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THE CHOICE OF WALL STREET

The Federal Reserve System was the crucial anomaly at the very core of representative democracy, an uncomfortable contradiction with the civic mythology of self-government. Yet the American system accepted the inconsistency. The community of elected politicians acquiesced to its power. The private economy responded to its direction. Private capital depended on it for protection. The governors of the Federal Reserve decided the largest questions of the political economy, including who shall prosper and who shall fail, yet their role remained opaque and mysterious. The Federal Reserve was shielded from scrutiny partly by its own official secrecy, but also by the curious ignorance of the American public.

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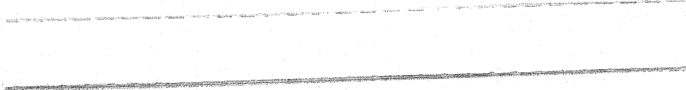
In the enduring folk wisdom, for instance, the entrepreneur who invented a new product was more virtuous than a banker; so were the workers and managers hired for his factory. They manufactured real goods that people could buy and use. But what did a banker make -- other than pieces of paper and occasional misery? The resentment of



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finance will still satisfying to many Americans, but of course utterly irrelevant to the daily reality of the American system. In modern capitalism, finance and production were inseparable. Business could not function without credit and neither could consumers. Except perhaps on the smallest scale -- a craftsman alone in his shop -- economic enterprise did not occur without bankers and borrowing.

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But the Fed could influence the financial flows inside the plumbing through two tiny values -- mere pinpricks in size compared to all the wealth in circulation. <u>One value was the Discount window at each of the twelve Federal Reserve Banks, where commercial banks routinely borrowed hundreds of millions, even billions, every day to make up the temporary shortages in their required reserves. The other, more important valve was the Open Market Desk at the New York Federal Reserve Bank in the middle of Wall Street, where the Fed bought and sold government securities in the open market, in daily transactions usually running from $500 million up to several billion. In both cases, the Fed created money with a key stroke of the computer terminal (computer</u>

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accounting having replaced "the stroke of the pen"). When the Federal Reserve bought Treasury bonds from a dealer or lent through the Discount window to a bank, the central bank simply credited the amount to the bank account of the dealer who sold the bonds or to the bank receiving the loan. In either case, it did not matter which bank or which dealer got the new money. Once it was created, it increased the overall money supply and was free to float from one account to another through the entire banking system. In reserve, when the Fed's Open Market Desk sold bonds or a commercial bank repaid its Discount loan, money was extinguished by the Fed. By a simple entry in the ledger, the money was automatically withdrawn from circulation in the private economy.

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In other words, the few lent to the many. The ladder of wealth looked like this: at the top were the 10 percent of American families that owned 86 percent of the net financial worth. Next came the 35 percent of families that shared among them the remaining 14 percent of financial assets. Below them were the majority, the 55

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percent of American families that, on balance, had accumulated nothing.

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Families in the top 2 percent owned 30 percent of all liquid assets, everything from checking and savings accounts to money-market funds and bank CDs. They also owned 50 percent of the corporate stocks held by individuals, 39 percent of corporate and government bonds, 71 percent of tax-exempt municipals and 20 percent of all the real estate.

The top 10 percent owned 51 percent of short-term financial paper, 72 percent of corporate stocks, 70 percent of bonds, 86 percent of tax-exempt municipals and 50 percent of all the real property.

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IN THE TEMPLE

"It is a truism that public confidence is important to banks," and editorial in the The Wall Street Journal observed. "That's why early Hebrews did their banking in temples and the later Americans and Europeans built banks that looked like temple." Officials of the Federal Reserve were themselves the ultimate rationalists -- economists who analyzed numbers, constructed scientific theories to explain economic behavior and tested the theories against reality -- yet they too unconsciously invoked the sacred aura of their institution. Federal Reserve governors spoke enthusiastically about "the mystique of central banking," without being able to explain it very succinctly. A former officer of the Federal Reserve Board, describing the confidential fraternity that economists entered into when they joined the Fed staff, called it "taking the veil," the expression that describes nuns entering a convent. A chairman of the House Banking Committee sometimes referred derisively to the Fed's senior economists as "the monks."

