encouraged by a transparency of the objectives of monetary policy. Independence combined with discretion impairs accountability and encourages political pressures that threaten the Fed’s independence. Independence combined within a rule mandating price stability would balance independence and accountability.

¹⁰ A mandate to stabilize the price level is not a complete rule unless accompanied by an explicit strategy. If Congress were to impose such a mandate, it would probably allow the Fed to select the strategy but require it to make that strategy explicit.

Rule of Law, Not Men

The Constitution originally provided for a commodity monetary standard. In doing so, it restricted the power of government significantly: the government could not manipulate the price level. In the twentieth century, the disappearance of the international gold standard that began with World War I led to a fiat money standard. The long, painful process of learning how to manage a fiat currency, where government sets the price level, has influenced significantly the history of the twentieth century (Friedman and Schwartz 1963; Goodfriend 1997).

At present, monetary arrangements are working well. However, monetary policy depends too much on the good luck of having wise policymakers. Widespread public support for a clear rule to guide the conduct of monetary policy would provide for a continuation of the current period of monetary stability. The major disasters of monetary policy in the twentieth century—the depression of the 1930s and the inflation of the 1970s—derived largely from a lack of public understanding that the central bank is responsible for the price level. A mandate clearly assigning responsibility for the price level to the Fed and requiring the Fed to stabilize the price level would prevent future major mistakes in monetary policy.

A rule that required the Fed to stabilize the price level and that eliminated its discretion over the use of seigniorage by requiring it to hold only government securities in its portfolio would complement the constitutional framework that constrains the exercise of government power. Such a rule would protect the public from the arbitrary redistributions of wealth that accompany unanticipated inflation and the interaction of sustained inflation with price controls. It would also prevent the political system from imposing an unlegislated tax in the form of inflation and assure that seigniorage is spent only as part of the congressional appropriations process.

The balance between rules and discretion in the exercise of power by government is the central issue in a constitutional democracy. That issue is also central to the design of a country's monetary institutions. Monetary institutions should be based on rules that are thought of as part of the broad constitutional framework. To protect property rights and the ability of citizens to monitor government, those rules should constrain the use of seigniorage and the recourse to an inflation tax.

APPENDIX : A BRIEF HISTORY OF MONEY AND THE CONSTITUTION

At the Constitutional Convention, members frequently cited the issuance of paper money by the states as a major abuse of power by government and a source of civil discord. For example, Governor Morris (Farrand 1911, Vol. 2, p. 299) talked about “the history of paper emissions . . . with all the distressing effects (of such measures) before their eyes.” Madison (Farrand 1911, Vol. 1, p. 317) stated:

He considered the emissions of paper money . . . as also aggressions. The States relatively to one another being each of them either Debtor or Creditor; The Creditor States must suffer unjustly from every emission by the debtor States. We have seen retaliating acts on this subject which threatened danger not to the harmony only, but the tranquillity of the Union.

In making the case for the checks and balances of a federal form of government, James Madison and others pointed to the overissue of paper money as an example of abuse of unrestrained government power. Madison (Farrand 1911, Vol. 1, pp. 134–36; Vol. 2, pp. 76–77) argued that the principal reasons for a national government were to provide

. . . for the security of private rights, and the steady dispensation of justice. Interferences with these were evils which had more perhaps than anything else produced this convention. . . . All civilized Societies would be divided into different Sects, Factions, & interests, as they happen to consist of rich & poor, debtors and creditors. . . . In all cases where a majority are united by a common interest or passion, the rights of the minority are in danger. . . . We have seen the mere distinction of colour made in the most enlightened period of time, a ground of the most oppressive dominion ever exercised by man over man. . . . The only remedy is to enlarge the sphere, & thereby divide the community into so great a number of interests & parties that in the 1st place a majority will not be likely at the same moment to have a common interest separate from that of the whole or of the minority; and in the 2d. place, that in case they shd. have such an interest, they may not be apt to unite in the pursuit of it.

