Spring 2021

G. Epstein, Democratic Money: Central Bank Independence vs. Contested Control (Part 2)

August 17, 2021

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Part Two: The Solution – Democratizing the Fed

The Federal Reserve is a Contested Terrain: Time to Democratize the Fed

As I argued in Part One, with both its monetary and regulatory policy, the Federal Reserve has often been biased toward helping the financial sector. This is due both to the Fed's structural interdependence with finance, but importantly, also to its desire to motivate the financial sector to support its political power and autonomy from the public and elected officials. This structural dynamic has contributed to a vast increase in wealth inequality and also undermined the overall health of our economy.

But finance need not and is not always in control. In other words, the Federal Reserve is a *contested terrain*. Thus far, given its advantages, finance mostly wins, giving it *contested control* over the Fed. But it does not have to be that way.

A more accountable and public-serving central bank is, in fact, not that unusual. In Part One I noted that, during the Second World War and for several decades afterwards, central banks in many countries were highly *integrated* into their government structures. The Central Bank of Sweden, for example, was controlled by parliament and monetary policy was highly supportive of the macroeconomic and credit allocation goals of the government. In 1944, the Swedish social democrats envisioned the role of the central banks this way: “The whole system of credits should be arranged from the point of view of the community so that production develops systematically according to national needs and all productive resources are utilized in the most efficient manner. The policy of the Bank of Sweden must further this aim.”[1] Such policies contributed to the post-War Swedish miracle, but central bankers, private bankers, economists and others who preferred a less active and assertive government, rebelled against them.[2]

The successful late, late developers, such as South Korea, Taiwan, China and others, also had “developmental central banks” highly integrated into the government and supportive of the governments’ development plans.[3] Note that, politically, these states ran the spectrum from left to right. So, a more accountable, *integrated*, central bank is not, historically, necessarily a *left* project.

None of these systems worked perfectly nor lasted for ever. But that is the way economic institutions function. They need to be modified with changing circumstances, and they need to have mechanisms to fight off corruption, opportunism, and capture. I don’t know of any institution for which that is not the case. But protecting the Federal Reserve’s current structure of finance-dominated policy is guaranteed to fail the economy. It already has, at least twice, in little more than ten years.

What is the Way Forward to a More Accountable, Effective and Equitable Federal Reserve?

Donald Trump’s presidency was a wake-up call. He made us understand the dangers of a corrupt and malevolent executive taking control over all our governmental institutions. People became concerned about Trump’s control over the Department of Justice, the Pentagon, the CDC and yes, the Federal Reserve. Perhaps it was this “Trumpster Shock” that led many to abandon long-held values of democracy and accountability of the Fed, including Congressional authority, but the irony of this should not be lost on us. Have we abandoned the idea of democracy because we are worried about Trump destroying democracy? Have we let him twist us around to that degree?

Clearly the solution to not enough democracy at the Federal Reserve is more democracy, not less. In order to ensure that the Fed operates more efficiently, more equitably, and serves the basic needs of the US economy, the Fed needs to become more accountable to society as a whole, and less accountable to finance and the ultra-wealthy. In order to make this happen, progressives need to stop defending this mythological idea of central bank independence, and instead think hard about how to construct a more democratic and accountable central bank. As Jedediah Britton-Purdy, Amy Kapczynski, and David Singh Grewal put it, "…we must limit the familiar anti-politics of legalism and technocratic decision-making through a commitment to democratic politics…Democracy also means deeper political empowerment, such as the capacity of communities to mobilize against the hoarding of political decision-making power in wealthier (and often whiter) constituencies." See Stefan Eich's roundtable piece, which makes a strong argument for more democracy and accountability.

Making the Federal Reserve more democratic, accountable and truly responsive to the needs of the public will require both strengthening the bonds of accountability that currently exist, while broadening the types of effective voices at key institutional levels.[4] This means first recognizing the legitimacy and authority of Congress over the Federal Reserve and the need for true accountability to Congress in the terms of the Fed meeting its mandate, both in terms of monetary policy and in terms of financial regulatory policy.