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IN THE TEMPLE

To economists, money was only what could be used immediately to buy things -- that is, the cash in one's pocket, coins and bills, or the demand deposit in a checking account at the bank. When economists talked about the "money supply," or the principal monetary aggregate known as M-1, they meant only the money that could be spent right away -- the gross sum of all the currency and demand deposits held by every consumer and business in the country.

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Unlike bank checking accounts, a savings account paid him interest on his money. But it was no longer so easy for him to spend it immediately. He would most likely have to withdraw funds from his savings account, deposit the money in his checking account at the bank, then write a check at the store. Thus, the money moved more slowly into economic transactions -- less liquid in the hydraulics of the economy. Economists, therefore, counted it in a second category, a broader monetary aggregate known as M-2. M-2 included all of the small savings accounts and time deposits at banks, credit

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unions or S & L's plus whatever people had invested in money-market mutual funds. With M-1 added in, M-2 totaled about $1.5 trillion.

Following the same distinctions, M-3 was a still larger category of money -- larger and less liquid than the other two. It added such large-denomination financial instruments as $100,000 certificates of deposit that only corporations, financial institutions or wealthy investors could afford to hold, usually for a specified time period like three months or six months. They could withdraw their money eventually, but it was not readily available for spending. The broader M-3 aggregate -- which included M-1 and M-2 -- totaled about $1.7 trillion. (A final measure of money, known as L, for total liquidity, attempted to count all the financial assets that could be sold and converted into spending money -- Treasury bills, commercial paper, U. S. savings bonds and a few others -- though perhaps at a penalty if market prices were down. L totaled a little more than $2.1 trillion.

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IN THE TEMPLE

In addition, the U. S. financial system also functioned in a "51st state," as one analyst called it -- the Eurodollar market. A huge pool of expatriate dollars, at first built up over the postwar decades by the trading and investment of U. S. multinational corporations, existed offshore for lending and borrowing. U. S. banks alone had assets of more than $400 billion in overseas offices -- essentially unregulated. Technically, it was not part of the domestic money supply, but every day the major banks, corporations and investors shifted back and forth between the two, seeking the highest rate of return or the cheapest loan. The dollar in Peoria, therefore, reacted eventually to the dollar in Zurich and vice versa.

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Banks, large and small, were the most secure business enterprises in America, sheltered by the government from failure like no other sector of the economy. Year after year, no more than a handful of the nation's fourteen thousand banks failed, usually six or eight a year and sometimes none. In 1979, ten banks would be

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forced to close, all of them quite small and marginal. This compared to 1,165 mining and manufacturing companies that failed, 980 wholesale goods suppliers, 3,183 retail stores, 1,378 construction companies. Banking was safe and profitable, nearly fail-proof.

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Together, Connally and Volcker engineered the most fundamental change in the world's monetary system since World War II -- the dismantling of the Bretton Woods agreement that had made the U. S. dollar the stable bench mark for all currencies. The changes that began in 1971 meant the final abandonment of gold as a U. S. guarantee behind its money and the introduction of floating exchange rates among the world's major currencies. Some critics still condemned Volcker bitterly for his role in those reforms, but he himself had originally argued for preserving the system of fixed exchange rates. In the course of those controversies, Volcker traveled the globe, confronting and bargaining with finance ministers and central bankers of every

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industrial nation. In the policy battles of Washington, his opponents included the Federal Reserve Board chairman, Arthur Burns. Volcker and Connally won.

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A PACK WITH THE DEVIL

Whatever the numbers showed, it seemed obvious to the Fed that it had to do something more. Governor Coldwell compared the Fed's role in the financial system to a traffic cop at a busy intersection.

"Every once in a while," Coldwell said, "the Fed flicks on the yellow light and people react to a yellow light -- they speed up and get through the intersection. Then the Fed has to flick on the red light, and when it hits red, people come to a screeching stop -- after a few of them try to run the light."

