6. A Brief History of the Federal Reserve

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When a business wants to expand, a family wants to buy a house, or a government wants to increase public spending, they need to borrow. The financial system is supposed to be the plumbing of the economy, letting credit flow where it is needed. But this plumbing is defective—it's a source of instability and crisis, as the supply of credit is either cut back to a trickle or pours out in floods. And it is also a site of political conflict: the majority of us, as borrowers, want credit to be cheap and abundant, while creditors (those we owe money to) want to keep it expensive and scarce. Thus, there is a fundamental conflict between people who borrow money and people who lend it. The Federal Reserve was set up to adjust the supply of credit to meet the needs of the real economy and manage this conflict, but in practice it serves the interests of creditors.

Debtor Versus Creditor: An Old Conflict

Conflict over debt is as old as the United States. Shays's Rebellion, an armed uprising against the new government in the 1780s, was a rebellion of debtors against creditors. When banks and moneylenders cut off credit to small farmers and demanded repayment, farmers who could not pay their debts saw their land seized and sold at auction to pay off their creditors. Rather than accept the loss of their homes, hundreds of veterans took up arms and marched on courthouses to halt the foreclosures.

One hundred years later, another period of rising debt burdens gave birth to the Populists, a movement of farmers, small business owners, and workers. At that time, the United States was on the gold standard, so bank lending was strictly linked to the supply of gold. Many people thought this was normal and natural. But it meant that as the economy grew, unless there were lucky gold discoveries, there was no way for the supply of money to grow with it. When something is scarce, that's good news for whoever owns it and bad news for whoever needs it. Under the gold standard, money was scarce. That was good news for the owners of money—banks, creditors, and the rich in general—and bad news for everyone else. So the Populists demanded a government-issued "people's currency, elastic and cheap, based on the entire wealth of the country." For that, the country needed a central bank.

Enter the Fed

The central role of a central bank—the Federal Reserve, or "the Fed," in the United States—is to control the availability of credit and the amount of money in

circulation. It does this mainly by buying and selling short-term government bonds. The details of these open-market operations aren't important; what matters is that they make it easier or harder for banks to borrow from other banks. When it is easy for banks to borrow, they should be willing to make more loans to households and businesses, and to accept lower interest rates. In theory, this allows the Fed to increase lending when the economy needs stimulus and to reduce it when demand is too high.

When the Federal Reserve was established in 1913, its mission was set by law as ensuring an "elastic" currency, just as the Populists had called for. The Fed was supposed to end bank panics and crises, and to regulate the supply of credit so that it grew steadily in line with the needs of the economy. Since the big banks couldn't stop the creation of the Fed, they did everything they could to control it. The Fed is unique among government agencies in that it is legally accountable to the same industry it is supposed to regulate: the Board of Governors that runs the Fed includes members chosen by private banks. And even though the Fed chair is appointed by the President of the United States, that doesn't mean our vote matters—each of the last three Fed chairs has been appointed by both Republican and Democratic administrations. The result is that the Fed is always divided between the interests of the real economy—the need to ensure sufficient credit for the economy to expand—and the interests of finance—the desire to keep credit artificially scarce. Most of us benefit from strong growth and low unemployment, even if that means moderate inflation (that is, rising prices or a falling value of money). But finance wants to preserve the value of money at all costs, even if that means mass unemployment and the waste of the economy's productive potential.

Unemployment and Inflation

For years after World War II, the Fed seemed to have learned its lesson and recognized the importance of keeping unemployment low. For three decades, it was committed to maintaining a low unemployment rate, even at the risk of inflation. As a result, for thirty years, prices rose, but unemployment stayed low and incomes rose faster. This period saw steadily rising wages, and some of the strongest growth in American history.

Unemployment is frightening for people who live on their labor. But inflation is frightening for people who live on their money. The high inflation of the 1960s and 1970s convinced the banks and other money-owners that things had gone too far, and they began pushing for tighter monetary policy. They scored their first big victory when, under President Carter, Paul Volcker became chairman of the Fed. Volcker was obsessed with reducing wages. To do this, he raised interest rates to unprecedented levels, deliberately provoking the deepest recession of postwar history (or at least the worst until the Great Recession). As historian William Greider puts it in *Secrets of the Temple: How the Federal Reserve Runs the Country*, "Volcker believed that inflation would not be securely defeated…until workers and their unions agreed to accept less. If they were not impressed by words, perhaps the liquidation of several million more jobs would convince them." When a delegation of legislators from farm states came to Volcker to plead for easier money, Greider reports that he bluntly replied, "Look, your constituents are unhappy; mine aren't." Volcker's constituents were the banks.

Under Volcker and his successor Alan Greenspan, "job insecurity" became a goal of Fed policy instead of something to avoid. Many industries, like steel, never recovered. But for Volcker and Greenspan, the important thing is that loans are no longer paid back in cheaper dollars. For lenders, the past quarter century has been the best of times. But for borrowers—homeowners, students, people with medical bills or who are in between jobs, small businesses—it has been a period of steadily growing debt burdens.

More Debts, More Problems

In the current recession the Fed seems to be doing more to support employment, with unconventional policy like quantitative easing, in which the Fed tries to stimulate economic growth by injecting more money into circulation. So why hasn't the Fed been able to fix the economy? Some economists think it hasn't really tried—that it is still working for its real constituents in finance, taking advantage of high unemployment to push down wages and prices. Other economists think it's because the Fed can't control the supply of credit—even when the Fed loosens, banks still won't lend. Still others think that even if banks are willing to lend, businesses don't want to borrow because there is little demand for their products. For these economists, while scarce credit has been a disaster for the real economy in the past, it's not the source of our problems today. There is controversy over how hard it is currently for households and businesses to get new loans; but whatever the answer, existing debt remains a huge problem for the majority of us who are debtors. If monetary policy can't or won't alleviate that burden, then debtors may have to take a page from Shays's Rebellion and challenge creditors directly.