Secrets of the Temple: How the Federal Reserve Runs the Country

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PART ONE:
SECRETS OF THE TEMPLE

Chapter 1: The Choice of Wall Street

In the summer of 1979, President Carter found himself stuck in the mud. His popularity was dwindling by the day, and many in the nation viewed his administration as a model of inconsistency and confusion. The next presidential election was not far off, and a recent Gallup poll had shown that Democrats preferred Ted Kennedy to Carter by a more than two-to-one margin (66 to 30 percent).

Carter and his inner circle decided it was time to turn his fortunes around. For 10 days, he secluded himself at Camp David, and invited leaders from all spheres of American life to tell him where he went wrong, and what he should do about it. On Sunday, July 15, Carter famously delivered what would soon be termed his "malaise speech" (Carter in fact never used the word). Carter told the nation that they were suffering from a sort of spiritual crisis, that America was losing its sense of unity and moral purpose. He criticized the nation as materialist, saying "too many of us now tend to worship self-indulgence and consumption. Human identity is no longer defined by what one does, but by what one owns."

Despite derisive coverage by the press, the speech resonated with the American people. Carter's popularity increased by 10 percent virtually overnight. But Carter wasn't finished yet. Determined to make a bold statement, on the Tuesday after his speech Carter asked for the resignations of his entire Cabinet. Carter would review each of them, and make the changes he found necessary. Over the following few days, the heads began to roll. The Secretary of the Treasury, W. Michael Blumenthal, would be replaced. So would the Secretary of Health, Education, and Welfare, the Energy Secretary, the Transportation Secretary, and the Attorney General.

Immediately, the actions Carter took to shore up public confidence began to backfire in that other center of American power—Wall Street. After his speech and the announcement of wholesale changes to his administration, the markets turned downward. Short-term interest rates spiked. What worried Wall Street were not abstract concepts like America's moral center or sense of purpose, what worried Wall Street was inflation. Throughout the Carter presidency and before, inflation raged at unusually high levels—11% around the time of Carter's speech. High core inflation, only compounded by surging oil prices in the wake of the 1979 Iranian Revolution, meant that every dollar an American earned today would only buy 89 cents worth of goods in a year. As a result, Americans were borrowing money to buy goods today that they would pay off tomorrow.

The change that worried Wall Street the most, covered little by the press, was the resignation of the chairman of the Federal Reserve, G. William Miller. Miller was to replace Blumenthal as Treasury Secretary, but who would replace

Miller? Markets began to get jittery fearing that the vice chairman, little known Florida banker Frederick H. Schultz, might take over. Schultz was viewed by many as a political crony, rewarded by Carter with the vice chairmanship for raising campaign funds. Carter soon realized he had to calm the markets by choosing a Fed chairman that Wall Street could trust to tamp down inflation.

Vice President Walter Mondale's chief of staff, Richard Moe, was given the task of vetting potential candidates. Moe sought the advice of many—leaders in business, government officials, lawyers, labor leaders, and academic economists. One name popped up over and over: Paul Volcker. Volcker was the President of the New York Fed and an economist who had worked in government and the private sector. In fact, his very first job was as a junior employee at the New York Fed. What Moe heard from everyone was that Volcker was eminently qualified, but what he heard from some disturbed him. Volcker was described as rigidly conservative, independent, not a team player. Moe urged Carter to look at other options. Carter did so, but when the president of Bank of America Tom Clausen turned down the offer, Carter made his decision. After Volcker's nomination was announced, the stock and bond markets shot up, as did the value of the dollar after a months long slide. Wall Street had their man.

Chapter 2: In the Temple

Since its conception, the Federal Reserve Bank of the United States has been cloaked in mystery, and subject to conspiracy theories. It was alleged that the Fed was run by a select set of individuals—Zionists, Illuminati, Satanists—who decided the fate of the nation and, indeed, the entire world through their control of money. Though many such outlandish accusations came from the fringes of society, even the average person had little understanding of how the Fed worked, or what it did.

Who owned the Fed? In fact, the Fed occupied a unique position in the American system, positioned in-between public and private management. At the top of the Fed's hierarchy were its seven governors, appointed by the President and confirmed by the Senate for 14-year terms. These governors shared power with the presidents of the twelve Reserve Banks, spread out all across the nation from New York to San Francisco. These twelve presidents were elected by the board of directors in their respective districts. The boards were made up of nine directors, six of whom were elected by member banks of the Federal Reserve System—private commercial banks. These private banks held stock shares in the Federal Reserve Banks.

Monetary policy was decided by the Federal Open Market Committee, or FOMC. In FOMC meetings, the governors had seven votes and the Reserve Banks presidents had five, which rotated among the twelve presidents, with the notable exception of the president of the New York Fed, who always had a vote. That private interests played a role in the decision making process and owned stock in the Reserve banks led many to accuse the Fed of representing a private

club of bankers. In fact, these stock shares were practically meaningless, and the greater weight of power on the FOMC committee was held by appointed officials.

These stock shares did however once give rise to an illuminating incident, in 1939. Representative Wright Patman, a populist from Texas, announced in a House hearing that the newly constructed Federal Reserve building was owned not by the US government, but by the twelve Reserve banks, who were in turn owned by private commercial banks. Thus, said Patman, the Federal Reserve building was not owned by the federal government and not tax exempt. This remark gave rise to several years of legal wrangling, after the D.C. tax authorities presented a bill that the Federal Reserve refused to pay, insisting it was a government entity. In the end, after an auction of the building had been set and postponed several times, the twelve Reserve Banks issued quitclaim deeds, asserting that the Federal Reserve building was indeed owned by the Federal Government.

What did the Fed do? To the average American, this was a more complicated question still. The Fed controlled the money supply. It set interests rates. This was all that was understood by the average American, but these assertions were too simplistic. For instance, what is money? The Federal Reserve did not use the word as the average American did. The Federal Reserve in fact had multiple definitions of money. M-1, their most basic measure of money, included all the hard cash Americans held in their wallets and their checking accounts. M-2 included M-1, plus what money that was stored in less liquid forms, such as savings accounts and money market mutual funds. M-3 included all that was in M-2 and even less liquid instruments like certificates of deposit held by banks or corporations. Finally, the measure of total liquidity, or L, included all financial assets that could potentially be converted to cash, such as treasuries, commercial paper, savings bonds, and more. The money of the American people would slosh around the economy over and over, each dollar being earned and spent many times in a year, and often moving between the M-1, M-2, and M-3 aggregates.

Not only did the Fed define what money was, it created money, seemingly out of thin air. In fact, the creation money was done not only by the Fed but by every commercial bank in the normal course of business, and was as simple as making an entry in a ledger. A bank made a loan to an individual or a corporation, assessing that the borrowing entity would be able to make repayments. The bank simply credited the money to their account. Money was created based on a banker's assessment of the future. If the bankers were wrong, if the future did not turn out as expected, and enough loans went bad and depositors lost enough confidence in their bank, the depositors would bang on the bank's doors and demand their money back. And they would find that the bank did not have their money. This is where the Federal Reserve stepped in, as the lender of last resort for the American economy.

If a member bank did not have enough money in reserve, it would go to the Fed's discount window and borrow funds, or go to another bank that had excess reserves and borrow from them. The price of this borrowing between banks was known as the Fed Funds rate, and it was the interest rate the Fed had the most control over and the rate that served as the foundation for all other interest rates in the economy. The price of membership in the Federal Reserve system was that the reserve rate for member banks was set by the Federal Reserve. It was through its control over reserves and the Fed Funds rate that the Fed influenced the economy.

To expand the money supply or contract it, the Fed sold or bought bonds at the Open Market Desk at the New York Fed. When the Fed bought bonds, it injected cash (reserves) into the banking system. These reserve deposits could immediately be lent out, creating a multiplication process. If the Fed bought $100 worth of bonds, $16 may be kept in reserves and $84 lent out. Then 16% of this amount would be kept in reserves and the rest lent out, and on and on. The original $100 purchase would create around $500 in new deposits. The Fed influenced the supply and demand for loanable funds, and therefore set short-term interest rates. The Fed had less control over long term interest rates—the bond market often had its own ideas about the distant future. The price of money influenced the amount of credit available to finance real economic activity. The Fed controlled reserves, which influence bank lending, which influenced the productive capacity of the United States of America and the lives of its citizens.

The governors, Reserve Bank presidents, and employees of the Fed saw Volcker's appointment as a long needed return to normalcy for the institution. The Fed had previously been led by Arthur Burns, who was abusive toward and manipulative of his fellow governors and others. After Burns came Bill Miller, Volcker's predecessor. Miller was considered to be unappreciative of the Fed's sense of protocol and his own position, and too close to the Carter Administration. Volcker was a company man, so to speak, a veteran of the system with decades of experience in banking and finance.

Chapter 3: A Pact with the Devil

Paul Volcker took the oath of office on August 6, 1979. The Fed had set a growth target of 1.5-4.5% for the M-1 measure in 1979. When Volcker took office, M-1 was growing at an annualized rate of 10%. Volcker quickly began sending signals in his private and public remarks that he would make an effort to tighten up the money supply. In their August 1979 meeting, the seven governors decided to raise the discount rate from 10 to 10.5%. This move was relatively small (though one must remember that that 0.5% gets multiplied by hundreds of billions of dollars in loans), but Volcker still had to contend with some governors who thought it too drastic. In their September meeting, however, Volcker signaled that he felt more action was needed. He proposed increasing the discount rate once more, but backed off when he saw his fellow governors might not be with him.

At the September meeting of the FOMC, the majority voted to increase the Fed Funds rate from 11.5 to 11.75%. (It is important to note at this point that the full FOMC decided the Fed Funds rate, but the seven governors alone decided the Discount rate). Again, Volcker had wanted to take a more drastic step, but moderated his position in order to ensure a majority. Slowly, Volcker was preparing himself and his fellow governors to take such action.

In the late summer and fall of 1979, inflation was raging into the low double digits. Inflation was fueling a speculative boom that worried many at the Fed and elsewhere. Individuals, farmers, corporations, and other entities rushed to spend now before prices rose again. Of course, their buying only led to a self-fulfilling prophecy—they drove the price up, encouraging still others to do the same thing. The boom was across nearly all markets—real estate, precious metals, paintings, and on and on. People were rushing out of dollars and into tangibles, considered a more reliable store of value in inflationary times.. Though some worried that more aggressive action could stop the economy in its tracks and cause a recession, outside critics and members of the Fed began to worry that the Fed's moves were too gradual to make a difference.

One symptom of this was the growing popularity and influence of an economist from the University of Chicago, Milton Friedman. Friedman had won the Nobel prize in 1976 for what came to be called monetarist theory, or monetarism. Friedman argued in his seminal work, *A Monetary History of the United States, 1867-1960*, that the Federal Reserve was directly responsible for exacerbating if not causing the crash of 1929 and the Depression that followed. In his view, the Federal Reserve should follow a simple policy of expanding the M-1 by 3% a year, the historical growth rate of the US economy. Many within the Fed disagreed, arguing they had to make adjustments as necessary for developments in the global economy. Despite strong opposition, monetarism was growing in popularity inside the Fed and out, especially within the Reserve Banks. Though Volcker was no monetarist, he would soon find reasons to advocate a monetarist approach to Fed policy.

Traditionally, when the Fed wanted to increase interests rates, it did so by announcing a target interest rate (the Fed Funds rate), and then authorizing the traders at the open market desk in New York to buy or sell treasury bonds until the target was reached. This approach had the advantage of keeping interest rates steady and financial markets calm. Critics alleged that the Fed was paying too much attention to the interests of traders on Wall Street. Monetarists argued that a much more direct approach would be to control the money supply directly through the reserve rates. Instead of targeting a price of money and hoping that price would produce the desired results for bank lending and inflation, the Fed would simply control the amount of dollars flowing through the economy. The Fed had never taken this approach before. Though this method would contain the growth of the money supply, many at the Fed believed that it would create interest rate volatility as bankers adjusted to the change, and the Fed abhorred instability.

Still, though, Volcker saw several reasons to try exactly such an approach. Volcker was convinced that drastic action—an increase of 2-3, possibly 4-5% in the Fed Funds rate—was needed to curb inflation. But he doubted he could cobble together a sustainable majority to vote for such action. Setting the reserve rate higher would likely produce the desired shift in interest rates, while distancing the FOMC from the move. Interest rate increases could be blamed on "market pressures" (which of course was true but neglected the fact that those market pressures had been set in motion by the Fed). With this approach, Volcker believed he could get both the hawks and doves to go along.

Volcker also thought such a move would inject a note of uncertainty into the system. By upsetting the Fed's traditional mode of business, Volcker would upset the psychological momentum of inflation; it was a warning to bankers that interest rates may not increase steadily, that they could move quickly against them. The bankers, thus warned, would become more cautious in their lending. It was important that the Fed send a strong signal that it intended to curb inflation.

Volcker proposed a reserve increase of 8% on the funds banks borrowed to finance loan expansion. This point demands some explaining. Traditionally, banks were constrained in their lending by the growth of their interest free deposits—money parked in their banks by the workers of America. Then, in the 1960's and 70's, banks figured out another way to finance loan expansion. Instead of relying on individual depositors, they could borrow large amounts of funds at a low interest rate, and lend them out at a higher interest rate. In effect, they could buy deposits. This allowed banks to dramatically expand their lending. Volcker proposed raising the reserve rate on these borrowed deposits. Hopefully, this would push short term interest rates up, and lead to a slight decrease in long term interest rates as markets became more confident that inflation would subside and lenders reduced the large inflation premiums they were demanding. On September 28, the seven governors gathered in Volcker's office and agreed to support the move. Volcker would push the idea at the next FOMC meeting, confident he could get the Reserve Bank presidents to go along, as they were in general more inclined towards the monetarist position anyway. President Carter, just some three blocks away, was not informed of the impending shift.

