After the Accord: Reminiscences on the Birth of the Modern Fed

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The 1951 Treasury–Federal Reserve Accord marked the birth of the modern Fed. However, that fact became apparent only in retrospect. The language of the announcement that accompanied the Accord left unresolved the issues that had created the discord between the Treasury and Fed in the first place. It 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.[1]

This statement left unsaid how the Fed and the Treasury would reconcile these conflicting goals.

William McChesney Martin, who became FOMC Chairman at the time of the Accord, created the idea of a modern central bank. Specifically, he made macroeconomic stabilization the rationale for central bank independence. Martin put this ideal into practice in three ways. First, as summarized in his phrase "leaning against the wind," he developed the practice of moving

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[1] *Federal Reserve Bulletin,* vol. 37 (March 1951), p. 267.

short-term interest rates in a way intended to mitigate cyclical fluctuations and maintain price stability. Second, he helped to create a viable free market in government securities whose stability did not require Fed intervention. Third, he reinvigorated the original structure of the Federal Reserve System by moving monetary policy decisionmaking out of an Executive Committee and into the Federal Open Market Committee where all the Board governors and regional Bank presidents could participate fully.

1. CREATING THE MODERN FED

Before the Accord, the New York Fed had run the market for government securities with an iron fist. A government securities dealer who wanted to change the price of a government bond by even a minuscule fractional amount would call Robert G. Rouse (head of the Fed's New York Trading Desk) for permission, and Rouse would probably say no. With the exception of a few academics at places like the University of Chicago, people could not imagine the Treasury placing the huge amount of debt created during the war without the assistance of the Fed. Board economists and policymakers, however, realized that the only way to avoid continued pressure by the Treasury on the Fed would be to make completely clear that the Fed would not intervene to control bond prices.[2]

Under the leadership of Chairman Martin, the Fed worked hard to develop an independent government securities market. During the summer of 1951, Fed staff including Leach held a series of meetings at the Federal Reserve Board with each of the government securities dealers. All 12 regional Fed Bank presidents plus members of the Board of Governors were invited to these sessions. The main purpose of the sessions was to ascertain the dealers' ability to support a free market in government securities. With some of the larger firms, Fed staff also explored the possibility of organizing the dealers into a self-governing association that would set minimum capital standards and assure low trading spreads.

During 1951, Leach made a number of visits to the New York Trading Desk and listened to dealers' questions and traders' replies. In discussions with the traders he tried to explain that continued market intervention by the Fed prevented the development of a strong market. He felt that each intervention by the Fed simply caused buyers and sellers to pull away from the market and wait for the Fed's next move.

As long as the Fed's New York Trading Desk was pegging the price of government securities, there was no need for the market to develop the capacity to smooth price fluctuations. Dealers did not take speculative positions.

[2] In addition to Winfield Riefler, the Board staff economists who advocated a free market in government securities included the long-time Fed economists Woodlief Thomas and Ralph Young and the younger economist Richard Youngdahl.

People extrapolated from that situation and concluded that, without regular Fed intervention, the government securities market would exhibit destabilizing price swings. In contrast, the Board staff believed that the market, if left alone, would work.[3]

On a trip to the New York Desk in early 1953, Leach was vigorously pushing his free market ideas with two of the traders. Suddenly, they broke into broad smiles while looking over his head. Leach turned around and found that Allan Sproul, President of the New York Fed, had joined the group. Leach was happily surprised when Sproul invited him to lunch. By this time Leach felt that he and Sproul were quite good friends and hoped that Sproul, one of the most admired financial leaders in the world, felt the same.

Sproul opened the luncheon conversation by reminding Leach that since its founding the Federal Reserve System had always had its focal point in New York, the financial capital of the United States and now of the world. He went on to predict that Leach would be leaving his present job soon and would end up with a major bank dealer in New York. "When that happens," he asked Leach, "would you still want New York to occupy that position?" He indicated that the next phase of the discussions at FOMC meetings might change that status.

As evidenced by Sproul's comments, fundamental economic and institutional issues lay behind the debate over how best to encourage a competitive market for government securities. The economic issue was whether the implementation of monetary policy required continuous monitoring of the money market and oversight over the entire term structure of interest rates. If so, then the institutional issue should be decided in favor of the New York Fed; that is, the Open Market Desk should report to the president of the New York Fed, who could continuously monitor its activities. New York would then retain its historic role as the center of gravity of the Federal Reserve System.

The Board view was that the money market did not require continuous monitoring. Market forces should determine bond yields and the term structure. The Open Market Desk could confine its operations to Treasury bills and need only report at regular intervals to the full FOMC in Washington. The center of gravity of the Federal Reserve System could reside in Washington with the full FOMC.