Further, executive aggrandizement and insulation from legislative accountability is a threat, because it leaves our institutions (including those whose leaders the president cannot remove at will) vulnerable to cooption by the President. A strong Congress can prevent that sort of executive capture. That was very much the theory of the Framers.[5] Still, with all the well-known flaws in the democratic organization of Congress, as I argue below, other democratic channels of influence on Federal Reserve policy are also desirable.

Creating a Federal Reserve that truly acts in the public interest also means making the decentralized Federal Reserve System more effective and subject to broader voices in society, especially workers, people of color, and everyone, regardless of gender. Given length limitations, in what follows I want to focus on this second channel.

A way forward here is to win the future by borrowing (and updating) a page from the past: the regional structure of the Fed still provides a structure for enhanced counterweights to the enormous power of private financial interests in Federal-Reserve decisions. As you recall, the Federal Reserve was established as a system of twelve regional Federal Reserve Banks (FRBs) in an effort to offset the enormous power of New York and Wall Street Banks. This effort was only partly successful: it made commercial banks the owners of the regional Federal Reserve Banks, and loaded up their boards with local bankers and businessmen.[6] With the Great Depression and the New Deal, some of this power was taken away from the Regional Banks and shifted to the Board of Governors in Washington, but, until the Dodd-Frank Act of 2010, when the commercial bankers were no longer allowed to formally participate in the selection of the Regional Bank Presidents, the basic ownership and regional board structures were not changed.[7]

But the regional FRB’s have in the past demonstrated the ability to help allocate credit on a decentralized basis, a history that can be built on to help achieve social goals such as address climate change, racial disparities, and cooperative and small business formation. Though the regional Federal Reserve Banks failed to engage in sufficient open market operations and other liquidity actions to stave off the Depression, there were some important initiatives undertaken at the regional Reserve Banks to support employment, credit, and investment. At some banks, industry-finance committees were set up to directly mobilize and then allocate credit for investment and job creation.[8] During the Second World War itself, the FRBs got even more involved in credit allocation. In the US, after the Great Depression of the 1930s, the Roosevelt Administration convinced the Federal Reserve to develop new tools and to engage in more activities to directly support other sectors of the economy besides finance. A little-known example of this is the "Industrial Advances Act" passed by Congress and signed into law by President Roosevelt in 1934, which added section 13(b) to the Federal Reserve Act.[9] Section 13(b) authorized the FRBs to make working capital loans to private non-financial companies, if they could not find credit from the financial markets and also authorized the FRBs to discount obligations of up to five years from financial companies of any sort if those obligations were loans to industrial or commercial businesses for working capital.[10] This bill was passed *not* as an emergency measure, but to serve as a permanent feature of Federal Reserve policy. By statute, The FRBs were directed to set up Regional Industrial Advisory Committees (IACs) made up of local businesspeople to advise the FRBs on how to allocate the credit to non-financial businesses in their districts. No limitation was placed on the amount of each loan. The FRBs continued making 13(b) loans during World War Two, and helped to fund companies contributing in the war effort. After the Treasury-Fed Accord of 1951, officials at the Federal Reserve Board were very anxious to restore the Federal Reserve's independence from the Treasury and Congress. Federal Reserve officials (most notably Chairman William McChesney Martin, who wanted to inculcate a more minimalist conception of Federal

Reserve policy) lobbied Congress to repeal Section 13(b). Those officials achieved their goal with the passage of the 1958 Small Business Investment Act, which, among other things, repealed section 13(b) of the Federal Reserve Act.

Broadening the Representation and Power of the public in the FRBs is Crucial

While 13(b) initiatives broadened the operations of the FRBs in the post-Depression era, they did not address the issue of the community or labor representation on the FRB boards. This issue of broad representation of labor, community groups and broad representation racially and ethnically at the Regional Reserve Banks is critical to limiting the power of finance in their governance and to making it more likely that the Fed will address the needs of those traditionally ignored. Building in the decentralized structure of the Fed creates an opportunity to limit the power of finance and enhance the power of workers, people of color, small business and the public more generally. But without explicit governance changes, it will only create more opportunities for finance influence on the Fed.[11]