Volcker would inform Treasury Secretary Bill Miller and chairman of the President's Council of Economic Advisors Charles Schultze of his plans the next day as they flew together to the annual IMF conference. Of course, the Fed chairman need not say anything to the President or his advisors, but Volcker well knew that though the Fed was an independent agency, its actions must fall within some broad consensus of what was allowable, or else it risked bringing on enough heat that the President and Congress would strip that independence away. Both Miller and Schultze opposed the move. Go ahead and raise interests rates, they said, but don't change the operating model. Such a move would create volatility in the markets and lock the Fed into a policy it could not back out of.

Nobody had to mention that the move would also likely bring on a recession just in time for the 1980 presidential election. Despite their urgings to change course, Volcker maintained his position. In the end, Carter acquiesced. He himself was too politically vulnerable to fight with his own Fed Chairman. The FOMC met on October 6, and approved the move.

Chapter 4: Behavior Modification

The impact of the rate increase was felt almost immediately. The Dow Jones fell several percentage points; bond prices, gold, and other commodities fell as well. For the next few weeks, short term interest rates bounced up and down and up again, from 11.5% before the Fed moved to 18%, then 14%, then 16%. Though volatile, it soon became clear the rate was settling at a substantially higher level.

And the effects were felt far beyond lower Manhattan. All across the country, businesses and consumers had to reckon with the new reality set in motion by the Fed. Construction, real estate, auto, and appliance sales were particularly affected, as these industries depend heavily on credit. Nobody was going to buy a mortgage with a 16% interest rate on it. These businesses found themselves squeezed on both sides. Their customers couldn't get loans to buy their products, and they couldn't get loans to maintain their inventories. Banks across the nation curtailed their lending significantly. Smaller credit organizations found that their depositors were leaving in droves, seeking the higher interest rates offered by money market mutual funds. Such funds would see their assets under management multiply several times over in the next few years. All this pointed to one conclusion: the Fed's policy was working.

It was an amazing fact that the organization responsible for this sudden and dramatic change in behavior was staffed by unelected bureaucrats. Yet these unelected bureaucrats had the power to chastise the American public at large for behavior they considered extravagant. Like a parent, they could reward some behaviors and punish others. Unfortunately, the costs of the Fed's policies fell unevenly on the American populace. The poorest Americans were least able to deal with the higher interest rates. Individuals and businesses in higher tax brackets could write-off a larger percentage of their interest payments. People in the lower tax brackets paid nearly full freight. The Fed's policy punished those least responsible for the behavior the Fed found so reckless.

And, as the months went by, it became clear that this reckless behavior was continuing. Part of the Fed's October 6 announcement of higher marginal reserve rates was an exhortation to the banks to curtail lending for speculative purposes. Though the banks made sounds of agreement, their actions said otherwise. In one of the most famous speculative events in history, dozens of banks from around the country lent hundreds of millions of dollars to the Hunt brothers, a pair of energy tycoons who made an attempt to corner the silver market. When the silver bubble burst in March of 1980, it became obvious that the Fed's urgings went unheeded.

The Fed's attempt to alter behavior met resistance elsewhere, too. Though auto sales and home building were down significantly, and small borrowers and lenders were being priced out of the market or losing depositors, the largest banks and corporations kept going. Credit became more scarce, but what remained flowed upward. Corporations sought guarantees that their credit needs would be met, and the large commercial banks could give these guarantees. Commercial banks expanded their loan portfolios at alarming rates. Part of the reason large institutions could do this was because they had access to the Eurodollar market—hundreds of billions of unregulated US dollars parked offshore. Through their foreign subsidiaries and branches, US banks could access these funds to make more loans. From the Fed's perspective, this represented a huge leak in the system. A leakage of $50 billion to the US market could expand the M-1 measure by 15%, far above the Fed's target of less than 5%. It turned out the Fed's move was not as effective as it first appeared. The US economy was far more adaptable and resilient than the governors had imagined.

In February, the FOMC agreed to tighten bank reserves further. The Fed Funds rate was hovering around 13% at this time, the governors set the ceiling at 15.5%. Two weeks later, the Fed Funds rate increased to 15%. The FOMC met again, and raised the ceiling to 16.5%. By March 6, this target too was pierced. Volcker called the FOMC to raise the target again, to 17.5%, and the very next day they decided to raise it again to 18%. Though this was far above the 12% rate in October, banks continued to pump out more loans.

The reaction in Congress and the White House was surprisingly subdued. Most Congressmen had little understanding of monetary policy, and were willing to defer to the Fed. Carter had drawn up his own anti-inflation initiative, but this was drowned out by the course of events. The White House became increasingly worried that a recession was bound to hit before the 1980 election. Ted Kennedy announced his attention to challenge Jimmy Carter for the democratic nomination. And, on November 4, Iranians seized the American embassy in Tehran and took more than sixty Americans hostage.

Chapter 5: The Liberal Apology

During the mid-to-late 1970's, banks were leaving the Federal Reserve system at an accelerating rate. Member banks are required to hold reserves with the Fed and its Reserve branches, and the Fed did not pay interest on these reserves. As a result, many banks found it more profitable to withdraw from the system and place themselves under state regulations. State laws typically had lower reserve rates and, more importantly, the reserves could be placed in a correspondent bank that would pay interest.

When Bill Miller became Fed chairman, he decided something needed to be done about this. He, and Volcker after him, argued that as banks left the Reserve system the Fed lost some of its ability to implement monetary policy and control the money supply effectively. Miller attempted to take unilateral action in 1978, but backed down under threat from Congress. The Fed would win out in

the end, though, with the Monetary Control Act of 1980. The Monetary Control Act was a major act of financial deregulation, a cause that had been gathering steam in Washington for the better part of a decade. Though the Fed couldn't win on its own, it got what it wanted by riding this larger wave.

The act required all depository institutions—banks, S&Ls, credit unions, etc.—to hold reserves with the Fed. In return, the Fed lowered the reserve rate from 16.25% to 12%. This freed up billions of dollars for the banks, who could now earn interest on these funds. Member banks would make the small concession of paying for some of the Fed's services, for instance the use of the payment system, maintained by the Fed. In return for the endorsement of the American Bankers Association, the Fed dropped its reserve requirement on time and savings deposits entirely.

The legislation had other important provisions as well. It repealed virtually all government limits on interest rates, allowing the banks to charge whatever they liked. It also allowed banks to pay interest on checking deposits, which would help them compete with money market funds. The Fed's Regulation Q, which set limits on the interest rates S&Ls and banks could offer on savings deposits, would be phased out entirely over six years. This stripped S&Ls of their competitive advantage over banks; over the next few years, thousands of S&Ls would be pushed out of business.

All in all, the act was a tremendous victory for banks, especially large banks (many smaller banks opposed the act). Lenders would earn higher returns, and borrowers would have to pay more. Once the new rules were fully phased in, banks would enjoy billions of dollars more in income every year. The fifty largest banks would take home about 50% of those gains.

Volcker lobbied hard for the legislation, though he and some others in the Fed had mixed feelings about it. What the Fed really gained was political cover. The assertion that the Fed would be less able to control the money supply as banks left the Federal Reserve system was dubious. As long as the system contained a large percentage of the nation's banks and the deposits they held, the Fed could inject money in and count on it spreading throughout the system. Yes, some banks had left the system, but the largest banks would never leave it. But keeping the thousands of smaller banks in the system gave the Fed a nation-wide network of political support. Even if some Congressmen attacked the large banks in New York City, they would listen to the banks in their district or state. Democrats preferred that small banks remain members; if the Fed only had relationships with the largest banks, it might lead to an institutional bias towards them and against the smaller banks. Of course, it could easily be argued that such a bias already existed, but Democrats nonetheless feared making it worse. Ironically, the Democrats' concern for small banks led them to support a piece of legislation that would allow large bank mergers, provide a windfall to the largest financial institutions, and ultimately pave the way for the creation of nation-wide banks at the expense of mom-and-pop shops.

Given the democrats' traditional support of labor and home builders groups, it may come as a surprise that they supported financial deregulation. But political opposition was worn down by inflation. In effect, America's liberals were apologizing to the owners of wealth for the great increases in inflation that occurred under their watch. This retreat from their traditional values was years in the making—inflation had been on the rise for the better part of a decade. Indeed, in 1978, the Democrats approved halving the federal income tax on capital gains. That same year they stopped the budget growth for programs that aided the poor. Over the previous two decades, during which the Democrats held majorities in both houses of Congress, corporations' share of the federal tax burden fell from 26 to 12%. At the same time, regressive Social Security taxes were imposed.

The small savers and little old ladies on fixed incomes who the democrats claimed to be protecting were largely fictional. At this time, 37% of American families had no savings account at all. Those who had any significant amount of savings were in the upper half of the income ladder. The legislation did little to help those on the bottom half of the income ladder, it did a lot to help the 10% of American families who owned 86% of the net financial wealth. The legislation represented a massive redistribution of income upward. As Greider puts it, "the little guys, once protected by government regulation, were free to pay more." Banks, on the other hand, were free to raise interest rates. The increased costs for businesses fell on the consumer.

The Fed had some reservations about the legislation. The removal of interest rate limits could make it harder for the Fed to slow down the economy through the imposition of a credit crunch. Previously, once interest rates hit their limits, lending and borrowing would stop, especially in the housing sector. Now there were no limits. Financial institutions could charge as much as they wanted, and borrowers could take on loans with enormously high interest rates. What if borrowers kept on borrowing, believing inflation would persist despite the Fed's efforts? The money supply would continue to grow, and borrowers would keep on borrowing until one day they overextended themselves and went bankrupt, at which point the Fed would be on the hook to save the lenders. In order to prevent this, the Fed would have to raise the price of money to nearly unprecedented levels (the prime rate in early 1980 reached 20%). Financial deregulation shifted some decision making authority to the private sector, but the Fed would still be held responsible for maintaining order in the global economy. This was Volcker's worry.

Chapter 6: The Roller Coaster

In the early months of 1980, President Carter began pushing his own program to control inflation. Worried about the poor economy's implications for his reelection campaign, Carter had told his advisors to come up with a program. Their recommendation was to impose credit controls on the economy; it was a move designed to cool off the economy and let interest rates come down slightly,

without pushing the economy into recession. Credit controls were legal supply limits on credit, and could only be imposed by the Federal Reserve.

Volcker was against credit controls, but Carter lobbied Volcker very hard to impose them. Carter met with Volcker time and again, and repeatedly included him in meetings with Congressional leaders and his own economic advisors (meetings Fed chairmen were rarely invited to). In theory, the Fed could refuse the President, but the Fed's independence was limited by political realities. It didn't look good to publicly refuse the President.

On March 14, 1980, Volcker announced a program of credit controls. The controls not only limited the amount of credit expansion done by banks but also included, at President Carter's insistence, limits on retail companies that issued credit cards. Volcker acquiesced to the President's wishes because Volcker believed that he could structure the program in such a way that it would have little, if any, effect. For instance, the restrictions on consumer borrowing and credit cards exempted nearly every large purchase a consumer might make—cars, furniture, appliances, mortgages, etc.. Volcker thought the program would be one of moral persuasion rather than economic, more cosmetic than substantive. However, both Volcker and the White House underestimated the psychological effect the program would have.

Carter announced the program in a televised speech. Volcker held a briefing the next day, after which a televised panel of Administration officials discussed the program. The evening news repeated the President's plea that consumers stop borrowing. The result was a collapse in consumer spending, which quickly brought on the long-feared recession. GNP fell by 10% over the next three months; unemployment rose from 6.3% in March to 7.8% in July; per capita disposable income fell; the housing market continued to decline (famously, builders mailed two-by-fours and bricks to the Federal Reserve building in protest). The credit controls were soon eased, but recessions create a momentum of their own. The program had worked all too well.

While the economy was deteriorating, Volcker faced another crisis. The Hunt brothers' attempt to corner the silver market was falling apart. Silver prices had come down from a peak of $52 per ounce to under $20. On March 27, the price of silver lost a third of its value, from $15.80 down to $10.80. The Hunt brothers were being asked to put up more collateral, and if the price fell any further they wouldn't have enough. They had borrowed some $800 million from a dozen national and foreign banks, which were now in danger of going underwater on their loans. Many on the Fed board were willing to see the Hunts and their bankers fail, but Volcker was worried that such an event could spark a larger panic in a time of economic uncertainty. Volcker helped arrange a private bailout of the Hunt brothers, who were able to restructure their loans to avoid default. In effect, Volcker approved a massive exemption from the credit controls he had imposed only weeks earlier, an exemption offered to institutions who had ignored his October 6 directive to avoid speculative loans. But it was his duty to prevent bank failures, so Volcker made the exemption.

Since October the Fed had been struggling to tamp down the money supply, by April it seemed they had gone too far. The April numbers showed that the M-1 aggregate was falling at an annualized rate of 17%, far beyond the Fed's target. Consumers were both paying off their debts—wiping deposits off the books—and shifting their money from checking accounts to other financial instruments to take advantage of high interest rates—in effect moving their money from M-1 to M-2.

According to the monetarist approach the Fed adopted on October 6, the solution was simple. If the money supply was falling too quickly, pump in reserves. In late April 1980, the FOMC approved just such a move. Though many in the FOMC had reservations, Volcker argued persuasively that if the Fed was to be taken seriously it must follow its new operating model, and that the depths of the recession were unknown. The consequences of not acting could be devastating. The open market desk in New York began pumping in reserves furiously—adding reserves at an annualized rate of 14% in March and an unprecedented 48% in May. Interest rates began to fall dramatically, from 18% to 13% in the two weeks after the Fed's April meeting, and still further from there, to 10.5%, and then to 8%. By July, the credit controls imposed in March were dismantled.