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A PACK WITH THE DEVIL

As a libertarian conservative, Friedman objected fundamentally to nearly any form of government intrusion in the natural functionings of the private marketplace. But he had a more pointed quarrel with the Keynesian perspective that then dominated political thinking. Fiscal policy, the budget choices that Keynesians thoughts so important, produced only ephemeral results, Friedman insisted. The fundamental source of government influence over the private economy was its control of money -- the monetary policy made by the Federal Reserve. The Fed's manipulation of the money supply, Friedman added, was consistently destabilizing and damaging.

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His solution was radical. Congress should strip the Fed of its privileged independence and enact legislative instructions for U. S. monetary policy. The Fed must be compelled to accept a simple rule governing its functions: from week to week, month to month, year to year, without deviation, the money supply should be expanded at a fixed rate, somewhere around 3 percent a year for the basic aggregate, M-1.

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Thus, money growth would be held to the historic average growth rate for the national economy and would avoid the sharp swings. Private business, financial markets and consumers could then count on a stable future, instead of lurching back and forth from inflation to recession. A monetary rule, Friedman explained, would not eliminate the natural highs and lows of the business cycle, but it would moderate them -- and guarantee that government intrusion did not make things worse.

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Friedman had an explanation:

> The Federal Reserve System is a political institution, and like every political institution, it is seeking to retain its own power, its own decisions, its own prestige. To what end do politicians want to maintain their positions? To what end does a CEO of a business concern want to run that concern for profit? Because the coin he is interested in is both income and power. In the same way,

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> people who are in the Fed want to maintain their position. Their coin is influence and power.

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The Consumer Price Index was calculated as 100 with 1967 prices. By 1970, the price index was at 116. By 1975, it was 161. Four years later, it was 217. During the Civil War, prices doubled in only a few years, but Lincoln was fighting a war. This time, the price level nearly tripled in less than twenty years. And the nation was at peace.

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Most of the politicians who served in the White House, as well as in Congress, could make a similar confession. As Tony Solomon observed:

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> No president really understands these things, but the disturbing thing about Carter was that he tried to use the economic jargon as though he did. He tried to make it seem that he understood the technical arguments when he clearly didn't. A President like Lyndon Johnson never pretended to understand all these things -- he was only interested in the bottom line. He would ask: What were the political effects? What would happen to interest rates? What did he have to do in order to deal with it? Carter would enter into technical discussions which he only partially understood.

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BEHAVIOR MODIFICATION

When Peter Sternlight surveyed the market turmoil and rising rates, he first thought he would do a modest repurchase agreement, $1 or $2 billion, to give some reassurance to the frightened traders. Repo's, as they were called, were a standard Fed

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BEHAVIOR MODIFICATION

technique, selling or buying securities with an agreement to reverse the transaction three or four days later -- in other words, a temporary withdrawal or injection of reserves that could be erased or continued depending on conditions later. The desk didn't want to put in too much assurance, he figured, because the Fed wanted to show the markets it was serious. After consulting with Stephen Axilrod, the staff director in Washington, he decided to do nothing -- let the market find its own way.

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The model defined by behavioral psychology had a simple premise: a series of predictable rewards and punishments could be used as incentives to induce a subject to alter its behavior. A laboratory rat that went the wrong way in a maze would receive an electric shock. If the rat discovered the correct path, the route the psychologist wanted it to take, it would be rewarded with a food pellet. In time, the rate learned how to get to the food without getting shocked. The same principle was applied to human behavior. A truant child received promised rewards, candy or extra allowance,

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if he went to school. Rewards were replaced with penalties when he cut classes. Thus, behavior modification commanded not by rigid edict but by external pressures. A child (or a rat) was free to ignore the signals and continue the miscreant behavior -- and pay a price for the wrong choice.