These views pitted President Sproul against Chairman Martin. Martin advocated the policy that the markets would call "bills only." By buying and selling only Treasury bills, the Fed would exert its influence only over the short-term end of the government securities market. The full FOMC could

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[3] Leach had graduated with an A.B. degree from the University of Chicago in 1938. At that time, Chicago had two of the great economists of the twentieth century, Frank Knight and Jacob Viner. Even at the height of the recession, they and other Chicago economists had retained a belief in free markets. Leach had absorbed that belief and made use of it while at the Board to convince the governors and others of the viability of a free market in government securities.

then oversee this limited intervention from Washington. Furthermore, the manager of the Fed's New York Trading Desk could report directly to the FOMC rather than to the president and directors of the New York Fed. As Leach's conversation with Sproul made clear, resolution of this operational issue would decide the broad issues of the character of the Federal Reserve System.

The operational issue came to a head over the seemingly technical instructions the FOMC issued to the New York Trading Desk in the directive to guide its purchases and sales of government securities. After the Accord, the directive had included a reference to "maintaining orderly conditions in the Government securities market." The FOMC had regularly authorized a very high level of funds for possible Desk intervention. One of the first post-Accord moves by the FOMC was to reduce the level of funds authorized for use by the New York Desk. Although this action limited the extent of Desk interventions, the Desk retained more latitude for market tinkering than the free market group at the Board felt was desirable. New York argued that even a tiny price drop could quickly develop into a disorderly market and continued to intervene on that theory. After ten years of quick intervention in response to very small price changes, the Desk could not discard the habit.

The Board staff argued for a market in government securities characterized by "depth, breadth, and resilience."[4] Buttressed by the staff, the FOMC made a truly basic change. In the March 4 –5, 1953, directive, the FOMC dropped the phrase "maintaining orderly conditions" and substituted "correcting a disorderly situation." Furthermore, the FOMC instructed the Desk to confine its operations "to the short end of the market." The FOMC stated, "It is not now the policy of the Committee to support any pattern of prices and yields in the government securities market." This step, the Board staff thought, should finally settle the debate over whether the New York Fed should intervene to influence the entire term structure of interest rates.

Just before the June 11, 1953, FOMC meeting, President Sproul caucused with the regional Bank presidents at the Federal Reserve Bank of Richmond. With their support, at the June 11 meeting, Sproul succeeded in rescinding the actions of the March 4 –5 FOMC meeting. His position was that if necessary the Desk should transact in "the long-term market" so as to put reserves "in where the pressures were greatest" (1953 *Annual Report,* p. 96). However, at the September 24, 1953, FOMC meeting, the Committee returned to the restriction that the Desk confine its operations to Treasury bills.[5]

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[4] Leach asked Winfield Riefler how he came up with those terms. He told Leach that he had trouble remembering names, so he used the initials of his son, Donald B. Riefler [as a mnemonic device].

[5] Martin prevailed in the September 24 meeting with the help of two governors who had not attended the June meeting (M. S. Szymczak and James K. Vardaman). Also, three regional Bank

Sproul was a redoubtable opponent. He decried the attempt to write a "constitution" that would not leave the FOMC "free to use its judgment" (1953 *Annual Report,* p. 100). According to Sproul, the exercise of monetary policy required that the Fed influence the psychology of the financial markets. The policymaker should exercise that judgment in an ongoing way in response to changing developments. Sproul's (1980, p. 10) view that an understanding of monetary policy derives from an understanding of the psychology of financial markets appears in a letter that he wrote to Robert Roosa:[6]

> [Bryan] has a strong tendency toward cosmic thinking and metaphysical roundabouts. Beneath all of the wordy embroidery he is really distrustful of the money market and people who operate it.... This is a legacy, perhaps, of a fundamentalist religious slant as bent and twisted by the University of Chicago, but it is also a consequence of his having had no experience in a money market.

Confining Desk operations to short-term government securities put the free market forces at a semantic disadvantage. While no public announcement was made of the new limitation until the release of the directive the following year in the Board's *Annual Report,* knowledge of it gradually leaked into market discussions. The market adopted the phrase "bills only" to describe the policy. Possibly with a little help from the New York Trading Desk, the market seized on the opportunity afforded by a then current advertisement for a deodorant. The letters "B.O." became a byword of market commentators. Nevertheless, the restriction remained.

On June 22, 1955, the FOMC abolished the Executive Committee. Henceforth, the FOMC met every three weeks and assumed full responsibility for monetary policy and its implementation by the Desk. Before 1955, the manager of the Desk reported to the president of the New York Fed and its Board of Directors. Upon the urging of FOMC Chairman William McChesney Martin, at its meeting of March 2, 1955, the FOMC initiated a study that ultimately led to making the manager responsible to the full FOMC. It is instructive to review the language Martin used:

> I have consistently endeavored to emphasize the word "System" in our activities. To me, that is the heart and core of what we are trying to build. If we do not work as a System, then we defeat the main purpose of our structure, which is really unique in terms of political science. (FOMC Minutes, 3/2/55, p. 131)

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presidents changed their vote to support Martin (J. A. Erickson from Boston, W. D. Fulton from Cleveland, and Delos C. Johns from St. Louis).