By midsummer of 1980, the economy seemed to be turning around. The recession had ended. Personal consumption began increasing once again, housing starts increased by 30% in June, business investment turned around as well. The GNP went from contracting at a 10% rate to expanding at a 2.4% rate. And, inflation turned upward once more to 11%. The Fed had almost completely undone months of work. Over ten weeks the Fed had doubled the price of money, and then let it fall nearly to where it started. The M-1 was once again growing quickly—11% June, 13% in July, 22.8% in August (monthly rates). This was nearly four times the Fed's target. It appeared the Fed had totally lost control; Volcker would later say that the easing on interest rates in mid-1980 was his greatest mistake as chairman. Interest rates were on a roller coaster ride, and would soon be on the climb once again.

By September, the members of the FOMC had come to a consensus. They needed to take action to slow the growth of the money supply once again. Though the Fed was reluctant to act during the election season—Fed officials were very sensitive to accusations from politicians on both sides that it pumped up the economy to support the incumbent or tightened it because it preferred the challenger—the FOMC felt it could delay no longer in light of the recent numbers. The FOMC voted to increase the discount rate and tighten the money supply every month during the fall of 1980. By December of 1980, the Fed Funds rate would reach 20% once again.

Despite the determination of the members of the FOMC to avoid political entanglements, they were attacked by both sides. During the summer, when the Fed was lowering rates, they were accused of pumping up the economy to improve Carter's chances. In the fall, when the Fed began raising rates, Carter

criticized them for raising rates too severely. In November, Reagan would win the election with 51% of the vote to Carter's 41%. It appeared that the Fed's hiking of interest rates over the two previous months did have some effect on Carter's share, as he was leading 45% to 42% before the Fed's action. Of course, many other factors played a role in Carter's defeat.

The Fed also came under attack from the business community, which criticized the Fed for waffling and refusing to hold the line against inflation. Still others—including some inside the Fed—criticized the Fed's new operating policy. These critics said that targeting the money supply directly allowed too much variation in interest rates, which in turn affected the money supply. Thus, the Fed was chasing its own tail, responding to the lagged effects of its last policy move. In the fall of 1980, there was solid ground for such criticism, although it must be said that the monetarist approach called for a steady increase or decrease in the money supply, something the Fed had hardly accomplished.

Volcker's first year as chairman ended in embarrassment. He had doubled interest rates, halved them, and doubled them again, along the way bringing the nation through a steep recession and recovery. And he got very little in return—by year's end inflation was still around 10%, only slightly less than what it had been when Volcker took office. Volcker was now determined to hold the line against inflation, while at the same time easing the automaticity with which he had used the monetarist approach.

The Fed's actions were complicated by certain facts of monetary policy that aren't mentioned in textbooks, and deserve explanation here. The textbook picture of monetary policy is that the money supply starts with the Fed, which decides the level of reserves to provide to the economy single-handedly. The true picture is more complicated. In reality, banks make loans, and then scramble to find the reserves to support them. They do this by borrowing from the money market or the Fed's discount window (they are aided by the fact that they report reserve levels to the Fed with a lag, every two weeks). The Fed nearly always lends to the banks that come to the window, to avoid setting off a liquidity crisis. But, the Fed chooses the price it charges at the window and, if a bank comes to window too often, the Fed may start an investigation into that bank's lending practices. Meanwhile, over the longer term, the Fed could tighten or ease the money supply through the Open Market Desk. Eventually, by balancing the discount rate and the Fed Funds rate, the banks would feel the weight of the Fed's moves and change their behavior accordingly.

PART TWO:
THE MONEY QUESTION

Chapter 7: The God Almighty Dollar

Greider explores the Federal Reserve's mystique, which is inextricably tied to its management of money. The psychological power of money, the importance attached to it, is seemingly rivaled only by God. Indeed, for centuries religious men have condemned the worship of money, denouncing it and the interest it produces as the work of the devil. Perhaps they did so out of a sense of competition, and rightly so. Money, like God, confers power. It gives man the means to extend his reach beyond his immediate environment, and even beyond his own lifetime. The mere fact that one possesses enough money to do something can provide as much satisfaction as actually doing it—akin to the superiority the man who can play the piano feels over the man who can't, even when he isn't playing. The detailed attention people give to the use of their money after their death in the writing of their wills shows money's capacity to fulfill the natural longing for an afterlife. A man may die, but his money lives on.

The capitalist system depends on millions of people putting their faith in scraps of paper, pieces of plastic, numbers on a screen. Though no longer backed by gold, they believe the numbers symbolize something real. Modern advertising has been enormously successful in getting people to attach their sense of self and individuality to the accumulation of cash. Acquiring money is an end in itself—seemingly, money does not only give its owner power, but exerts a power over its owner.

The root of the Fed's mystique is the religious and spiritual significance we attach to money. Money has power over us, and the Fed has power over money. Its governors explain their actions in a dense, technocratic language the common man cannot understand, and does not want to understand. The Fed's pronouncements are akin to religious orders given by high priests. This helps explain the Fed's peculiarity as an institution. America is a democracy, with levels of democratic representation piled on top of each other. Even the installation of a stop sign is subject to review by the people. And yet, the American people are happy to let their money be managed by a small group of people, mostly men, who are independent of their control or even the President's. Money has huge political implications, but its management is beyond politics.

Chapter 8: Democratic Money

It is a great irony that many of the ideas that led to the creation of the Federal Reserve System came not from Wall Street or the world of academia, but from poor, uneducated, conservative farmers in the South and Midwest.

The trouble began with the Civil War. To finance the Union army, Congress suspended the gold standard in 1861, and Lincoln borrowed over $2

billion dollars and issued $500 million "greenbacks"—a new currency not backed by gold. Prices rose by 74% between 1861 and 1864. After Lincoln's death, the Republican party became ever closer to powerful Eastern business interests. They reinstated the gold standard, but at the prewar parity level—$20 per ounce of gold. This set off a 30 year period of deflation. Prices fell to prewar levels and then still further, as farmers increased yields in an attempt to keep their incomes the same despite the falling prices, exacerbating the problem. To make up for their losses farmers took out loans at ruinous interest rates. They were further beset by outrageous shipping costs imposed by the railroad companies. When farmers could no longer make payments on their loans, the banks seized their land. Over the course of a few decades, millions of famers were reduced from landowners to sharecroppers.

In the late 1800's, an organization of populist famers known as the Farmers Alliance was spreading across America—from its origin in Texas across the South to the Carolinas and up north to the Dakotas. They advocated for a progressive income tax, railroad regulations, legal rights for labor unions and, most importantly, government regulation of money. Up until the Federal Reserve System was created in 1913, the "lender of last resort" for the American economy was usually a consortium of Wall Street banks. The money supply was constricted by the gold supply, so the US economy regularly ran into short-term credit problems (it took 15 days for gold supplies borrowed from Europe to reach the US). Farmers would borrow from their local banks, who would turn to the big city banks, who would eventually turn to the centers of American financial power: Chicago, St. Louis, and Wall Street. Time and again J.P. Morgan would be called on to organize a syndicate to the bailout the nation's banks. The Wall Street tycoons were able to charge high interest rates for their services, and in the process, many of these small banks failed. This is the origin of populist anger at Wall Street that reverberates in American politics to this day. And, despite the efforts of Wall Street, the US was hit by recessions and depressions repeatedly: in 1873, in 1882, and a full-scale panic in 1893. It is a testament to their anger at Wall Street that these famers turned to the none too popular politicians in Washington to solve their problems. The farmers wanted a flexible money supply, regulated by the government on a democratic basis, that would grow at a rate commensurate with the growth of the overall economy. One of the leaders of the Farmers Alliance, Charles Macune, proposed a scheme in which the government would lend directly to farmers at low interest rates, going around the banks entirely. What they got in the 1913 Federal Reserve bill would be a far cry from what they wanted.

The populists' grand agenda would soon be co-opted by the democratic party, and largely emasculated. After the People's Party fielded their own presidential candidate in 1892 and lost, in 1896 the populists pinned their hopes on William Jennings Bryan. By now, their agenda was simplified to advocating for the adoption of silver money, which would create inflationary pressure and ease the pain of the farmers. Bryan lost, and the movement lost all momentum

when new gold stores were discovered in Alaska, Colorado, and South Africa. The new stores led to a new inflation, lasting some twenty years. Some elements of the populist agenda would be adopted decades later under New Deal legislation—for instance government purchase and storage of crops, and subsidized credit for farmers.

The Federal Reserve bill would preserve the position of banks in the American system, allowing them to distribute credit as they wished, charging as much as they wanted (subject to interest rate limits). The populist moment was lost, but it is a reminder that the money question is a political question. Though the Fed is isolated from politics by law, the actions it takes have profound political consequences. The divide between lenders and borrowers has always boiled under the surface of American politics, and there it remains.

Chapter 9: The Great Compromise

Strangely enough, the cause of the populists—those uneducated farmers and laborers who directed their anger at the financiers of Wall Street—would be taken up by those same bankers. Every autumn, farmers needed credit to finance the harvest. They would turn to their local banks, who would turn to the city banks, who would turn to Wall Street, as well as Chicago and St. Louis. If even these three centers of financial power failed to meet the demand, they could sometimes turn to London or Paris for the necessary reserves. In the two decades leading up to the passage of the Federal Reserve Act, these contingencies failed a number of times. Once banks started to fail, panic would spread and depositors would run on the banks, causing even otherwise solvent banks to collapse The banking panics of 1893 and 1895 were resolved only when J.P. Morgan organized syndicates of Wall Street bankers who pooled together enough funds to save the system. In effect, these financiers decided who survived and who did not. This created considerable resentment in the countryside towards the so-called "money trust."

Even J.P. Morgan and his fellow bankers could not come up with the funds necessary during the panic of 1907. This time, even the third largest bank on Wall Street—the Knickerbocker Trust Company—failed. In desperation, they turned to the Federal government, which provided the hundreds of millions of dollars in emergency loans necessary to stave off a total collapse of the system. This panic convinced Wall Street that money reform was necessary to their own survival.

The first draft of what would become the Federal Reserve Act was written at an infamous, clandestine meeting held at Jekyll Island, Georgia, in 1910. Under the guise of going duck hunting, Rhode Island senator Nelson Aldrich took some of America's most prominent bankers to the island to discuss monetary reform. They came up with what would become known as the Aldrich Plan. The plan called for a reserve system broken up into 15 regions, controlled by a board of commercial bankers and empowered by the government to create money and lend reserves to private banks.

In 1912, Woodrow Wilson was elected President. The Democratic Platform was explicitly opposed to the Aldrich Plan, as many democrats believed it gave far too much power to private interests. A new bill, which kept the fundamentals of the Aldrich plan intact, was proposed by representative Carter Glass and senator Robert Owen. The new president, who was less distrustful of the great financial institutions than many others in his party, accepted the outline of the new plan but added a Federal Reserve Board on top of the privately controlled network of regional reserve banks. The board would be appointed by the president and, until the reforms of 1935, would include the Secretary of the Treasury and the Comptroller of the Currency. As a consolation to the bankers, a Federal Advisory Council of private bankers would be established to advise the Federal Reserve Board.

The new plan called for a hybrid institution the likes of which had never been seen before. Predictably, and to Wilson's satisfaction, the plan was angrily denounced by both sides. Eventually the bankers got on board, and the act was passed and signed into law in 1913. At the time of its passage, the Federal Reserve Act was celebrated as a great victory over the "money trust." However, looking back, the Act was a victory for the bankers. At the time, as historian Gabriel Kolko has written, the large banks were in fact losing influence rather than gaining it. The large industrial firms of the west and south were finding that they could finance themselves using their own profits, without having to turn to Wall Street. Thousands of banks were springing up across the country, mostly in these regions. Far from being reigned in, Wall Street would now be able maintain and expand its influence—until the crash of 1929.

The passage of the Federal Reserve Act had implications far beyond the management of the money supply. The Federal Reserve was an institution of Republican and Democratic parentage, and run as a hybrid institution between public and private interests. It was a bargain struck between the most powerful forces in American politics. Over time, one of the many consequences of the new system would be to almost entirely remove the money question from American political debate. Though the Fed's actions could have profound effects on the lives of the American people, and therefore profound political implications, its role in the economy would eventually be taken for granted by both sides of the aisle. The Fed was one of the first initiatives in a growing movement to remove the work of running the country from the whims of the public. Money would now be managed by technocrats hidden away in their temples, emerging every six weeks to announce their actions in statements full of dense jargon, impenetrable to the layman. Neither Congress nor the President could influence these actions.

This was in line with other changes occurring in American life at this time. The Progressive movement, determined as it was to root out political corruption, called for "good governance" practices. This included the use of unelected city managers to replace the old corrupt machine politics that had existed for generations. There was a shift away from democratic government towards

technocratic expertise. The leaders of the progressive movement were for the most part educated members of the middle and upper middle classes—professionals, managers. Not surprisingly their new movement called for the professional management of government affairs. This was also a reflection of changes occurring in the business world. The old idyll of the self-sufficient American farmer, or the lone, bold capitalist adventurer, was dying at the hands of the corporation. To manage the difficulties of an increasingly complex world, organizations were formed and professional managers brought in to run them. What worked for private business was applied to government.

America, once a rural nation, was becoming an urban one. American literature, once dedicated to celebrating the virtues of self-sufficiency and individualism, now explored the feelings of loss and alienation associated with city living, with being a mere employee who worked not for himself but as a cog in a larger machine. The compensation for their emotional loss was material gain. They put their trust not in themselves, but in larger more distant forces who, empowered by their own expertise and new technology, were supposedly more fit to run the country. This was the bargain that created the Federal Reserve.

