

CHAPTER 4

WHY THE FEDERAL RESERVE SYSTEM?

In this chapter, I explain why the Federal Reserve System is an important institution to study when examining administrative legitimacy. First, I show how much power and influence the Fed has over our nation's socioeconomic order. Second, I show how the distinction between political and career appointees is less clear at the Fed than elsewhere. Third, I examine the Fed's status as an independent regulatory agency—and the implications of this for its administrative legitimacy. Fourth, I discuss the Fed's unique public-private character. Lastly, I show how the Fed's organization, administration, and responsibilities relate to America's Constitutional principles and political practices, the principles and practices making administrative legitimacy an especially serious issue in our country.

After explaining why the Fed is an especially important institution to study, I briefly discuss the historical background of the period I examine, which is 1970 to 1995. First, I study the controversy surrounding the 1st and 2nd Bank of the United States. Second, I discuss the Founding of the Fed itself, showing how its Founders legitimated it. And, finally, I examine the Great Depression era, when the “modern” Fed was born—the more centralized and independent institution that it is known as today.

POWER & INFLUENCE

Because its policies affect our nation's economy and society so profoundly, the Federal Reserve is an important institution to study when examining administrative legitimacy. In many ways, the Fed is our nation's supreme regulatory body, partially determining how economic and social rewards are distributed. By controlling the money supply, it roughly determines the rates of interest, unemployment, and inflation. By regulating the nation's financial system—issuing regulations, supervising banks, protecting consumers, and working with economically distressed communities—it affects the economic lives of all Americans.

Consider how monetary policy, one of the Fed's most important tasks, affects elected leaders' policy options. Although raising revenue from citizens and allocating funds to public activities is one of the most important political acts, the Fed's monetary policy affects the federal budget, so the decisions elected leaders make about fiscal policy are guided by the actions of unelected officials. The Fed's influence over interest rates, in particular, partially determines the amount necessary to pay interest on the federal debt instead of funding programs with direct public benefits. And its influence over unemployment affects how much money government (at all levels) must spend on welfare, for unemployed individuals receive public assistance.

Monetary policy, of course, has both fiscal and social effects. In fact, the two are closely linked. By influencing inflation, the Fed can increase or decrease the earnings of citizens who invest for a living. Similarly, it can increase or decrease the earnings of citizens living on fixed incomes—the elderly, for instance. Due to the COLAS built into many public programs, more inflation means more welfare spending too.

To sum up, Fed policies partially shape the way social and economic rewards are distributed. Not that the Fed is the only administrative institution of importance; but its direct influence on every citizen's standard of living is a responsibility unlike any other.

The Fed's power and influence is widely recognized by people both inside and outside the institution. By the 1980s, "polls of leading Americans regularly rated the chairman of the Federal Reserve Board as the second most influential person in the nation, second only to the president" (Kettl 1986 p. 1). In *Economics*, the leading textbook in the field for many years, Nobel laureate Paul Samuelson and his co-author William D. Nordhaus reported that the Fed "is the most important factor in the making of macroeconomic policy" (Kettl 1986 p. 1). Donald Kettl, a leading scholar of public administration, observed in *Leadership at the Fed* that "unquestionably the Fed has enormous power over the American economy." It not only keeps "the currency stable by managing the nation's supply of money and credit," but also "has used that function to gain great influence over the nation's—and increasingly the world's—economy" (Kettl 1987 p. 1).

Alfred Broaddus, president of the Richmond Reserve Bank, reported in the twelfth edition of *The Federal Reserve Today* that "the actions of the Federal Reserve System affect everyone":

Economic conditions worldwide depend on how well the System helps strengthen the United States economy. The integrity of our country's financial institutions, the efficiency of its payments systems, the adequacy of its money and credit, and the soundness of its dollar are all responsibilities of the Federal Reserve (Federal Reserve Bank of Richmond 1996 p. 1).