[6] The letter comments on the views of Malcolm Bryan, President of the Atlanta Fed, who argued that the FOMC should control bank reserves rather than money market conditions. Bryan corresponded with Milton Friedman at the University of Chicago. See Hafer (1999).

2. THE WORLD'S MOST LIQUID MARKET

Sproul lost all the major battles over System governance to Martin, and he resigned in 1956. Sproul retired and moved to California but came to New York regularly and always included a lunch with old friends at Morgan. In 1953, Leach joined Guaranty Trust Company in New York, which merged with J. P. Morgan in 1959. At a luncheon in early 1961, Sproul took Leach aside and said, "I just want you to know 'B.O.' is dead. I'll tell you about it after lunch."

After lunch Sproul came back to Leach's office and explained the death of bills only. The new President, John F. Kennedy, had never met Chairman Martin, so he invited him for lunch with the top Treasury appointees, Secretary Douglas Dillon and Under Secretary Robert Roosa. Roosa had formerly been Senior Vice President of the New York Fed and was very close to Sproul. During the lunch, Roosa urged the abandonment of bills only.

Roosa wanted to replace it with a policy that would later be called "operation twist." In 1961, the country had two conflicting economic objectives. One objective was to recover from recession. It required lower interest rates to stimulate economic activity. The other objective was to stem gold outflows that were occurring under the Bretton Woods system of pegged exchange rates.[7] It required higher interest rates to attract inflows of foreign capital.

Roosa wanted to raise short-term interest rates and lower long-term interest rates by increasing short-term debt and reducing long-term debt in the hands of the public. The Fed would have to abandon bills only and purchase government bonds for its portfolio. Roosa believed that the result would be higher short-term interest rates, which would attract foreign funds, and lower long-term interest rates, which would stimulate domestic investment and economic activity.

Martin agreed to drop the restriction that the Fed conduct open market operations only in short-term government securities. However, he added that there would be no change in the Fed's basic policy. The New York Desk would limit its intervention to correcting a disorderly market and would refrain from guiding it in any way. He explained that the Fed depended on a free market as an indicator of the combined judgments of investors worldwide. As it worked out, Martin retained the essential ingredient of Fed independence in that the Fed retained the ability to raise short-term interest rates as necessary.

The effort by the Fed to promote a competitive market in government securities was remarkably successful. In the fifties, the dealers in government securities followed the course of action the Board staff had hoped for in its

[7] At the end of World War II, the United States held a large fraction of the world's gold reserves. It willingly allowed gold to flow out. However, in 1958 the outflows had reduced gold stocks to the point where the United States became concerned that its stocks could become depleted.

1951 discussions. They made a market with guaranteed, minimal spreads between bids and offers. Once assured of no interference by the Fed, the market strengthened quickly. Within a very short time, the Treasury invited the dealer community to advise on its financing.

For forty-odd years, the market for U.S. Treasuries has been the strongest financial market in world history. For anyone who doubts the competitive strength of the market, Leach offers the following anecdote. In the early 1960s, the Treasury offered a $1 billion issue of long-term bonds on a competitive basis. Two syndicates formed, with Morgan Guaranty Trust heading one of them. Ordinarily, the second number after the decimal point determined the winning bid. Leach's recollection is that Morgan's competitor won the bid based on the fifth digit. A difference of $100 decided a $1 billion offering!

Chairman Martin and the Federal Reserve established the dollar as the preeminent measure of value in world markets. In the postwar period, the dollar replaced gold and the pound sterling as the standard measure of value worldwide. At its March 4–5, 1953, meeting, the FOMC had stated its desire to create a market that would "reflect natural forces of supply and demand and thus furnish a signal of the effectiveness of credit policy." Over time, the behavior of the government bond market would become an essential ingredient in the monetary policy process. Sharp increases in bond yields often revealed the market's concern that inflation could rise.

3. CONCLUDING COMMENT

The Treasury-Fed Accord of March 1951 marked the birth of the modern Fed. The Fed then had to grow as an institution. It grew under the guidance of Board of Governors Chairman William McChesney Martin and capable staff economists. The characteristics one associates with the present Federal Reserve System appeared at this time. They include full participation in FOMC meetings of governors and regional Bank presidents. They also include the pursuit of macroeconomic stabilization and price level stability as the rationale for central Bank independence.

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