The Federal Reserve would have a great decade in 1920's. Though the Fed played a role in starting recessions in 1920, when the Fed tightened the money supply, and again in 1926, when the Fed failed to ease, the "roaring twenties" brought an entirely new level of prosperity to America. Labor productivity increased by some 60%. New technologies like automobiles, radios, and refrigerators came onto the market and then into the homes of millions of Americans. As Milton Friedman later wrote, this was the Fed's "high tide."

Then came October, 1929. Many have blamed the Fed for creating the crisis with easy money policies that encouraged speculative lending and pumped up the stock market. Indeed, the Fed did ease credit conditions in 1927 to combat what it perceived to be a potential recession ahead. In August of 1929, worried about speculative activity in the stock market, the Fed made a modest reversal by increasing the discount rate. But it was too little too late, and in October the market crashed, ushering in the Great Depression. Over the next four years, 40% of the nation's banks failed, and unemployment rose to 25%.

Though opinions differ as to the role the Fed played in starting the crisis, the Fed's much more serious error was in failing to ease money conditions after the Depression had started. The forward thinking Benjamin Strong, president of the New York Fed and the Fed's most important policy maker at the time, died a year earlier, in October, 1928. The Fed's new leadership viewed the downturn as necessary but painful medicine for irresponsible speculation. Writing in 1929, George Norris of the Philadelphia Fed said, "The consequences of such an economic debauch are inevitable. We are now suffering them. Can they be corrected or removed by cheap money? We do not believe that they can. We believe that the correction must come about through reduced production, reduced inventories, the gradual reduction of consumer credit, the liquidation of security loans and the accumulation of savings through the exercise of thrift."

President Hoover received advice along the same lines, and did little to ease the nation's suffering.

The Fed did not lower interest rates, except for one abortive attempt in the spring of 1932. And this was only after the Fed *raised* the discount rate two points in October of 1931. In their private deliberations, many Fed officials argued against lowering rates because such a move would hurt bank profits. Some have argued that the Fed refused to act because it did not have the tools or knowledge. Greider argues to the contrary. Some in the Fed did argue for lowering rates, and all Fed officials understood they had the tools to do so. They simply decided not to use them. By relying principally on the discount rate to control the money supply, the Fed took a de facto pro-cyclical policy, deepening slumps and accelerating booms. In the future, the Fed would implement countercyclical policies, otherwise known as leaning against the wind.

Chapter 10: Leaning Against the Wind

The Federal Reserve's damaged reputation would be restored during Franklin Roosevelt's presidency by Marriner Eccles. A Mormon Republican from Utah, Eccles was an odd fit for the Roosevelt Administration. In 1931, Eccles was still a private banker, the owner of one of America's first bank holding companies, which controlled several dozen banks in Utah and across the Midwest. For the early years of the Depression, Eccles' focus was simply on preventing the failure of his banks, which he managed to do with a 100% success rate. Only a high school graduate, Eccles became a self-educated economist through his own efforts to understand the Depression's causes and potential solutions. He concluded that the Depression was caused not by profligate spending and irresponsible consumers, but by too much saving. To get the economy back on its feet, money would have to be put in the hands of consumers who would spend it. The only way to do this on the scale needed was to work through the federal government. Eccles' analysis preceded Keynes' *General Theory* by three years.

By 1932, Eccles was testifying before the Senate, recommending policies like unemployment relief, public works projects, agricultural allotments, federal insurance of bank deposits, old-age pensions, and federal regulation of the stock market. Over the next three years, Eccles would be brought into the Roosevelt administration as one of the President's principle advisors, and virtually all of his recommendations would be enacted into law.

Eccles was the architect of the Banking Act of 1935, which restructured the Federal Reserve. The Secretary of the Treasury and Comptroller of the Currency were removed from the Board of Governors, further insulating the Fed from political influence. The legislation took away much of the power of the twelve Reserve Bank presidents by creating the Federal Open Market Committee, on which the Board of Governors would have seven of the twelve votes, with the remaining five rotating among the Reserve presidents. The Act also forbid paying interest rates on deposits (Regulation Q), and empowered the Fed to

discourage speculative lending by setting margin requirements. Roosevelt appointed Eccles chairman of the Fed in 1934, a post he would hold for the full 14 year term. Under Eccles' leadership, the Fed placed much more emphasis on open market operations rather than the discount rate. And, instead of buying commercial paper, under Eccles the Fed began primarily buying Treasury bonds. Eccles was also an important advisor in the creation of the FDIC, which effectively stopped bank runs across the country, and the Glass-Steagall Act, which effectively split commercial and investment banks.

In 1936, Keynes published his *General Theory*, finally bringing the ideas espoused by Eccles and others into the mainstream of economic theory (of course there was significant resistance, but Keynes described his theories with such rigor that they were at least made respectable). Then, in 1937, a new recession caused by reduced federal spending and a tightening on reserves by the Fed finally discredited the classical economic theory. Keynes' ideas did indeed provide a new deal for the American system—it gave something to everybody. Consumers were encouraged to spend rather than save, so businesses could invest and expand production, and round and round it went. World War II would further prove the point, as unprecedented government spending and borrowing increased the nation's productive capacity by 75% in just five years.

The Fed maintained a passive stance throughout the War and for years after. In the face of war, all pretense of independence was lost, and the Fed obeyed the Treasury's command to keep interest rates—the price of the government's borrowing—low. As the War progressed Eccles, to the annoyance of many in the Administration, began advocating for a stricter policy to avoid runaway inflation after war's end. The inflation did occur—8.5% in 1946 and over 14% in 1947—but the nation's real productive capacity increased so much that it hardly mattered. Economic contraction was feared more than inflation.

The outbreak of the Cold War, and the Korean War in 1950, meant that defense spending did not significantly decrease after the end of World War II, and the Truman administration pressured the Fed to maintain low interest rates. In 1948 Truman, annoyed with Eccles' demands for stricter money, refused to reappoint him as chairman, Thomas B. McCabe was offered the job instead. The argument would continue, however. For the next three years, the Fed continued to acquiesce to Treasury's demands, though it issued louder complaints about the policy. The issue was resolved in 1951, when the President and the FOMC managed to strike a bargain, the Treasury-Federal Reserve Accord, in which the Treasury acceded to slightly higher interest rates and allowed the Fed more independence. William McChesney Martin, who presided over the meeting, was appointed Fed chairman in 1951. Interest rates climbed steadily over the course of the 1950's. Eisenhower's election in 1952 finally gave the Fed a free hand to handle the money supply; Republicans shared the FOMC's concerns about inflation and sound money.

In 1960, the Kennedy Administration cut taxes and increased spending to counteract a recession that began in April 1960 (six months after the Fed had

halted increases in the money supply—notably, Nixon partially blamed the Fed for his defeat). The "New Economics" of the Kennedy administration continued under Johnson. Federal spending increased to finance his Great Society programs and the war in Vietnam, without corresponding increases in taxes. From February 1961 to December 1969, the US experienced 106 months of uninterrupted growth, the longest period in its history. This was the age of "fine tuning" the economy; politicians and academics alike believed that they had finally beaten the boom-bust cycle, they could prevent recessions and control inflation and employment levels at will and with precision.

Keynesian economics calls not only for tax cuts and spending increases in time of recession, but also tax increases and spending cuts when the economy overheats. When all the slack is taken out of the labor market, and the economy begins operating above capacity, inflation is inevitable, and government must use fiscal policy to counteract it. But this side of the Keynesian theory proved much harder politically—indeed, impossible. A tax increase was passed in 1968 to finance the war, but it was too little too late. The New Economics was unraveling in the face of political realities. The Fed was pressured into following an accommodative policy, and inflation resulted—5% in 1968, 6% in 1969.

In 1969, the Fed finally acted to slow the growth of money and credit, and recession resulted. This time, however, inflation did not slow as unemployment rose. The unusual condition of rising unemployment and prices would be termed "stagflation." In August, 1971, with inflation still speeding along and an election year looming, Nixon announced price and wage controls and changes to the exchange rate regime. The post-War order created in Bretton Woods that had allowed stability in international trade by pegging the dollar to gold and foreign currencies to the dollar was done away with. The US had been paying out large sums of gold abroad for the better part of decade by this point, and the regime would have collapsed by default if the trend had continued. The dollar, and all major world currencies, would now "float" on international markets, their value changing daily.

In 1973, six months after Nixon dismantled the gold standard for good, the OPEC nations quadrupled the price of oil. At the time the move was blamed on greedy sheiks, but the dollar's devaluation was an important motivation. The dollar had lost a third of its value over the previous six years, with a corresponding decrease in the real value the OPEC nations received for their oil. So they increased the price and then some to account for future US inflation.

Nixon replaced Fed chairman William Martin with Arthur Burns in January, 1970. Nixon had been very clear with Burns about what he wanted: "lower interest rates and more money." Burns delivered, and eased credit conditions at the next Fed meeting just two weeks later. Burns' management of the money supply would come into question after Nixon's reelection in 1972. Nixon pumped up the economy with more spending that year, while keeping inflation in check with price controls. Burns' Fed grew the money supply at a monthly rate of 11% throughout 1972, compared with just 3% the year before.

Burns was accused of pumping up the economy to help Nixon win reelection. Despite vigorous denials by Burns and others at the Fed, Nixon had sent a clear message that he wanted easier money, and he got it.

Inflation reached 8.8% in 1973, and would eventually rise to about 12%. The Fed pushed up interest rates, causing the worst economic contraction since the Depression—the economy wouldn't begin recovery until March of 1975. President Carter replaced Burns with G. William Miller in 1978, and Volcker not long after.

PART THREE:
THE LIQUIDATION

Chapter 11: A Car With Two Drivers

On January 20, 1981, Ronald Reagan was inaugurated as the 40th President of the United States. In his inauguration speech, Reagan repeated the promises he had been making for the duration of his campaign: To cut taxes, reduce spending, tackle inflation, and increase productivity and employment. "In this present crisis," Reagan famously said, "government is not the solution to our problem; government is the problem."

Reagan's economic agenda brought back three strains of classical economic orthodoxy that had been out of fashion for some fifty years by the time he delivered his speech. Balanced budgets, sound money, and a reduction and flattening of the progressive income tax. Reagan brought economists from all three schools of thought into his administration, and left it to them to work out any conflicts. Reagan supported Volcker's tightening of money and credit to combat inflation. Yet Reagan also planned to stimulate the economy through tax cuts that would amount to over $100 billion per year. Reagan advocated balanced budgets, and recommended cuts in domestic spending to achieve them, but he also planned to increase defense spending by some $100 billion—more than the proposed cuts in other discretionary spending. This was a recipe for even larger deficits, which would push inflation up, not down.

Members of the administration argued vigorously over setting priorities. The economic forecast they would eventually produced was, by their own admission, an article of faith more than anything else. To achieve their forecasts of lower inflation, greater growth, and balanced budgets, they relied on assumptions of changes in economic behavior. Consumers and businesses would, if they considered the Administration's policy credible, change their expectations, and the inflation premium would disappear virtually overnight.

But the Fed chairman knew better. Even before Reagan was inaugurated, Volcker made speeches warning—in the circumspect and obscurant language typical of a Fed chairman—that significant pain lay ahead. If the administration was going to pursue an expansionist fiscal policy, then the entire burden of

curtailing inflation would fall on the Fed, and the result would be high interest rates for a longer time and, potentially, recession. Volcker understood very well that the inflation premium existed not only in people's minds, but in contracts enforceable by law. If the Fed restricted the nation's nominal GNP growth, and inflation persisted at double digit rates, the real growth of the economy would be low or even negative. The chairman's warnings were ignored by the press and most Washington decision makers. The Fed's independence meant that no coordination was necessary—nor was it desired. The executive branch and the Fed were free to pursue conflicting policies.

From January to March, 1981, the Fed eased up on interest rates a bit, allowing short-term rates to fall from 20% to 16% (still very high by historical standards). Long-term rates, however, went in the opposite direction. Bondholders were rattled by the Administration's expansionary economic policy and budget deficits, and skeptical that the Fed would hold the line against inflation. When numbers came in early April indicating rapid growth in M-1, bond prices took a tumble. Bondholders—a group made up of the nation's wealthiest individuals, corporations, and banks—were an important constituency for the Administration and the Fed as well. Bondholders and the Fed were kindred spirits—both focused on long-term stability and low inflation. The rise in long-term interest rates represented a critique of Fed policy, one that was given careful attention.

The bond markets were not the only ones criticizing the Fed. Members of the Reagan Administration blamed the Fed's lack of credibility for foiling the change in expectations their "rosy scenario" depended upon. Reagan summoned Volcker to the White House to speak to the chairman about the dangers of "zooming" the money supply. The talk was not quite the lecture it was reported to be by the press—Volcker certainly did not play the part of pupil to Reagan or his economic advisors—but nonetheless the White House's position was made clear: more tightening was needed. The Fed responded to the critiques, and by the end of April began tightening up again.

Though Volcker made promises of gradualism, the Fed stepped hard on the brakes. By the second week of May, the Federal Funds rate was above 18%. Alarmed by the sudden surge in M-1 during April, the Fed decided to lean towards the hard side. If it were to err, this time it would err on the side of too much tightening rather than too little. But there were good reasons to think that the Fed did, in fact, err.

April money numbers are always confused by the fact that Americans are drawing down on savings accounts to pay taxes, while at the same time the government is sending billions of dollars out in income tax returns. The Fed ignored other economic signals that pointed in the other direction—commercial banks were borrowing heavily at the discount window, and inflation had subsided from double digits to 7.2%. These and other indicators showed the Fed's previous six months of tight money were working, but the Fed largely ignored them in their analysis, and chose to focus on the money aggregates.