Interestingly, the institution's founders did not expect it to have nearly as much power and influence as it does today. The opinions of leading Americans, the views of Samuelson and other intellectuals, the many other indicators of the Fed's power and influence: all these "would have astounded the Fed's founders." Admittedly, they "recognized in 1913 that they had created an important agency." Yet they "scarcely conceived of it as one of the most powerful institutions in American government" (Kettl 1986 p. 1). To the contrary, they "viewed it as a regulatory agency, in the spirit of the Interstate Commerce Commission" (Kettl 1986 p. 1). Even the Fed's officials recognize how much the institution's power and influence have grown, with Alfred Broaddus reporting:

The System's principal goal of economic stability has not changed since the Federal Reserve was created 80 years ago. In the intervening years, however, *its role has grown a great deal*. In the past decade, for example, System functions changed and expanded to deal with dramatic transformations in financial institutions, payment processes, markets, and instruments [my emphasis] (Federal Reserve Bank of Richmond 1996 p. 1).

In his analysis of the “culture of contentment,” which was published in a book of the same name, John Kenneth Galbraith placed particular emphasis on the Fed’s monetary policy. Specifically, he observed that “what economists call macroeconomic policy has come to center not on tax policy but on monetary policy—the mediating actions of the central bank, in the United States the Federal Reserve System” (Galbraith 1992 p. 43). What Galbraith is most concerned about are the distributional consequences of restrictive monetary policy, a policy that’s neither socially nor politically neutral. “The modern reliance on monetary policy and the rejection of tax and expenditure policy,” he argues, “emerge from the entirely plausible and powerfully adverse attitude toward taxation in the community of contentment” (Galbraith 1992 p. 44).

Considering its vast power and influence, scholars who are concerned about administrative legitimacy should find the Fed to be an especially important institution to study.

AN INDEPENDENT REGULATORY AGENCY

Because it is an independent regulatory agency, the Federal Reserve is an important institution to examine when studying administrative legitimacy. W. Craig Bledsoe & Leslie Rigby report that “no univerrally accepted definition” of a regulatory agency exists, but the Senate Government Operations Committee observes that they usually have five characteristics. First, these agencies have “decision-making authority.” Second, they establish “standards and guidelines conferring benefits and imposing restrictions on business conduct.” Third, they operate “principally in the sphere of domestic business activity.” Fourth, the “head(s) and/or members are appointed by the president.” And, finally, their “legal procedures are generally governed by the Administrative Procedure Act” (Bledsoe & Rigby 1997 p. 141).

Independent regulatory agencies “are governed by bipartisan commissions of five or more members” who “usually serve lengthy, fixed terms.” These administrators “cannot be removed by the president” except under certain conditions—sometimes statutes list these explicitly, while other times they require “cause,” a largely undefined standard. “Among the major independent regulatory agencies,” Bledsoe & Rigby observe, are “*the Federal Reserve Board* (FRB), National Labor Relations Board (NLRB), Federal Communications Commission (FCC), Federal Trade Commission (FTC), and Securities and Exchange Commission (SEC)” [my emphasis] (Bledsoe & Rigby 1997 p. 141).

When creating independent regulatory agencies, the Congress has “attempted to protect their independence.” Each Commissioner, for example, is appointed by the President and confirmed by the Senate. Different Commissioners serve “overlapping fixed terms, usually of four-to-seven years,” so “presidents cannot simply fire them.” Also Congress has made these agencies bipartisan ones, often placing “limits on the number of appointees from any single political party.” What Congress often mandates is that “neither political party may have a majority of more than one.” Above all, such “organizational design makes these agencies and commissions independent of other executive organizations and places responsibility for the execution of their policies with the commissioners rather than the president” (Bledsoe & Rigby 1997 p. 141).

In our field, the independent regulatory agencies *raise more questions of legitimacy* than any other administrative institutions, since they are independent of both the President and the executive departments. So independent regulatory agencies, while they govern society, are subject to the command of neither the President nor the Cabinet Secretaries. In most of these agencies, too, the commissioners are policymakers, administrators, and adjudicators (Bledsoe & Rigby 1997 p. 141). More than any other parts of public administration, such agencies raise the specter of a “headless, fourth-branch of government” that is unaccountable to the democratic process. How can we legitimate the role these institutions and their administrators play in governance? How have the administrators themselves as well as political actors attempted to (de)legitimate the officials’ actions and their institutions?