There have been periodic attempts from community and labor groups to get more representation. Of course, the central bankers were not too happy about this. Alan Sproul, President of the New York Fed exclaimed in 1952: “Labor members – what we don’t want is members of the Board of Directors of (Federal Reserve) banks representing and acting as a pressure point for one segment of the community. Have no objection, in principle to labor on boards, but their record as militant class interest advocates is bad.”[12] Edwin Dickens, in a fine book on the politics of Federal Reserve Monetary policy notes many such anti-labor sentiments within the Fed top echelon’s to be found in minutes and archives.[13]

Some more recent initiatives were undertaken by Fed reformers and labor unions in the 1990s to broaden representation on the

FRB boards. In the 1990s, the AFL-CIO implemented an initiative to get more labor union members appointed to FRB boards. Sheldon Friedman of the AFL-CIO, along with Tom Schlesinger and activist and director of *the Financial Markets Center*, recruited labor union members to run for board membership. Though these efforts were short-lived and only somewhat successful, they do suggest a path forward to getting broader representation on Regional Boards, and having boards get more involved with important regional issues.

There have been some more recent and promising efforts to broaden the orientation and even the representation on Regional Bank Boards, especially around issues of race and ethnicity, and climate change. The Federal Reserve Banks, especially the Reserve Banks of Atlanta, San Francisco and Boston have been at the forefront of these promising efforts.[14] And they have not been ignored by right wing critics of the Fed who have strenuously pushed back against these efforts.

The Regional FRBs were actively involved in administering some of the special facilities that Congress created to allocate money to small business and communities in the wake of COVID-19.[15] They could expand their activities in "normal times" to allocate funds for local projects to address important social needs. And, as I suggest next, the regional Feds could support local public banking initiatives which, among other benefits, would help to undermine Wall Street's hold over the Federal Reserve.

That is, the banker-political constituency is only the first line of defense for the Fed's autonomy from the public. The second line of defense is the economy's dependence on financial markets and the power of market participants to conduct a "capital strike" if the Fed gets too focused on the public interest. Though this second line of defense against socially desirable monetary policy is often overestimated and over-hyped, in some circumstances it is real. The negative financial reactions to the inflation of the late 1970s was real, for example.

The defense against capital strike and capital flight, as Keynes well understood, is for there to be sufficient public suppliers of finance, including public banks, and other public financial institutions at the state and local level as well as the federal levels to provide the financial services that private finance will not provide.[16]

Though public banking initiatives are on the upswing in many parts of the world according to Thomas Marois, in the US the implementation of such initiatives is lagging despite an increase in advocacy activity across the country.[17] Part of the reason for the difficult obstacles these initiatives face in the US is the uneven playing field between public banks and private banks. As we have seen, private banks get extensive subsidies from the government, including the Federal Reserve, and these are generally lacking for most public banks.

One initiative to address this inequality, is the ‘Public Banking Act (PBA)’ (HR 8721), which was introduced in Congress in October 2020 by Congresswomen Rashida Tlaib and Alexandria Ocasio-Cortez, with the support of nine other Democratic members of the house. It aims to enable and encourage the creation of public banks at state and local levels by establishing a comprehensive federal regulatory framework, grant programs, and supporting financial infrastructure for these banks. Although the bill would not create new public banks, it encourages the creation of public banks by providing “top-down” support for “bottom-up” local initiatives.

Under the PBA, public banks could become members of the Federal Reserve. In addition, state-chartered banks would be permitted to gain federal recognition. The legislation also identifies a framework for public banks to interact with postal banking (where the USPS serves as a bank), or FedAccounts (where everyone gets an account with the Fed through which they could receive direct payments).[18] By providing public banks with the framework and enabling infrastructure that the Fed provides to private banks, some of both lines of Federal Reserve defenses against public orientation begin to weaken. This would be progress.

Conclusion

The lesson here is that in the fight against authoritarianism and the destruction of accountability and public orientation at the Federal Reserve, we need to turn to more democracy – at multiple levels – to act as a counterweight to the banks and to re-direct Federal Reserve policy for the disenfranchised, the working class and the public good. I have not presented a blueprint here, nor could I. What I do argue is that we need multiple points of democratic/public control of our central bank – in Congress and at the Regional Reserve Banks – to serve as a strong counterweight to the excessive power of finance over our money and credit. The Fed is a contested terrain, and we need to contest it more… a lot more, if we are going to have a monetary and regulatory policy that serves us all.