But another complication presented itself here, too. The Monetary Control Act of 1980 was coming into effect that April, and millions of Americans were transferring money into newly authorized NOW accounts—checking accounts that paid interest, blurring the lines between traditional savings and checking accounts. The Fed was unsure whether these accounts should be counted in the M-1 or M-2 aggregates. They came up with a NOW account-adjusted measure, M-1B, but in truth they did not know how much money was flowing into these accounts. Since October 1979 the Fed had opted for faithfully following the money aggregates. Now those aggregates were breaking down, and the Fed was refusing to change course for fear of sending inconsistent signals and embarrassing itself.

By July, 1981, the money supply had shrunk significantly, the Federal Funds rate rose above 19%, and the economy once again fell into recession. But the Fed was not as incompetent as it may have seemed. The Fed had made a political decision. The Administration, the bond markets, and the Fed's Advisory Council were all pushing for a harder policy. The Fed had been badly embarrassed by its premature easing of money in the 1980 rollercoaster, and this it time opted for a harder policy to shield itself from criticism and protect its own prerogatives. Considered on political terms, the Fed's decision made perfect sense.

During the summer of 1981, the Reagan Administration was trying to push its tax cuts through Congress. By this time, the President's economic advisors began to realize that the "rosy scenario" predicted in their first forecast would not materialize. Congress had whittled down the spending cuts to half the originally proposed figure of $40 billion, and the tax cuts were increased from $540 billion over five years to nearly $750 billion. On July 27, Reagan gave a televised speech saying that budget deficits would come down year after year, until a balanced budget was reached in just a few years. Even when Reagan gave this speech, his economic advisors knew better. Over the next five years, budget deficits would skyrocket, and the national debt would double.

Volcker and the Fed Board were alarmed by the tax cuts, another reason they chose to keep rates high through the summer of 1981. Many felt at the time, and in retrospect, that Volcker overreacted. The tax cuts would be phased in over several years, and their inflationary effects would not hit quite as strongly or quickly as Volcker and the Fed expected them to. Volcker and vice-chairman Schultz discreetly lobbied against the tax cut bill, but it passed with large majorities in both houses.

The combination of the tax and spending cuts along with high interest rates would prove to have highly regressive effects on income distribution. The tax cuts benefitted the wealthy far more than the middle and lower classes (some of whom actually lost money when spending cuts were factored in). As inflation subsided and nominal rates remained high, the real rate of return on financial assets reached record highs. During the summer of 1981, the real interest rate on bank loans peaked at over 9%. The rate on long-term bonds was double the

historical average. This had further regressive effects, since financial capital was already concentrated in the upper income brackets.

Chapter 12: That Old-Time Religion

The 1981-82 recession caused businesses all over America to lay off employees and close their doors. General Electric's sprawling Appliance Park manufacturing plant in Louisville, Kentucky, laid off a third of its workforce. This was the Federal Reserve's brutal remedy for inflation. High interest rates meant that consumers could no longer afford to buy homes, cars, or appliances. This would cause a cascading effect of job losses throughout the economic system. As businesses built up supplies, and people were put out of work, businesses would find that they could no longer increase their prices, causing inflation to subside.

But one sector of the economy was not struggling. The financial sector was, in fact, reaping record returns. Banks typically did well in recessions, at least over the short-term. As the economy declined and interest rates declined along with it, the banks would still be collecting payments on loans made back when interest rates were high. Meanwhile, they would finance these loans by borrowing newly cheaper funds in the money market. The largest banks benefitted the most from these mechanics, because they relied more heavily on managed-liabilities strategies (smaller banks relied mostly on deposits). If the recession went on long enough, the banks would inevitably suffer as well as they were forced to write off more bad loans. But in the short-term, the banks experienced record returns on their equity.

High US interest rates also had important implications for foreign exchange and export markets. Financial capital flowed into the US, seeking higher returns. This boosted the value of the dollar in international exchange markets, but depressed US exports and made imports relatively cheaper, costing domestic producers some of their market share. Once again, however, this was good for American financial firms. Higher demand for US financial assets meant their holders naturally took in higher profits. It is an interesting note that the Treasury Department actually has jurisdiction over setting US exchange rates. If Treasury told the Fed it had to adjust the exchange rate, the Fed had to listen. But the Reagan Administration was committed to a laissez-faire policy, and accordingly surrendered their one point of leverage over the Fed.

This wasn't the only element of Administration policy that lent the Fed more power. By the fall of 1981, it was very clear that the tax cuts would create huge federal deficits, deficits on a scale never seen before. For the Administration that had promised balanced budgets, this was a great embarrassment. Capitol Hill became obsessed with the idea of pulling back on the tax cuts and bringing some balance to the fiscal picture, an idea they would debate for five more years. Their preoccupation with deficits deflected criticism that may have otherwise fallen on the Fed, allowing the Fed some maneuverability.

By October 1981, inflation had fallen below 5%. The numbers heartened Administration officials, who took the opportunity to brag that their program was working. With the next Presidential election more than three years away, they were happy to take their lumps now and ride an improving economy to victory in the fall of 1984. Congressional leaders, however, were considerably more annoyed with the recession and the Fed's high interest policy. The Senate majority leader, Republican Howard Baker, called Volcker into his office numerous times to lecture him on the importance of bringing down rates. But the Fed would not give.

Volcker was waiting for wages to come down. Despite the recessionary conditions and moderation of inflation, labor leaders and businesses were still negotiating for generous cost of living clauses in their contracts. Volcker made several speeches urging them to forgo these adjustments, with little luck. But Volcker understood that wages would come down one way or another. The alternative to negotiated reductions was layoffs and liquidations which would inevitably increase the supply of labor and pressure wages downward. At its October 1981 meeting, the FOMC held steady on its tight money policy.

Throughout the 1970's and into the early 1980's, America's largest banks were lending aggressively to less-developed nations, or LDCs. By 1980 Brazil, Mexico, Argentina, South Korea, the Philippines, Taiwan and others had accumulated about $400 billion in debt to foreigners, 40% of which belonged to American banks. The aggressive lending brought the capital-to-asset ratios of these banks to below 5%. For a decade, the loans had brought on record levels of economic growth in the LDCs, in some case doubling their standard of living. These loans made sense when US inflation was high, and the LDCs could pay back their loans in cheapened dollars. But with interest rates at record highs, the loans became progressively more expensive. As these nations took on debt at an accelerating pace in the late 1970's, and the projects became increasingly questionable and their exports were squeezed by a depressed US economy, the risks of default grew. With the LDC loans making up some 10% of the top 24 American banks' business, the consequences of such an event could be disastrous.

The Federal Reserve understood the role its high interest rate policy played in increasing the risks of such an event. But it was committed to reducing inflation at home and could hardly back out of that mission now. The Fed did have their own country-risk analyses, and could have forestalled a crisis if they acted earlier and more forcefully. When asked why they did not, several Fed officials quoted in this book, including Volcker, cite political concerns. Said Governor Partee: "We're talking about the top fifty banks. They have extraordinary clout in the financial and business and political worlds… They'll go around the back doorways and complain to senators that the regulators are being too tough. It's like pulling teeth to go against them."

Just when the Fed was starting to earn the approval of the financial markets and the Administration with its tight money policies, a sudden surge in

the M-1 occurred. In December, the M-1 expanded by nearly 13%, and accelerated through the early months of 1982. It looked like the Fed was once again losing control of the money supply, as they had in the rollercoaster of 1980. In October, 1979, the Fed had pledged to follow the M-1 aggregate with automatic rigidity—if it went above targets, the Fed would tighten. The Fed's approach was finally starting to earn the confidence of financial markets—the Fed said M-1 mattered, and the financial markets trusted them. The markets watched the aggregates, and when M-1 started to grow, the markets bid up interest rates, anticipating tightening by the Fed.

Many in the Fed advocated ignoring the aggregates. For a number of reasons, including the recent invention of NOW accounts, the aggregates were not trustworthy. It was foolhardy to increase interest rates in the middle of a recession, they said. Volcker, however, remembering the mistake made in 1980, vowed to take the M-1 seriously this time. In February, the FOMC decided to "seek no further growth" in the M-1 which, effectively, meant tightening in the midst of the recession. By December, 1981, the Federal Funds rate had fallen to 12.5%, down from over 19% in July. Now, over the next few weeks, the Federal Funds rate was bid up to nearly 15%. The recession, which was forecasted to end by the Spring of 1982, would go on for many months beyond that, accompanied by a rise in unemployment throughout 1982 and the liquidation of thousands more businesses.

Chapter 13: Slaughter of The Innocents

The unemployment rate rose month after month during 1982, reaching a peak of 10.8%—the highest rate since the depression—in December of that year. The suffering was not doled out equally; the poor were the hardest hit. Blue collar jobs suffered much greater losses than service jobs, which continued to expand throughout the 1981-82 recession. Unemployment reached 23% in the automobile industry, 29% in steel and metals, 22% in construction, 19% in appliances and fabricated metal products. In many cases, the factories that shut down would never open their doors again. Employers moved their production facilities from the Northeast to the Southwest or even overseas in search of cheaper labor.

Meanwhile, holders of financial wealth benefitted greatly from the increased interest rates. Some said that this was only right, because the holders of wealth had seen their earnings eroded by inflation for so many years. It was their time to be made whole, and the debtor's to be punished. But such a sentiment reveals a strange societal value—that of placing dollar value rewards over the realities of human suffering. The top 10% of American families owned 86% of the country's financial wealth. When inflation was high, these wealthy families did not make their expected return. But, for the most part, savers were not put out of house and home, did not have difficulty feeding themselves or accessing proper medical care. But when businesses closed their doors and laid off workers, working class people suffered tremendously. A study of the 1974-75 recession by

Johns Hopkins University found that some 45,000 people died prematurely because of the hardships imposed by that recession. It is a sad fact that some people were quite literally dying for the sake of sound money.

The Federal Reserve Board Governors were not entirely insensitive to this pain, but they were convinced that their course was the right one—that even those who were now suffering would benefit from the curbing of inflation in the long-run. The Fed has been accused of taking a patriarchal stance, of imposing punishment on a misbehaving nation through tight money. Volcker played the role of aloof disciplinarian wonderfully, and was widely praised by his colleagues for his "guts." Volcker agreed to give an address to the 1982 convention of the National Association of Home Builders—and unfriendly audience if there ever was one. Volcker refused to give ground or apologize for the Fed's policies, and received a standing ovation in return for his honesty.

Nancy Teeters, perhaps not coincidentally the only woman on the Board of Governors, was the only one who resisted Volcker's consensus. Again and again she voted against Volcker, and emphasized the human suffering they were imposing in real terms. Her colleagues did not appreciate the reminders, and stuck to discussing technical issues. Here Greider goes into a discussion of why this may be, focusing on differences in the socialization of girls and boys. Boys traditionally tend to focus on defining and applying rules, whereas girls are more likely to build consensus and form compromises, and are much more willing to abandon rigid enforcement of rules or even change the game entirely if there is a danger of fracturing relationships. Greider quotes a number of studies to support his analysis.

Congress was also becoming increasingly unhappy with the Fed's policies, and Senator Byrd even introduced legislation to curb the Fed's independence. The legislation would have forced the Fed to focus on interest rates, abandoning Volcker's monetarist approach, and keep them near historic norms. Volcker was not cowed. The White House was divided, and distracted by a focus on bringing down deficits. They were working with Congressional leaders on a tax measure that would raise some $100 billion in more revenue over the next five years—its passage was highly uncertain.

Though Volcker held the line in front of Congress and the Administration, within the Fed there was considerable disagreement. Fed economists had been predicting that a recovery was around the corner, but it failed to materialize again and again. In searching for the reasons why, many Governors were finding new reasons to question the monetarist operating system. When setting targets for the growth of M-1, the Fed formed theories about the level of economic activity those levels of M-1 growth would support. Those theories depended on the velocity of money—how many times an individual dollar turned over in a period of time. If a dollar changed hands six times in a year, that dollar added $6 to nominal GNP.

In the face of financial uncertainty brought on by recession, individuals were holding on to money for longer—reducing the velocity of money. Under

these circumstances, the M-1 aggregate failed to provide accurate predictions of economic activity. Because velocity levels were lower than what the Fed had assumed, they were in fact keeping money much tighter than they had thought. This is why the surge in M-1 in late 1981 produced no appreciable economic growth. Many within the Fed began to question the usefulness of the monetarist approach, and began advocating for once again targeting interest rates. But Volcker would not budge. The monetarist approach provided useful political cover—its complexity and seemingly automatic rigidity blunted criticism from Capitol Hill, and gave the Fed credibility with Wall Street. If Volcker announced they were backing off from M-1 now, he would lose that credibility. Volcker was not ready to ease the money supply yet. If he abandoned M-1, it would mean taking full responsibility for high interest rates and the ruinous economic conditions they imposed. Targeting M-1 meant Volcker could say he was only targeting money supply, interest rates were set by "market forces." Few on the Hill were savvy enough to challenge the Fed Chairman.

A developing financial crisis in Mexico and the collapse of a bond dealer had rattled financial markets and the political establishment. The Fed stepped into to reassure markets. It set up a series of currency swaps with Mexico to get them through the summer until they could approach the IMF (after their presidential election in July), and boosted liquidity in the bond market with its own open market operations. But these events, and the deteriorating balance sheets of corporations across the nation and even of sovereign nations, convinced many people that perhaps it was time to finally ease up. At the FOMC's May, 1982 meeting, Volcker disagreed. Once again invoking the need to preserve the Fed's credibility, the FOMC voted with Volcker to keep monetary policy the same—neither tightening nor easing. Again, only Teeters dissented.