These agencies’ independence has often been controversial, with Presidents attempting “to bring various regulatory agencies under their authority by removing commissioners who have proven uncooperative” (Bledsoe & Rigby 1997 p. 141). Nevertheless, even though this controversy exists, the federal courts “have generally upheld the independence of commissioners from executive control.” In *Humphrey’s Executor v. United States*, a case the Supreme Court decided in 1935, the justices ruled that “President Franklin D. Roosevelt had acted unconstitutionally when he fired a member of the FTC” (Bledsoe & Rigby 1997 pp. 141 – 142).

Humphrey’s is worth examining in somewhat greater detail. Serving as a federal trade commissioner, Humphrey had a seven-year term. Before his term expired, however, President Roosevelt removed him from office. In response, Humphrey sued, and the Supreme Court agreed to hear the case. The Supreme Court reached a unanimous decision, with Justice George Sutherland reinterpreting *Myers*—a previous case that provided the President with broad removal power—as applying only “to purely executive officers, like postmasters” (Rohr 1989 p. 25). Since federal trade commissioners “exercised quasi-legislative and quasi-judicial functions,” Congress could “protect them from presidential removal for reasons other than those Congress might choose to allow” (Rohr 1989 p. 25). A trade commissioner, Sutherland argued, “occupies no place in the executive department” and “exercises no part of the executive power vested by the Constitution in the President” (Rohr 1989 p. 25). Indeed, Sutherland even claimed that a trade commission exercised no “executive power in the constitutional sense.” Consequently, a trade commissioner’s so-called “executive” action is “in the discharge and effectuation of its quasi-legislative or quasi-judicial powers, or as an agent of the legislative or judicial departments of the government” (Rohr 1989 p. 26).

Rohr, quite rightly, is critical of Sutherland’s reasoning. After all, it is “difficult to justify a distinction between ‘executive power in the constitutional sense’ and some other form of executive power” (Rohr 1989 p. 26). Michael Froomkin’s article, “In Defense of Administrative Agency Autonomy,” distinguishes Presidential functions from executive functions *per se*. While doing so, he argues that the “distinction in *Humphrey’s Executor*” should “be abandoned.” In its place, the Court should adopt “a taxonomy based on constitutionally committed powers, which preserves the holdings of existing cases and provides a coherent guide for the future” (Froomkin 1987 p. 814).

The Constitution, Froomkin argues, reserves Presidential functions to the President. But executive functions “can be performed by any official of the executive branch” (Froomkin 1987 p. 793). Indeed, the “Constitution vests only limited powers in the President.” Article II, for instance, “clearly anticipates that there will be Heads of Departments” (Froomkin 1987 p. 793). That article, too, says that “Congress may, if it chooses, grant them—not the President—the important discretion” to other officials (Froomkin 1987 p. 799). *If the executive power were solely the President’s, this provision “would be meaningless”* (Froomkin 1987 p. 799).

Likewise, the Necessary and Proper Clause “supports the constitutional validity of the distinction between the President and the executive branch,” for it “specifically includes departments and officers in a list of potential repositories of federal authority” (Froomkin 1987 p. 799). Congress, Froomkin concludes, “can assign a Head of Department any executive power not textually reserved to the President in Article II” (Froomkin 1987 p. 799).

Nor does the requirement for the President to “take Care that the Laws be faithfully executed” place all executive authority in his Office. Article II grants the President authority to receive “the Opinion, in writing, of the principal Officer of each department”—which would be meaningless if all executive power were vested in the President. That provision, Froomkin observes, was put in the Constitution because “it was not assumed, or at the very least not obvious, that the President had absolute control over the Heads of Departments” (Froomkin 1987 p. 800). So the Take Care clause simply means that the President “shall Take Care that the laws be faithfully executed regardless of who executes them—a duty quite different from the single-handed responsibility for executing all the laws” (Froomkin 1987 p. 801).