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[1] Avner Offer and Gabriel Soderberg, The Nobel Factor; The Prize in Economics, Social Democracy, and the Market Turn, (Princeton: Princeton University Press, 2016.) p. 89.

[2] *Ibid*., p. 95.

[3] Alice Amsden, *The Rise of the Rest,* (Oxford: Oxford University Press, 2001); Gerald Epstein, *The Political Economy of Central Banking*: *Contested Control and the Power of Finance,* (Northampton, MA: E. Elgar Press, 2019), Chs. 15, 16, and 17.

[4] I cannot give a comprehensive blueprint for Federal Reserve reform here but please consult Epstein, 2019, *supra*,

Chapter 24 for a survey of reform proposals.

[5] Thanks to Lev Menand for this insightful argument.

[6] Jane D'Arista, The Evolution of U.S. Finance, Volume I: Federal Reserve Monetary Policy, 1915-1935. (Routledge: Armonk, New York, 1994); Peter Conti-Brown, "The Twelve Federal Reserve Banks: Governance and Accountability in the 21st Century", Hutchins Center, Brookings Institute, March 2015; Jordan Haedtler, Andew Levin and Valerie Wilson, "Making the Federal Reserve Fully Public; Why and How", Economic Policy Institute, 2016.

[7] The Reserve Banks are formally private corporations with stockholders: private banks that join the Federal Reserve System must buy stock in the Banks; they also elect two-thirds of the Reserve Bank's directors. Each board is divided into three classes: Stockholder bankers selected by the stockholder banks (Class A); nonbankers selected by the stockholder banks (Class B); and directors who are nonbankers and selected by the Fed's Board of Governors (Class C). Conti-Brown, *supra*, p. 13.

[8] Robert Pollin, "Public Credit Allocation Through the Federal Reserve: Why It is Needed; How It Should Be Done"., in Gary A. Dymski, Gerald Epstein and Robert Pollin, eds. *Transforming the U.S. Financial System; Equity and Efficiency for the 21st Century*. (Routledge: Armonk, NY, 1993), pp. 321-354.

[9] See Gerald Epstein and Lilia Costabile, "An Activist Revival in Central Banking? Lessons from the History of Economic Thought and Central Bank Practice", the *European Journal of the History of Economic Thought*, 24:6, 1416-1439, DOI: 10.1080/09672567.2017.1378691 and the references therein.

[10] This is very similar to the design of Canada's Industrial Development Bank, started after World War 2, to maintain new

industry started during the war that they were concerned wouldn't be able to find adequate funding from chartered banks. Thanks to Dan Rohde for this insight.

[11] See, for example, Conti, 2015, who emphasizes this danger; Hockett also explores expanding the role of the regional Feds, but does not emphasize the need to give more power to communities in order to limit the power of finance https://justmoney.org/r-hockett-two-blades-one-scissors-central-bank-independence-with-some-central-bank-allocation/).

[12] Sproul, confidential memo, files, New York Federal Reserve, see Epstein, *supra*, 2019, Ch. 2.

[13] Edwin Dickens, The Political Economy of U.S. Monetary Policy; How the Federal Reserve Gained Control and Uses I*t.* (Routledge: New York, 2016).

[14] For some of the Regional Banks' efforts, see https://www.minneapolisfed.org/policy/racism-and-the-economy; https://www.atlantafed.org/news/conferences-and-events/conferences/racism-and-the-economy.

[15] See, for example, the Just Money roundtable "Money in the time of Coronavirus".)

[16] On Keynes see James Crotty, Keynes Against Capitalism; His Economic Case for Liberal Socialism. (Routledge: New York,2019.

[17] Esra Ugurlu and Gerald Epstein, "The Public Banking Movement in the United States: Networks, Agenda, Initiative, and Challenges", PERI Working Paper, March 2021.

[18] Urgulu and Epstein, *ibid*. 2021.

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