Chapter 14: The Turn

In June of 1982 Penn Square Bank, a small bank located in a shopping center in Oklahoma City, was visited by bank examiners from the Kansas City Federal Reserve. What they found there disturbed them. Penn Square made loans to oil prospectors, and the examiners found that it had used loose standards and generous assumptions when making these loans. Many of the loans were reckless and in some cases even fraudulent. More worrying, however, was the size of the loans. Penn Square carried $500 million in deposits, but carried $2 billion in loans. They did this by making the loans and then selling them upstream to larger banks. Continental Illinois, the seventh largest bank in the nation, owned $1 billion worth of these loans, and other large money-center banks, including Citibank, were on the hook for several hundred million dollars more.

Worried that Penn Square's collapse could send a shockwave through the financial system, the chairman of the FDIC, the Comptroller of the Currency, and Volcker gathered to decide its fate. Volcker and the Comptroller wanted to avert a failure and arrange a merger or other scheme to keep Penn Square open. The

chairman of the FDIC, William Isaac, wanted to close it down, pay off depositors up to $100,000, and teach the financial system a lesson. The three regulators left it up to Treasury Secretary Regan to settle the issue (this was not necessary but a matter of courtesy, as they recognized the Administration would be on the hook for the political fallout). Regan sided with Isaac. Fortunately, the effects on the financial system at large would not be quite as bad as Volcker and the Comptroller had worried, at least not in the short-term. Nine months later Seattle First, which had taken on much of the loan participations, nearly went under and had to be bought by Bank of America. Two years later, Continental Illinois would collapse and be taken over by the government.

Penn Square's failure had a far larger impact than any of individual events may indicate. On June 30, the FOMC met in the midst of the Penn Square turmoil. It was at this meeting that the Fed would finally turn its monetary policy around. All its primary responsibilities—caretaker of the financial system, lender of last resort for the domestic and global economy, and manager of the money supply—seemed to point in one direction: easing the money supply. The financial system looked shaky, Mexico was going broke and the LDC debt crisis was clearly nearing a nasty turning point, and the long-predicted economic turnaround failed to materialize—in fact the economic numbers kept getting worse.

A majority of the Governors argued strenuously for easing the money supply. Volcker agreed with them, although for his own reasons he made it look as if he was being dragged by his colleagues. In fact he himself had changed his mind. It was on July 1, 1982, that the Fed finally abandoned the monetarist approach and started to ease credit conditions. Inflation had fallen from a peak of 13% to less than 4%. Interestingly, M-1 growth had been exceeding targets for the previous six months, and some within and outside the Fed advocated for still more tightening. But Volcker was finally convinced it was time to change. He had kept short-term rates higher than long-term rates for over two years, an unprecedented action. Three weeks after the July meeting, a more normal term structure would take hold.

For months, the Fed had been making the counterintuitive argument to Congress and the Administration that if they eased the money supply, interest rates would in fact increase as financial markets bid up interest rates in anticipation of higher inflation. The argument absolved the Fed from blame for punishing interest rates. In the event, when the Fed finally did ease, just the opposite occurred. The Federal Funds rate, 12.6% in July, dropped to 9% by the end of 1982. The Fed cut the discount rate seven times during this period. All other interest rates followed in step—including, importantly, long-term rates. Volcker's fear had been that the bond markets would bid up long-term rates in anticipation of future inflation. This would indicate that the easing had been a failure, that he moved too soon. Much to the relief of him and others, long-term rates came down. The bond markets rallied, as did the equity markets. On

August 17, the Dow Jones index saw the largest one-day jump in its history. This began a six month rally that would raise stock prices 50%.

The Fed's shift effectively ended all political pressure. On August 3, Senator Robert Byrd introduced the measure he had been threatening the Fed with for months, the Balanced Monetary Policy Act of 1982. The Act would have effectively eliminated the Fed's independence by forcing it to reduce interest rates immediately and keep them near historic averages. But once Byrd saw rates coming down, he told Volcker he would not push the measure. Also in August, the Congress finally took action on deficits by passing a moderate tax increase. After interest rates started to come down, both sides declared victory. Byrd said his "shot across the bow" turned the Fed, while the Administration said the tax increase finally gave the Fed the room it needed to relax interest rates. In reality, neither was true. Volcker decided to take action before Byrd's legislation was introduced, and before the tax bill was sure to pass.

That same month, the Mexican debt crisis came to a head. Over the previous several months, the Fed had made a number of loans to Mexico. But now it seemed Mexico was finally going to go broke; its reserves had dwindled to less than $200 million, and capital was fleeing the country at a rate of $100 million a day. If Mexico defaulted on its $80 billion in debt, the US financial system would enter a serious crisis. Over the weekend starting August 13, Volcker organized $3.5 billion in new loans to Mexico. Mexico's private creditors agreed to a refinancing. Crisis in Mexico was averted for the time being, but this marked the beginning of the international debt crisis. Over the next several years, one developing nation after another would be faced with a similar situation, and be forced to accept punishing austerity by the IMF. Though the Fed would play an important part in resolving these many crises, it is true that the Fed itself had played a major role in instigating them. By keeping interest rates so high for so long, the Fed increased the cost of borrowing for these nations while at the same time depressing their export earnings.

Continental Illinois, the nation's seventh largest bank, had made irresponsible loans to Penn Square and many others. Under the management of CEO Roger Anderson, Continental Illinois followed an aggressive loan expansion policy. In late 1982, in the wake of the Penn Square crisis, Volcker became increasingly concerned about the quality of Continental's loan portfolio, and its management. It was clear that Continental would soon be in dire straits. Volcker recommended to Continental's board that it suspend dividends, change its management, and work to improve the quality of its loan portfolio. The board would do no such thing, and in 1984 Continental became the nation's largest bank ever to fail.

This episode is very revealing. The Fed in fact had the power to impose strict discipline on its member banks—it could issue cease-and-desist orders to stop dividends or change management, or cut Continental off from discount lending. Volcker refused to use any of the tools available to him, and instead chose to restrict himself to pleading with Continental's board in private. The Fed

was responsible for the soundness of the financial system, and dependent on financial institutions and banks for political support. In reality, the Fed could not credibly threaten to cut off discount lending to a troubled bank.

And not only was the Fed unable to punish severely on the downside, it also couldn't slow down banks on the upside. The problem began when Continental was making huge and irresponsible loans to oil and gas companies in the 1970's—but how could the Fed discourage this type of activity when business was good and the banks were making huge profits off these types of loans? The Fed seemed much less powerful, and more much political, than it portrayed itself to be.

The Fed was given independent control of the nation's money supply because it was thought that politicians would be unable to restrain themselves—they would pump up the money supply irresponsibly, just like they continuously voted to cut taxes and increase spending, creating huge deficits. An independent Central Bank would handle the money supply much more responsibly. But we have seen how the Fed itself has political motivations and constraints, just as elected politicians do. Furthermore, the Fed makes mistakes. The contraction of 1981-82 was much deeper and lasted much longer than the Fed ever thought it would or intended it to. It consistently undershot its growth targets and estimates throughout the year. The result was human suffering on a massive scale.

In the end pages of this chapter, Greider makes the suggestion that perhaps this governing arrangement is fundamentally flawed. Perhaps the Federal Reserve and the Congress should not be allowed to act independently of one another, without having to take consideration of what the other is doing. And if the Fed is going to be able to impose punishment on the national economy to the extent that it did in 1981-82—and presumably it could go further—then perhaps the Federal Reserve should be brought into the Treasury Department, so elected officials can be held accountable for the Fed's conduct and interest rate levels.

PART FOUR:
THE RESTORATION OF CAPITAL

Chapter 15: A Game of Chicken

Volcker finally abandoned the monetarist approach at the FOMC's October, 1982 meeting. Volcker took the unusual step of speaking before his colleagues, and outlined his worries regarding the debt crises in Latin America and the implications for the financial system and domestic economy. The FOMC agreed with Volcker and voted 9-3 to expand the money supply and lower interest rates. If the Fed was to follow the M-1 numbers faithfully, they would have raised rates—something Volcker was not willing to do in the face of the difficulties outlined above. Of course, Volcker did not announce the change in operating method outright, but described the shift as a temporary one, due to technical difficulties regarding the M-1 measure arising from Super-NOW accounts. The financial markets got the message, though, and the shift resulted in huge rallies in bond and equity markets.

Despite President Reagan's previous complaints about the Fed "zooming the money supply," this time he didn't complain. Once the market rallies took hold, the White House declared victory, claiming their policies had finally succeeded in improving public confidence. Many in the Administration knew better, and learned to disregard the complaints of their monetarist colleagues. The Fed cut the discount rate seven times in the last five months of 1982, all the way down to 8.5% by December. The rate would stay there for the next 15 months.

By January, 1983, the IMF and the Fed were forming "work out" plans for the dozen or so developing countries—mostly in Latin America—that needed debt relief. Each of these countries took loans of several billions dollars from the IMF and private banks so they could continue to make interest payments. Meanwhile, the principal of their loans was rolled over. In return, the countries agreed to harsh austerity terms imposed by the IMF. Volcker played an important role in forging the agreements and getting American banks to go along. The austerity hurt the standard of living not only in Latin America, but also in the American Midwest, where farmers found themselves unable to export their product to Latin America. The indebted nations had to drastically cut down on imports in order to build up the foreign reserves necessary to make their interest payments. In effect, Midwestern farmers, American taxpayers, and the citizens of Latin American nations were asked to pay the price of Wall Street's recklessness. And Volcker ensured that they did—part of his duty to protect the American financial system.

The Fed's actions fundamentally reversed the conditions that had prevailed in the American economy for much of the previous decade. The power shifted from borrowers to lenders. Inflation was down, nominal interest rates were high. High real interest rates meant that financial assets were profitable,

and real assets were not. All across America farmers folded, caught between falling land and crop prices and increasing real debt burdens. Millions of Americans were paying outrageous interest rates on mortgages they accepted in times of double-digit inflation. But much of America was not aware of this reversal. They were distracted by the good economic news—in early 1983, the economic recovery started to look like it had legs. Unemployment started to fall in March, and would continue to decline for the next several years. President Reagan's approval ratings—and his chances for reelection—improved dramatically.

Volcker's stature improved, too. Among elite opinion makers, Volcker was considered a brave man who had done a nasty and difficult job. He had succeeded in taming inflation, and enjoyed support from the financial sector and even Congress. The White House, however, was much less fond of the Fed chairman. They blamed him for bringing the nation deeper into recession than they thought necessary, and swore not to reappoint Volcker when his term was up in August of that year.

The Administration's fiscal policy and the Fed's monetary policy would also continue to be in conflict. Though interest rates were much lower than they had been, they were still much higher than the historical norm. Volcker told the White House that deficits had to come down before interest rates could, while the White House warned Volcker not to get in the way of the economic recovery. Thus they were in a game of chicken, and it would have to be seen who would blink first. Judging from the past, many expected that it would be the Fed. The Fed, aside from managing inflation, had a duty to assist the executive branch in its borrowing of money. The United States' creditworthiness must be maintained, its bonds must be sold. Historically, the Fed had assisted in this task by ensuring that enough money was in the hands of the people to absorb the bond offerings—expanding the money supply. Thus deficits exerted a subtle pressure on the Federal Reserve to follow an accommodative monetary policy and, historically, high deficits had usually been followed by run-ups in inflation.

Volcker, though, was determined not to let inflation take over once again. He followed an alternative strategy—keeping interest rates high in the face of economic recovery, high enough to attract the foreign capital necessary for the United States to sell its debt paper. This allowed the Fed to fulfill its obligation while keeping a lid on inflation. Though nominal interest rates were coming down, inflation was coming down even faster, so real interest rates actually increased modestly in 1983. This kept foreign capital flowing in, and produced record returns in the bond markets.

Though no member of the FOMC would ever admit so explicitly, in the trade-off between higher unemployment or higher inflation, the high interest rate policy implied a choice in favor of higher unemployment. Volcker, and other Fed governors, believed that in the past the Fed had made the mistake of letting money be too loose in the early parts of an expansion. This time around, Volcker was determined not to make the same mistake, and so made the deliberate choice

to keep the brakes on. In fact, in the FOMC's May 1983 meeting, the Committee voted to tighten modestly. The Fed funds rate increased by a full percentage point over the following two months. The vote was unusually contentious, Volcker won with only a 7 to 5 majority. Many Fed governors felt that the recovery was not yet strong enough, and warned that a tightening could reverse the progress made over the previous six months. Housing and other interest rate sectors did in fact experience a reduction in their growth rates following the May rate increase, but these governors, and Volcker, underestimated the recovery. In the second quarter of 1983, the economy grew by 9%. This was far above expectations, and enough to trample over the Fed's modest dampening.

Chapter 16: Winners and Losers

In April, 1983, an article was published in the Washington *Times* that claimed President Reagan was planning to replace Volcker once his four-year term as Fed chairman was up in August. Many Administration officials, frustrated by what they considered to be Volcker's prolonging of the recession and his refusal to be a team player, were adamantly against Volcker. So, too, were many small business organizations and other interests. Wall Street, however, was on Volcker's side. The financial world lobbied hard for Volcker's reappointment—he was endorsed by the US Chamber of Commerce, the Business Council, the *Wall Street Journal*, thousands of individual bankers, and more. On June 18, 1983, Reagan announced Volcker's reappointment. The lobbying from the financial world was an important factor, but the Reagan White House also assured themselves that Volcker would play ball. In private meetings at the White House, Volcker satisfied Administration officials that he would not screw up the economic recovery during an election year. Additionally, Volcker said that he would consider resigning halfway through his next term—in 1985 or 1986—so Reagan could appoint a new chairman. These discussions meant more to the Administration than to Volcker, but they were satisfied enough to reappoint him.