For good or ill, the President’s authority over the Federal Reserve is extremely limited. The President can, for instance, “fill vacancies that occur on the board and name one member to a four-year term as chairman,” but “such appointments are subject to Senate confirmation” (Kettl 1986 p. 4). Not only do Governors serve fourteen-year terms, but also “the appointments are staggered so that one term expires on January 31 of each even-numbered year” (Board of Governors 1994 p. 4). As long as no Governor dies or resigns, a President serving a four-year term can make only three appointments: a Chairman and two Governors, one of whom will become a member during the President’s last year in office. Even here, Congress has imposed restrictions on the President’s appointment power, restricting the number of appointees from each region. At the same time, the Governors “are not responsible to the president, who has no official channel of communication to the Fed and no legal power over the Fed’s policies” (Kettl 1986 p. 4). Most importantly, *the Governors “may be removed only for cause, a standard never tested”* [my emphasis] (Kettl 1986 p. 4).¹

¹ On one point, I disagree with Bledsoe & Rigby. Discussing the Board of Governors, they argue that “all appointees serve at the pleasure of the president,” which is simply incorrect. *First*, Congressional restrictions on the President’s removal power—restrictions forbidding removal of administrators except for cause, for example—do not mean that these officials serve “at the pleasure of the President.” To the contrary, to serve *at the pleasure* of someone is to be removable at his or her will. Examining the

Even by the standards of independent regulatory commissions, the Federal Reserve “occupies a unique place in American government.” First, it consists of “a public board supervising quasi-private reserve banks.” Second, it is “free from congressional appropriations and presidential oversight.” Third, it is “composed of officials exercising Congress’s monetary powers yet possessing great autonomy and broad flexibility” (Kettl 1986 p. 4). For all these reasons, the Federal Reserve is especially important to study when examining administrative legitimacy.

THE POLITICAL-CAREER DISTINCTION

Because the distinction between political and career appointees is less clear at the Federal Reserve than elsewhere, it is an important institution to examine when studying administrative legitimacy. Members of the Board of Governors serve fourteen-year terms, a longer tenure than any other federal officers have except for the Comptroller General and federal judges. The Board’s employees are not subject to the civil service system—and the Reserve Banks’ administrative systems are organized on a variation of the Council-Manager model; the Boards appoint the Presidents for five-year terms. By examining the political-career issue at the Fed, scholars can see that the “legitimacy problem” faces not just career executives, but political appointees as well. All too often, scholars assume that (il)legitimacy applies to career executives, while spending little time, if any, determining what it means for political appointees.

In *Ethics for Bureaucrats*, John Rohr identifies administrative discretion as *the ethical issue* for public administrators. “The heart of the ethical issue for American bureaucrats is that through their administrative discretion they govern a democratic polity,” Rohr argues. He also reports that “this book is written for *career government managers* and those aspiring to such careers” [my emphasis]. By “bureaucrat,” he means “a public official hired, retained, and promoted through a merit system.” While defining bureaucrat this way, he emphasizes that they “are neither elected nor politically

President’s removal power, Froomkin observes that “Congress has sought to limit or eliminate the President’s removal power in several areas.” The President, he continues, “may remove the seven members of the Federal Reserve Board for ‘cause.’” Also the “heads of the Federal Trade Commission (FTC), the Occupational Safety and Health Review Commission, the Federal Mine Safety and Health Review Commission, the Interstate Commerce Commission, and the Nuclear Regulatory Commission may be removed by the President for ‘inefficiency, neglect of duty, or malfeasance in office,’ but presumably no other cause” (Froomkin 1987 p. 787). *Second*, the Fed is more than three-quarters of a century old. Yet *no President* has ever attempted to remove a Governor, which shows not only how independent the institution is, but also how misleading it is to claim that they serve at the President’s pleasure. Moreover, if a future President attempted to remove a Governor, a court challenge to his decision would surely be made. Certainly the federal courts would define what “cause” means, and I am certain that they would interpret it as imposing significant restrictions on the President’s power. (Why else would Congress have forbidden their removal except for “cause” in the first place? The legislative history would be informative here, where the Act’s proponents wanted an independent, politically insulated institution.) *Third*, if a President attempted to remove a Governor, *Congress* would certainly step in to define “cause” very clearly. Legislators, I believe, would be unlikely to define it as giving Presidents’ unfettered authority to remove Governors. All in all, Kettl’s description of how independent the Fed is legally—which reports that Governors “may be removed only for cause, a standard never tested”—is much more accurate than Bledsoe & Rigby’s.