Emissions of paper money, largesses to the people—a remission of debts and similar measures, will at sometimes be popular, and will be pushed for that reason. . . . it is necessary to introduce such a balance of powers and interests, as will guarantee the provisions on paper. Instead therefore of contenting ourselves with laying down the Theory in the Constitution that each department ought to be separate & distinct, it was proposed to add a defensive power to each which should maintain the Theory in practice.

Alexander Hamilton (Farrand 1911, Vol. 1, p. 288) argued:

In every community where industry is encouraged, there will be a division of it into the few & the many. Hence separate interests will arise. There will be

debtors & Creditors &c. Give all power to the many, they will oppress the few. Give all power to the few they will oppress the many. Both therefore ought to have power, that each may defend itself agst. the other. To the want of this check we owe our paper money.

Under the Articles of Confederation, Congress had the power to “emit bills of credit,” that is, issue paper money. Governor Morris moved to omit that power from the powers assigned to Congress by the Constitution. Several delegates objected:

Col Mason had doubts on the subject. . . . Though he had a mortal hatred to paper money, yet as he could not foresee all emergencies, he was unwilling to tie the hands of the Legislature. He observed that the late war could not have been carried on had such a prohibition existed.

Mr. Randolph, notwithstanding his antipathy to paper money, could not agree to strike out the words, as he could not foresee all the occasions that might arise.

In opposition,

Mr. Elseworth thought this a favorable moment to shut and bar the door against paper money. The mischiefs of the various experiments which had been made were now fresh in the public mind and had excited the disgust of all the respectable part of America. By withholding the power from the new Governt. more friends of influence would be gained to it than by almost any thing else—Paper money can in no case be necessary—Give the Government credit, and other resources will offer—The power may do harm, never good.

Mr. Wilson. It will have a most salutary influence on the credit of the U. States to remove the possibility of paper money. This expedient can never succeed whilst its mischiefs are remembered. And as long as it can be resorted to, it will be a bar to other resources.

Mr. Butler . . . was urgent for disarming the Government of such a power. . . . Mr. Read thought the words, if not struck out, would be as alarming as the mark of the Beast in Revelations.

(Farrand 1911, Vol. 2, pp. 309–11.)

On the vote to omit “and emit bills of credit” from the Constitution, that is, to give Congress the power to issue paper money, nine of the delegates voted in favor and two voted against. In a later letter to Timothy Pickering, Robert Morris, who had been a delegate, wrote, “Propositions to countenance the issue of paper money, and the consequent violation of contracts, must have met with all the opposition I could make. . . . to the best of my recollection, this was the only part which passed without cavil” (Farrand 1911, Vol. 3, p. 419).

In 1862, Congress first authorized the issuance of paper money as legal tender (Greenbacks) as an expedient means of financing the Civil War. Timberlake (1993, p. 143) wrote:

Up until the time of the Civil War, almost no one had seriously considered interpreting the money clauses in the Constitution in any light except that of prohibiting state and federal issues of currency on the basis of discretionary authority. “To coin money” meant to provide the technical facilities for minting coins. “Regulate the value thereof” meant only to specify a weight of fine gold or silver as equal to a number of the units of account, which were dollars.

Eventually, however, the Supreme Court decided in favor of the constitutionality of Greenbacks and the issuance by the federal government of paper money. At the time, these legal tender decisions were highly politicized (Timberlake 1993, pp. 133–45). President Grant appointed to the Supreme Court individuals who favored the constitutionality of Greenbacks as legal tender. Ultimately, the government issuance of paper money as legal tender was made inevitable by the change in the prevailing interpretation of the Constitution. The government’s power to issue paper money became inevitable with the demise of the view that Congress possesses no power not expressly granted to it by the Constitution and the emergence of the view that Congress possesses all powers not explicitly denied to it.

In the final legal tender case, *Julliard v. Greenman* of 1884, the Supreme Court decided that Congress had the power to issue paper money and make it legal tender in peacetime as well as wartime (Timberlake 1993, p. 137). The issuance of paper money then ceased to be a Constitutional issue (capital C) in the sense of an issue decided by the Supreme Court. It remains, however, a constitutional issue (small c) because of the role of seigniorage as a tax and the insecurity of property rights engendered by inflation.

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