The Federal Reserve's monetary policy was meant to influence the real economy in approximately the same manner -- rewarding or punishing borrowers in order to change their behavior. When the Fed pushed up interest rates, this was a negative incentive, intended to dissuade both consumers and businesses from taking on new loans. If they did not borrow, then they would not buy things. Cumulatively their decisions not to borrow money and spend it would slow down the entire economy. The shrinking pool of willing buyers changed the incentives for producers too, inducing them to cut prices or to manufacture fewer of their products or both. They closed shop and laid off workers, just as frightened home builders like William Kline did after October 6. Smaller payrolls meant fewer citizens with money to spend, and the demand for goods and services contracted further.

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BEHAVIOR MODIFICATION

Aside from the unfairness, the effectiveness of the existing system was also flawed: when the Federal Reserve attempted to restrain, its primary leverage was directed at the wrong end of the spectrum of borrowers -- not at those most responsible for generating new credit. The pressure of higher interest rates was felt first and most potently by the weakest buyers and producers, but it was the strongest and largest enterprises that were the primary source of expanding credit. In order to budge them, the Federal Reserve had to keep raising the threshold of pain for others -- squeezing the mice harder and harder, in effect, in the hope that eventually the elephants would respond. The strong, meanwhile, and their bankers managed to continue business as usual.

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The Euromarket pool was as large as $800 billion, according to an estimate by the Morgan bank. The funds were not subject to reserve requirements imposed by central banks or any other government regulation, and therefore, the Eurodollar pool was

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an attractive place for international banks, both foreign and American, and the global corporations to park their money. The "offshore" label, in fact, was largely a bookkeeping fiction. Eurodollar transactions were executed in New York City or Chicago as easily as in London (the fiction was largely discarded in 1981 when America's multinational banks were permitted to operate unregulated "international banking facilities" in the U.S. -- a foreign branch, in other words, that was located right at the home office).

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A leakage of $50 billion could effectively add nearly 15 percent to the size of M-1, the basic aggregate of spending money that was used as the principal measure of the U. S. money supply. The Federal Reserve, in comparison, was attempting to hold M-1 to a growth rate of less than 5 percent. The Fed's technicians tried to reckon with the inflow of Eurodollars and compensate for it. "If we ignore it," Wallich said, "the rate of growth of the total dollar supply, combining the U. S. and the Euromarket, would be rising faster than we think."

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THE LIBERAL APOLOGY

The ultimate result was the Monetary Control Act of 1980, enacted just as the Fed was driving interest rates to historic peaks. The legislation required all depository institutions, member banks and nonmember banks alike, savings and loan associations, even credit unions, to maintain reserves with the Fed. The imposition of universal reserve requirements was presented to Congress as an arcane question of monetary management, the sort of issue few members of Congress cared much about or understood. In reality, the Fed membership issue was a political question, only marginally relevant to economics. Passage of the Monetary Control Act had very little to do with how effectively the Federal Reserve could control the supply of money. Its purpose was to protect the Federal Reserve's political base.

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The most important enticement offered to the Fed's member banks was a substantial reduction in their reserves. The Federal Reserve agreed that if it won universal coverage for all banks, then the existing level of reserve requirements could be

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THE LIBERAL APOLOGY

lowered for everyone. In the end, after much bargaining, the reserves that banks had to hold on demand deposits, the checking accounts that were the core of their funds, were reduced from 16.25 to 12 percent. The Fed's reserve holdings actually shrank from $27 to $16 billion. In other words, the Fed member banks would enjoy a huge dividend in freed-up funds on which they could now earn interest income -- while their competitors, the nonmember banks, would be subjected, for the first time, to the "tax" implicit in Fed reserves. (Bankers on the Federal Advisory Council argued for an even greater bonus -- a reserve level of only 8 percent.)

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Congress went along with the Fed's proposal, though many legislators probably did not grasp the true meaning of what they were enacting. In the midst of tight money and record-high interest rates, Congress effectively granted a huge windfall to the fifty-six hundred commercial banks that were members of the Federal Reserve System -- especially the largest ones. This point was never mentioned in the congressional