appointed,” and they “hold their positions with a relatively high degree of security.” In short, bureaucrats are “exempt from the discipline of the ballot box” (Rohr 1989 pp. 1 – 2).

Notice how relevant Rohr’s argument about administrative discretion is to the Fed’s administrative legitimacy. Administrative discretion is inextricably linked to administrative legitimacy, for legitimacy *is an issue of governance*: How can we justify the power and influence of administrative institutions as well as the administrators who work for them? Without discretion, public administrators would not be governing. Without discretion, administrative legitimacy would not be the issue it is today. So in many ways, Rohr’s main points in *Ethics for Bureaucrats* apply to political appointees too.

In *To Run A Constitution*, a book written to “legitimate the administrative state in Constitutional principle,” Rohr discusses both political appointees and career executives. Regarding political appointees, he praises Alexander Hamilton, the nation’s first Treasury Secretary, for having “a statesmanlike vision to see in” the department’s “dual subordination the opportunity to shape events” (Rohr 1986 p. 182). He applies his theory of public administration to an important debate during the Civil War—whether West Virginia should be admitted to the Union, which divided such political appointees as the Secretaries of State, War, and Treasury from the Attorney General, Navy Secretary, and Postmaster General (Rohr 1986 p. 193). Also he devotes a whole chapter to Thomas Cooley, who was the first chair of the Interstate Commerce Commission (Rohr 1987 p. 90).

Regarding career executives, he examines the Superfund scandal, a scandal showing how careerists can “choose between constitutional masters struggling for control of a particular agency.” “Career civil servants at the Environmental Protection Agency (EPA),” he observes, “tilted toward Congress and away from the president in that newsworthy battle.”

Without political support from Congress, EPA’s career personnel could not have executed the agency’s statutory responsibilities. Without an aggressive and cooperative civil service, Congress could not have uncovered the depth of the scandal (Rohr 1987 p. 182).

Other studies of administrative legitimacy ignore political appointees altogether—Douglas Morgan’s “administrative phroenis” approach, for example.² Still others focus *largely*, though not solely, on career civil servants. In *The Founders, the Constitution, and Public Administration*, Michael Spicer says public administration is legitimate if it checks political power. After discussing the importance of mixed accountability (neither the executive nor the legislative branches “should have absolute authority over the actions of public administrators”), he shows how important career civil servants are to checking political power, hence to his theory.

² Many other studies focus *implicitly* on career executives, though technically they could apply to political appointees as well.

Clearly, one the most important forms of control that political leaders can exert over the actions of public administrators is the power to substantially affect their economic livelihood. Discretion in following the directives of political leaders is severely limited if the tenure, pay, and promotion prospects of public administrators in office are dependent upon the approval of these leaders. The exercise of meaningful discretion by public administrators makes it desirable that a significant number of administrative appointments be protected from political control so that the pressure that political leaders can exert on individual public administrators is limited. A career civil service then, by providing such protection, increases the discretion available to public administrators in following the directives of political leaders (Spicer 1995 p. 69).

I do not deny the importance of career executives, whether for fundamental issues of legitimacy or general issues of governance or practical issues of management. Certainly some scholarship should focus solely on career civil servants, as *Ethics for Bureaucrats* does so well. But I want our field, too, to study public administration as public administration—ignoring neither the career executives nor the political appointees. Since the Federal Reserve does not make a sharp distinction between the two, studying *it* may be a useful way to accomplish my goal.