Meanwhile, the economic recovery was picking up speed. Industrial production, durable goods orders, manufacturing employment, retail, auto, and home sales, were all up. Consumer confidence was approaching its highest level in a decade. Administration officials boasted about the victory of their supply-side economic policies, but the reality pointed to a different conclusion. This recovery was as Keynesian as any other. Massive tax cuts and corresponding federal deficits put more money in people's pockets, which increased their consumption. Administration officials had predicted that this money would be saved and invested in new productive capacity, but in fact the savings rate declined. Demand side stimulus and lowered interest rates had driven the recovery.

The Reagan recovery did differ from other recoveries in one important respect, however. In this recovery, the progressive distribution of income was being turned on its head. The largest gains were going to the top fifth of the

income distribution, and many in the lower brackets were actually losing ground. Across the board tax cuts, increased defense spending, decreased entitlement spending, all pushed income in the same direction: upward. High real interest rates did the same, as most of the wealth was concentrated in the upper brackets. The portion of US income coming from wages and salaries decreased from the historical norm of two-thirds to just below 60%. Personal income derived from interest grew by 70% from 1979 to 1983, while income derived from wages grew by 33% in the same period. This fact was largely absent from the political conversation, however. The joy of economic recovery overshadowed issues of fairness.

For the first time in many years, real interest rates exceeded the real growth rate of the US economy. When a creditor is guaranteed a return for the use of his capital that is higher than the return that the capital actually produces, the borrower must swallow the loss. If this condition persists, the borrower falls steadily behind until the rentier comes to own his assets; the wealth flows upward. Back in the 1930's, Marriner Eccles had understood that a more equitable distribution of wealth improved the health of the economy. As Governor Partee explained: "There's been quite a lot of redistribution of income toward the higher income groups, and that saps the aggregate demand for the economy. It requires consumers to accumulate more and more debt in order to keep spending." Partee, other Fed Governors, and some Congressmen were concerned about the growing disparity of wealth, but did little to change it.

From mid-1983 to mid-1984, the unemployment rate dropped nearly three percentage points, from over 10% to just above 7%, as the economy added nearly five million jobs. But this rapid expansion was concentrated in the service sector—from high paying finance jobs to lowly work in data processing or food service. High paying union jobs in the industrial sector began to disappear. Union workers were laid off in large numbers, or forced to accept wage cuts or freezes. Reagan's tax plan incentivized spending on capital-intensive rather than labor-intensive projects—computers and buildings rather than workers. Union membership declined from 20 million to 17.4 million from 1979 to 1984, plants closed, and this sector would never truly recover.

Another transformation of the American economy took place in the mortgage market. Mortgage rates were running at 12%, 16%, or higher, even in the face of inflation running below 4%. Many people were priced out of the market, and those who bought were forced to make sacrifices in other areas—a smaller car, less square footage. And these homeowners could no longer count on accumulating wealth in their homes. Housing prices were increasing at a slower rate than general inflation, so in many cases the homeowner was unable to increase their equity, instead it was shrinking. Mortgage foreclosures, in contrast to the normal pattern of a recovery, increased to record levels. The primary tool for realizing the American dream was slipping away.

Manufacturing was hurt not only through tax incentives, but also by a strong dollar. Though the Fed's monetary policy was relatively more

accommodative than it had been in 1981-82, real interest rates were still at historically high levels, and far higher than the prevailing rates in foreign countries. Foreign money, seeking higher returns, flowed into the United States, and pushing the dollar higher. Between 1979 and 1983, the dollar appreciated by more than 50%, on average. Exporters were damaged severely, and many went out of business or moved their operations overseas. The higher level of competition meant that manufacturers could not raise their prices or their workers' wages if they wanted to hold on to their market share. A similar plight affected America's farmers, who were priced out of their Latin American markets (these countries were also cutting down on imports in an attempt to deal with their debt burdens, as noted last chapter). While the service and financial sectors of the economy were experiencing economic booms, the US manufacturing sector was facing deflation, cutbacks, and layoffs.

This was the result of a deliberate choice made by the Fed to keep interest rates high. Though Volcker and other governors expressed concern over the damage being done to America's exporters, they felt that their hands were tied. Large budget deficits meant that the Fed could not ease, to do so would risk bringing on inflation once again. The White House, too, made the choice not to act. Manufacturing CEOs across the country lobbied for a tariff on Japanese imports, and were roundly rejected. The manufacturing sector did not have the political clout it used to, and a Reagan White House that had spent years espousing laissez-faire attitudes was unwilling to take such an action.

The Fed, far from thinking about a more expansionary policy, was considering tightening once again. The FOMC had planned for real economic growth of 3.5-4.5%, but the real number came in at 6.3%. Monetary policy looked tight, interest rates were high, but the economy was booming far beyond expectations. The answer was party explained by an increase in money velocity—the money increases that had taken place over the previous months was feeding more transactions than planned for, and now the Fed had to consider whether or not to put on the brakes.

Chapter 17: "Morning Again in America"

During the 1984 campaign, the two major American political parties played a strange game of role reversal. The Democrats, still bearing the scar of stagflation and the Carter years, abandoned their old message of rapid growth, low interest rates, full employment, and active government management of the economy. Instead, they espoused a message of fiscal prudence—higher taxes, spending cuts, and a return to balanced budgets. They stuck by the Federal Reserve, buying Volcker's line that only reduced deficits would bring down interest rates.

The Republicans, though they kept up the rhetoric of responsibility, ran the highest peacetime budget deficits in history. Republicans had long warned that a stimulative fiscal policy inevitably led to inflation—this time around they didn't seem to mind. And, fearful that Volcker might step on the breaks and

disrupt the recovery in an election year, the Republicans turned to Fed bashing. Jack Kemp introduced a bill to place the Treasury Secretary back on the FOMC. The bill never advanced, but was occasionally used to threaten the Fed in case it did anything to disturb the recovery.

And that is just what the Fed was planning to do. The FOMC did not take any actions during their January 1984 meeting, but between that meeting and the next one, in March, the economic news startled the Governors and the bond markets. Housing starts hit their post-1978 peak, auto sales were up 33% over last year, spending on new plants and equipment was estimated to increase an incredible 13.6%. The numbers pleased Reagan and the Republicans, but the bond markets took them as a sign that inflation was coming. The old hands on the FOMC, who had seen the disasters wrought by the double digit inflation of the 1970's, were also worried by the economic news. Lyle Gramley and Henry Wallich argued for vigorous action to slow down the recovery before inflation took hold once more. Only the vice chairman, Preston Martin, argued for the opposite line. Martin, a businessman with considerable experience in finance and the only Reagan appointee on the FOMC, believed that the recovery was already on its way to slowing down, and that the Fed ought to be considering easing, not tightening. The other governors dismissed Martin's analyses as unscientific, poorly thought through, and politically motivated. Volcker leaned towards the hawks—though not as far as they would have liked—and in March the FOMC voted to increase the Federal Funds rate target by 1-1.5%. Gramley and Wallich dissented, saying stronger action was needed. Martin dissented from the other direction.

In the event, Martin would be right. The reaction came swiftly. Mortgage rates increased, auto sales declined, unemployment flattened out and then ticked up slightly. The recovery would never assume its previous momentum. It is important to take note of the nature of this choice. The unelected members of the FOMC made the deliberate decision to benefit one segment of society at the expense of another. They removed a risk that affected their prerogatives and their natural constituencies—the bond markets and the bankers—and pushed the cost of doing so on to the backs of workers and the real economy. They reassured the financial markets, but thousands of average Americans lost income or even their jobs.

Neither the White House nor Congress were brought in on this decision—in fact the Fed did exactly the opposite of what the White House wanted: tightened in an election year. Members of the Reagan Administration lashed out at the Fed in the press, but were soon beat back themselves by financiers who supported the Fed's move. The Fed would not tighten further, but their caution was not due to heat from Administration officials. In the summer of 1984 the nation's seventh largest bank, Continental Illinois, was on the verge of failure.

On May 9, an erroneous news report surfaced in Japan, saying that a Japanese bank may acquire Continental Illinois. The report sparked an electronic run on Continental. That day, $1 billion of Asian money was pulled out of the

bank. The same thing happened in Europe the next day. Realizing the failure of Continental might mean a full blown banking panic, Volcker, the Comptroller of the Currency, and the FDIC chairman arranged a bailout of the bank. When billions of dollars in emergency loans from both the Fed and a consortium of private banks failed to stem the tide of withdrawals, and no private buyer could be found, the Federal Government finally purchased Continental for $5.5 billion.

The bailout—a government rescue of an irresponsible bank—failed to arouse the anger of the conservative Reagan government. Only a few Congressmen spoke out against the action. Unlike in the Penn Square Bank incident, this time regulators did not even dream of letting Continental fail and only bailing out depositors up to $100,000. Doing so may very well have created a worldwide panic. Though that claim has credibility, the contrasting treatments of large and small banks had consequences. Large depositors realized that it was much safer to place their deposits with a large bank that would be bailed out in the case of a financial panic, rather than a smaller bank that might be allowed to fail. Over time, smaller banks would suffer a competitive disadvantage because of this practice. As smaller banks failed—were allowed to fail—they were bought up by larger banks. This was yet one more factor contributing to the consolidation of the banking system.

Continental Illinois was not the only bank having troubles. Loan losses in 1984 were double 1981 levels. The ratio of nonperforming loans to total assets was 3-4%, twice the expected level of 1-1.5% typical of an economic recovery. After the collapse of Continental Illinois, the financial markets became panicky. The spread between three month bank CDs and Treasury bills grew from 35 to 160 basis points. Any bank perceived as troubled could see billions withdrawn overnight as investors fled to safer banks. The Fed would then have to step in with emergency loans. And the Fed was, in an indirect way, at fault for shaky banks. Banks made some irresponsible loans, but the true cause of their troubles was the customer. The Fed had pushed interest rates to record levels in 1980-81, and the rolling liquidation that had swept through manufacturing, farmers, and Latin American nations was finally reaching the banks.

But the Fed seemed to have much more sympathy and patience for the lender than the borrower. Defaulting farmers were written off as a necessary consequence of the process of deflation. Troubled bankers were given emergency loans, and leniency when it came to writing off bad loans. During the panic immediately following Continental's failure, the FOMC sent out directives to its supervisory departments, telling bank examiners to be lenient. Only later would the Comptroller of the Currency impose harsher capital requirements and order certain banks to improve their loan portfolios.

The panic spreading through world financial markets had important consequences for monetary policy. If a bank was seen borrowing at the discount window too often, it may be perceived as weak, inviting a run by its depositors. So, in the months following Continental's collapse, nervous bank managers hoarded reserves and curtailed their borrowing. Discount lending dropped to

half its expected level. Normally, discount lending is a leading indicator of credit conditions. If lending was up, money was tight. If lending was down, money was easy and available. Now these signals were confused. The FOMC could not tell if the fall in discount lending was a reaction to real economic circumstances (the money supply was ample) or an extraordinary event caused by panicky banks.

Reserves are provided to the banking system through the discount window and open market operations. When one valve clogs, the other must be opened up wider. Thus, the Fed ended up tightening far more than it had anticipated. That summer, the Federal funds rate jumped 1-1.5%. Real interest rates hit a record level of 9.6%, the highest level since Volcker took office in 1979. The M-1, which grew by 11% in June, fell 1% in July. Unemployment crept upwards to 7.5%, and growth fell to 2.1% in the fall quarter. This was the end of the Reagan recovery.

When the FOMC met in August of 1984, the majority voted for no change in monetary policy. They still believed the economy was going strong; they refused to believe the fall in discount lending was due to extraordinary circumstances. Volcker, though, was becoming very concerned about the money supply. In an unusual move, Volcker directed the open market desk in New York to begin easing anyway. He interpreted the FOMC directive as liberally as possible, and the Fed funds rate fell by roughly 1% over the next month or two. Volcker's colleagues complained, but Volcker disregarded their "bitching." Volcker felt he had to act quickly because of the approaching election—he believed the Fed had to ease, but any move between labor day and the election would look politically motivated. He had a short window in which to make a change, and he took it.

Though the Reagan recovery was coming to an end, Reagan seemed to take no notice. Neither did the American people. That summer and fall Reagan campaigned around the nation proclaiming America's strength—militarily, economically; American industry was a "giant re-emergent on the scene." "It's morning again in America," one of his television commercials proclaimed. The people were indeed feeling better. Inflation was down, unemployment was down, and disposable income was up. A renewed spirit of nationalism took hold. But this fuzzy feeling masked a decimated manufacturing sector, and the plight of the farmer. Reagan boasted about the strong dollar, never mentioning that this was due to real interest rates being at record levels, that it hurt America's exporters, and ceded a growing share of world trade to foreign nations. These concerns were washed away by patriotic fervor. The majority of Americans did indeed feel better than they felt four years ago.

Reagan won the 1984 election in an historic landslide. Volcker's concerns about the political consequences were overridden by his concerns about the slowing economy, and so the FOMC voted to ease rates in October. By election day, the Federal Funds rate was 9.7%, about two points down since August.

Volcker won his battle against inflation, but the costs were high. In 1984, the quarterly growth numbers were 11.4%, 5.1%, 2.1%, and then 0.6%—close to

recession. Clearly the Fed had braked too hard. Inflation subsided, but the consequences for jobs, production, agriculture, industrial development, home ownership, and the distribution of income were severe. The strong dollar forced American companies to move production overseas, taking jobs with them. American farmers lost their export markets in Latin America. homeownership declined for the first time in over 40 years, despite the coming to age of the baby-boomers, who should have been purchasing their first homes. Robert O. Anderson, chairman of the Atlantic Richfield oil company and former chairman of the Dallas Fed, called the Reagan recovery "a white-collar recovery." The services and financial sectors received the greatest benefits, creating a new class of consumers referred to in the press as the "Yuppies." The bottom 40% of the income distribution actually lost ground during the Reagan recovery, to the tune of $477 per family, or 3% of their incomes. The top 10% enjoyed gains of $5,085 per family, an increase of 7%.