Why is the legitimacy issue as important for political appointees as it is for career executives? For one, both “types” of public administrators work in administrative institutions, institutions facing the legitimacy problem for many reasons: they combine two or more powers of government; they are not directly accountable to the electorate; they possess much authority; they coerce elected officials at the state and local level, and so on. Whether administrators are political or career appointees, then, they work *in an institution* that faces questions of legitimacy.

For another, political appointees—like career executives—are not directly accountable to the electorate. What distinguishes *them* from career executives is their employment contract: career executives have tenure in their positions; political appointees do not. In the traditional case, the President can legally fire a political appointee for any reason whatsoever. (In independent regulatory agencies, by contrast, Congress has placed restrictions on the President’s removal power; this it has done with the Fed and others.) While in office, though, a political appointee is *governing* our polity by exercising discretionary authority.

And the President, it is important to remember, may legally be able to fire political appointees, but *that* does not mean he can do so politically. Consider President Clinton, who was for a while in a weakened position *vis-à-vis* the Congress. While facing impeachment in the House and conviction in the Senate, he could hardly fire his top cabinet officers: Madeline Albright at State, Robert Rubin at Treasury, William Cohen at Defense, Donna Shalala at Health and Human Services. Even under normal

circumstances, Presidents are often unable to fire political appointees, since these officials represent important interest groups. Democratic Presidents cannot fire the representatives of organized labor; Republican Presidents cannot fire those of big business.

PUBLIC-PRIVATE CHARACTER

Because its unique public-private character challenges the traditional model of public administration, the Federal Reserve is an important institution to examine when studying administrative legitimacy. Traditionally, scholars of public administration have studied agencies that were both owned and funded by government. But “third-party government” is now challenging this model, eroding its hegemony at all levels of government. For this reason, scholars should study public-private partnerships—determining what effect they have on administrative legitimacy.

Larkin Dudley wrote an important article entitled, “Fencing in the Inherently Governmental Debate,” which was published in *Refounding Democratic Public Administration*. In it, she observes that one of the Blacksburg Perspective’s “basic aims . . . was to refocus dialogue in public administration from *whether* public administration to the *place* of public administration and the public administrator in the governance of the twentieth century.” Unfortunately, the contributors to *Refounding Public Administration* did not discuss “the serious challenge to the place of the institutions of governing by what has been called third-party government, government by proxy, and government by contract” (Dudley 1996 p. 68).

In the United States, Dudley reports, we “have incrementally moved to a new manner of governing,” with public service provision “by sources other than the originating government” representing “up to half of all service delivery” (Dudley 1996 p. 68). Yet scholars studying administrative legitimacy, for the most part, assume an “administrative state” consisting of purely public organizations, ones both owned and funded by the government. By studying the Federal Reserve, scholarship may become more realistic, more reflective of organizational realities.

In *The Public-Private Character of United States Central Banking*, J.Z. Rowe reported that America “is among the few countries of the world having a central banking organization which is relatively independent of direct intervention by government” (Rowe 1965 p. 4). At the same time, our System has “both public and private aspects” (Rowe 1965 p. 4). The Board of Governors is a public institution, while the member banks are private enterprises; the Reserve Banks’ status is more complicated. Seidman & Gilmour, writing about federal organization in *Politics, Position, and Power*, place these banks in “the twilight zone,” since they “float suspended . . . between the public and private sectors” (Seidman & Gilmour 1986 p. 309).

The capital stock of the Reserve Banks is held by the banks that are members of the Federal Reserve System. The board of directors of each bank is composed of six directors elected by the stockholders, three of whom must be engaged actively in agriculture, industry, or

commerce, and three public directors appointed by the board of governors of the Federal Reserve System. Bank presidents are appointed by the board of directors, subject to approval by the board of governors. Among other functions, the banks have been given the privilege of issuing currency and they act as depositors and fiscal agents of the United States (Seidman & Gilmour 1986 p. 309).