Much of this destruction was wrought by high interest rates and a soaring dollar—but the Fed disclaimed any responsibility. Time and again, Federal Reserve officials would point to high deficits as the cause of high interest rates. This is a stretch. High interest rates and breaking the recovery were choices made by the FOMC. The choices were not inevitable, nor unavoidable. Lower interest rates could have been pursued for a longer period, the Fed could have stepped more lightly on the breaks and likely still have kept inflation under control. Did the Fed truly mean to bring the recovery to a halt?

Another irony of Volcker's war against inflation was that it undermined some of the Fed's other duties. The Fed is charged with regulating the expansion of credit—ensuring it is adequate to allow economic growth but doesn't outpace the economy's productive capacity, or its ability to repay the debt. But under Volcker's tenure, private businesses, consumers, and the government all took on new debt at a rate that far outpaced economic growth. It was a strange conundrum—interest rates were at historic highs, monetary policy was tighter than it had ever been by this measure, and yet the huge growth in borrowing seemed to say that interest rates were still not high enough.

This was the result not just of Congress's choice to outlaw interest rate limits, but also the Fed's high interest rate policy. In previous expansions money flowed away from financial intermediaries once interest rates reached their legal limits. As depositors took their money elsewhere, banks and S&Ls were forced to curtail their lending. This moderated the expansion of debt in the economy. If the Fed wanted to slow lending, it could push rates up closer to their ceilings, and shrink the supply of credit. In 1980, these ceilings were abolished, and lenders were free to charge whatever the market would bear. The limit was determined by how optimistic borrowers and lenders were about the future. They were free to be overoptimistic, even irresponsible. The Fed was left with only one lever to restrain the expansion of credit—bringing interest rates higher than they had ever been before. It was a blunt instrument, one that worked ultimately by bankrupting the customer.

But the Fed's high interest rates actually had the strange effect of incentivizing many types of borrowing. High interest rates drove up the price of financial assets at the expense of real assets, and encouraged borrowing to speculate on financial assets. Unlike speculation on real assets, however, financial speculation did not have the side effect of stimulating real production. No homes were built, oil drilled, or crops harvested. The only byproduct was more paper. The increased return of financial assets caused by high interest rates also incentivized the frenzy of corporate takeovers and leveraged buyouts that began in 1980's. When financial assets offered higher returns than real assets, naturally it made sense to sell off the real assets and invest in financial assets.

The conquering of inflation and high rates also meant that some borrowers were caught in the middle, forced to borrow to pay off their old loans, in effect digging themselves into a deeper hole. The Latin American debt crisis was a classic example. Though the exposure of American banks to these countries fell, between 1980 and 1984 the real debt burden of these countries actually increased. The same logic applied to many American farmers, consumers, and businesses. And, though Volcker claimed that high rates were a consequence of federal deficits, some part of those deficits was caused by the high rates. A depressed economy meant less tax revenue, and higher rates meant higher interest payments.

Perhaps the solution was to reimpose ceilings on interest rates, and some—including many investment bankers—advocated for this. But the political culture had shifted in favor of free markets, laissez-faire economic policy. No one in the press or Congress seriously considered this option.

Chapter 18: The Triumph of Money

The Reagan recovery and the American economy of the 1980's demonstrated that the idea of a stable, neutral, dollar value is, in truth, an illusion. It is a statistical abstraction that masks the fact a stable average price level means some prices must fall while others rise. While some sectors of the economy experienced steady price and wage growth, other sectors experienced crippling deflation. In effect, the white collar worker made gains at the expense of the farmer, the union worker, the laborer. The service sector saw steady inflation—as high as 6-7% in some cases—while the agricultural, commodity, real estate, and manufacturing sectors experienced falling prices and cutbacks. This reality, in effect a two-tiered recovery, a two-tiered economy, was unacknowledged by some, applauded by others. For inflation to come down, "there must be losers," as E.F. Hutton explained to its clients. Some pain was necessary for the greater good of the economy—of course, the people holding this view were usually beneficiaries of the Fed's hard money policy.

Greider reminds us again that this is a choice. The Fed placed stable money, low inflation, ahead of other goals. Ahead of full employment, or faster growth. The Fed prioritized certain sectors of the economy over others. It did not have to make the choices it made, did not have to set the priorities it did. Fed

governors may pretend that they are merely technocrats, doing what must be done, what is best for the economy. But these are choices of values. Which economic goals do we value most? What comes first? In the 1980's, as during the 1920's under Benjamin Strong, Volcker's Fed decided that money came first—ahead of the real economy, ahead of full employment. Some governors disagreed with this setting of priorities. Strangely enough, the governors who disagreed most strongly were Preston Martin and Martha Seger, the two Reagan appointees to the Board. Though appointed by a conservative, monetarist President, they consistently argued for an easier policy, for more emphasis on unemployment and growth rather than inflation.

Volcker held his ground—he continued to insist that deficits had to come down before interest rates. To some degree, Volcker was deferring the course of monetary policy to the bond markets. Time and again the argument was advanced that if the Fed eased, bondholders would push up long-term interest rates to protect themselves against inflation. Yet, by 1985, this argument was looking more and more specious. Economic growth was roughly 2% per year, unemployment was above 7%, and the economy was estimated to be operating at roughly 80% capacity. Was it necessary for these conditions to continue, in perpetuity, just to relax the bond markets? The Fed could have challenged this market psychology by demonstrating that easing need not touch off runaway inflation—such an event was very unlikely considering the slack in the labor and goods markets. But Volcker chose to preserve his own credibility, saying: "…will a test that fails damage the process in the other direction? It might build up doubts about your long-term commitment. Are you holding firm against inflation or are you not?" Bond returns averaged 18.5% between 1981-1985, the most profitable era for bondholders in the 20th century.

In July 1985, Volcker found himself between a rock and a hard place. He was still instructing the markets to follow the M-1 aggregate as a guide for monetary policy, but the M-1 aggregate was growing at twice the Fed's target rate. Volcker dared not tighten—economic growth was low, and financial institutions appeared vulnerable. Thrifts, farmers, real estate, corporate and foreign debt were all in precarious positions. Money velocity was evidently once again at a low ebb, but if Volcker let the money supply grow too much, inflation might return once velocity rose back up again. This bind finally led to the collapse of monetarism as a practical theory for managing the money supply. Volcker, for the second time and for good, abandoned using the aggregates to decide monetary policy. Volcker let the money supply grow, but took no action to lower interest rates (the governors did vote for a 0.5% reduction in the discount rate in May, evidently this was as far as Volcker was willing to go).

Meanwhile, the Reagan Administration finally figured out a way to exert some leverage over the Fed. By law, the President had the primary responsibility for managing the dollar's international value. The Fed had long understood this, but the White House, committed as it was to laissez-faire economic policies, had never tried to use this lever before. Only when James Baker replaced Donald

Regan as Treasury Secretary was the change made. Baker took a different tact with Volcker. Rather than engage in the "Fed bashing" his predecessor had, Baker focused on private meetings with the Fed chairman to enlist his support in an effort to bring down the dollar's international value and aid America's exporters. Volcker himself was concerned about the dollar, and aided Baker in the creation of an accord between the five leading industrial nations—the US, West Germany, Japan, France, and Britain. The nations agreed to coordinate the efforts of their central banks to correct currency imbalances on international markets. Over the next year and a half, the dollar would depreciate by roughly one-third of its value, as measured against ten other major currencies. Though the accord did not induce Volcker to ease, it effectively cut off Volcker's ability to tighten any further, as any such move would push the dollar in the wrong direction.

The accord was an important move, but it failed to reverse the damage already done. The plants moved overseas and the manufacturing jobs that moved with them would not come back, nor would US businesses win back the market share they had lost over the previous four to five years.

Strangely enough, Reagan's economic policies wound up giving Keynes the last laugh. Reagan came into office vowing to fix the supply side of the economy—tax cuts would spur investment and increase capital formation. But, as businessman George P. Brockway said, "sensible businessmen do not produce things they cannot sell and certainly they do not build new factories when they have usable factories standing idle." The illness plaguing the American and world economy during the 1980's was not a dearth of supply, but a glut. Put another way, it was the same illness Keynes had identified in the 1930's—inadequate demand. Federal deficits stimulated a boom in consumption, consumption financed by increased debt. The strong dollar meant that much of this consumption was of products produced overseas. Factories in the United States closed by the thousands.

The economic disorder of the 1980's demonstrated a need for a new Keynesian theory, an elaboration on it. A globalized economy meant that supply gluts could exist, and had to be dealt with, on a worldwide scale. Recessions in far off countries could create one in your own. Stimulating demand worldwide necessitates international cooperation, and in most cases the political mechanisms for this do not exist. With each country afraid to act unilaterally, the status quo prevailed, and a gradual liquidation of producers—both American and foreign—was the result.

The economy of the late 1980's defeated another idea that had ascended to the level of economic orthodoxy. Beginning in February, 1986, stock and bond markets rallied miraculously. In Volcker's words, the rallies occurred "for not any obvious reason." Oil prices were down, and Congress had recently passed a bill promising to bring deficits down to zero within five years. These changes, combined with Reagan's sunny optimism and the fact that inflation was still low (and even negative for a time as oil prices dropped), seemed to finally break the

inflationary psychology of the bond markets. But the drop in oil prices—from $26 a barrel to $12 in just a few weeks—actually produced soaring unemployment in the Southwest and a new wave of threatened banks. The bill Congress passed was merely a promise, and in the meantime deficits were setting new records. (Congress would not keep its promise.) Economic growth in the second quarter of 1986 was just 0.6%. So the drop in interest rates was just a matter of psychology. Volcker had been insisting for years that rates would not come down until deficits did, this turned out not to be the case.

In September, 1985, Lyle Gramley retired from the Fed. In February of 1986, Charles Partee did the same. They were replaced by two new Reagan appointees, Manuel Johnson and Wayne Angell. Gramley and Partee were the Board's leading hawks, and Volcker's staunch allies. Now there were four Reagan appointees on the Board of Governors, and all four favored lower interest rates. Volcker was outnumbered. This led to an unusual incident at the FOMC's February 1986 meeting. The four Reagan appointees argued strongly for a reduction in the discount rate. Volcker still refused to budge—he feared that if the Fed moved without at least both West Germany and Japan moving alongside, capital would flee the United States seeking higher returns elsewhere. If that happened, the value of the dollar might fall swiftly, reversing the terms of trade and bringing on inflation. When the vote was cast, Volcker found himself in the minority of a 4-3 vote for lowering rates.

Furious, Volcker threatened to resign, but Treasury Secretary Baker worked out a compromise—the reduction would be postponed for two weeks, in the meantime Volcker would ask the central banks of Japan and West Germany to follow the Fed's lead. By 1987, Henry Wallich and Emmett Rice retired as well, replaced by two more Reagan appointees, Robert Heller and Edward Kelley. Volcker was now completely outnumbered on the Board, and over the course of the year the discount rate was reduced three more times to its lowest level in 10 years, 5.5%. Given the near zero inflation rate, real interest rates were still quite high.

Volcker's second term as chairman was scheduled to end in August, 1987. It seemed like an ideal time for him to retire—he had succeeded in quashing inflation, he was losing control of the Board of Governors, and a number of troubling predicaments were arising on the economic scene. Volcker could retire victorious, any subsequent crises would be blamed on his successor. Volcker, though, signaled he was willing to continue as chairman—if the President was willing to fulfill certain conditions. Volcker wanted Reagan to deliver a declaration in support of Volcker's leadership, so that the other Governors would be more inclined to go along. The White House ignored the suggestion, and on June 2, 1987, Reagan made the announcement that Volcker would retire from the Federal Reserve. The new chairman would be Alan Greenspan, an economist sufficiently conservative for Wall Street's tastes. The new chairman was reported to be more practical, more interested in consensus, more of a team player. Volcker's one man show was coming to an end; the man that had dominated

America's political and economic scene for the better part of a decade was leaving.

Volcker was successful in the narrow mission he had set for himself. Under his leadership, the Federal Reserve brought down the inflation rate from 13% to near 0%. But the cost was high. When he took office, Volcker predicted large productivity gains, real wage increases, and, eventually, lower interest rates. None of these goals was accomplished during Volcker's tenure. In fact, the economy of the 1980s was by many measures worse than the disappointing economy of the 1970s. Expansion of economic output was a third of what is was in the previous decade, real disposable incomes and jobs grew more slowly. Productivity gains, already weak in the 1970s, were worse in the 1980s. Unemployment was persistently higher, and the poverty rate increased accordingly. Prices were the exception. Stable money was achieved, through great sacrifice. Stable money was supposed to be worth the sacrifice. But if the economy was worse off by nearly every other measure, how could this be true?

Money concealed a conflict between classes. Interest rate levels correlated to the balance of power between creditors and debtors, decided the share of income that went to each group. In the 1980s, the creditors were the great victors of this struggle. The rich benefitted greatly from Reagan's supply-side tax cuts and Volcker's hard money policy. The poor, in many cases, found themselves worse off. For centuries, the way out of this conflict was steady economic growth. So long as everyone's boat was being lifted, issues of inequality could be put to the side. If the economy was stagnant for too long, if the power of compound interest combined with the fact that real interest rates were higher than real growth produced a rentier class that slowly accumulated the assets of the poor, then these social divisions may finally one day be pushed out into the open, as they were in the Mid-west in the late 1800s.

On Monday, October 19, 1987, the stock market crashed. The Dow-Jones lost 508 points in a single day. Greider poses the question of whether this crash may be the moment when the supremacy of money over the demands of the real economy may be dismantled. History has shown that it was not. Perhaps such a moment will arrive one day—but Greider raises the question of whether American society really wishes to face the realities such a moment would raise.