In the end, Seidman & Gilmour conclude that the Reserve Banks—“although privately owned and controlled”—are “public institutions performing public functions.” Their “net earnings” must “be paid into the U.S. Treasury.” Moreover, if the banks were ever liquidated, “any surplus remaining after payment of all debts, dividends, and the par values of capital stock” would “become the property of the United States government” (Seidman & Gilmour 1986 p. 309).

Compromise between diverse interests, according to Rowe, explains how the System’s structure became so complex. In fact, the way it is structured and the responsibilities it received “evolved from historical experience” and is “compatible with the American philosophy” (Rowe 1965 p. 175). By combining “private and public representation in the Federal Reserve System,” Congress continued the nation’s experience with “banking and financial arrangements following the termination of the Second Bank of the United States,” he argues (Rowe 1965 p. 175).

The Reserve Banks were established in twelve regions to meet “the requirements of the large geographical expanses of the nation whose regions varied considerably.” Since the Fed’s Founders wanted the Reserve Banks to be banks’ banks, allowing the member banks to “participate in their management” and requiring the member banks to “provide the capital for the regional institutions . . . was sensible” (Rowe 1965 p. 176). Restrictions on their activities—restrictions intended to protect the public interest—were equally important.

Limitations upon dividends, the placement of public members on the Banks’ boards of directors, and the division of authority between the banks and the Board of Governors was designed to restrict the improper domination of policies by private groups (Rowe 1965 p. 176).

All in all, the Fed is a true public-private endeavor. Scholars concerned with administrative legitimacy can learn much by studying it.

CONSTITUTIONAL & POLITICAL PRACTICES

Because of its relationship to the constitutional principles and political practices making administrative legitimacy an especially serious issue in the United States, the Federal Reserve is an important institution to study. The Constitutional principle is the separation of powers—with Congress possessing the legislative power; the President, the executive

power; the Supreme Court, the judicial power.³ The political practices are the combination of either two or all three powers in independent regulatory agencies and the belief in both limited as well as decentralized government.

SEPARATION OF POWERS: THREE CONSTITUTIONAL MASTERS FOR ADMINISTRATIVE AGENCIES (CONSTITUTIONAL PRINCIPLE)

The American Constitution establishes a legislative branch, an executive branch, and a judicial branch—so our national government is not a parliamentary system. These three branches are “supreme in their respective spheres,” which has a substantial effect on public administration. Typically, each branch influences the actions of executive departments and administrative agencies. In the process, administrative agencies have three Constitutional masters. This, somewhat paradoxically, increases their discretion. Who will they obey in a given instance? How will they interpret the commands of each branch? In traditional parliamentary systems, these questions are not raised, for the Parliament is sovereign. Administrative institutions must do what it says. In a polity with a separation of powers, by contrast, these questions are raised, and public administrators must answer them.

For John Rohr, public administrators should “use their discretionary power in order to maintain the constitutional balance of powers in support of individual rights” (Rohr 1987 p. 181). What public administrators must do, he argues, is choose “which of its constitutional masters it will favor at a given time on a given issue in the continual struggle between the three branches” (Rohr 1987 p. 182). Although this sounds like a modern doctrine, administrators have long practiced it—beginning with Alexander Hamilton, who attempted “to position the Treasury Department he headed and himself as a buffer . . . between President Washington and the First Congress” (Rohr 1987 p. 182).

The Federal Reserve is somewhat different from other administrative institutions, as the federal courts have exercised less control over its actions than that of many others.⁴ In *Melchner v. Federal Open Market Committee*, the U.S. Court of Appeals for the District of Columbia rejected a “Senator’s challenge to [the] constitutionality of appointment of Federal Open Market Committee by private individuals” (Froomkin 1987 p. 790). But federal courts have had some influence. In *Merrill v. FOMC*, a federal district court held that “the FOMC’s 45-day delay in releasing policy decisions ‘cannot be equated with promptness’ required by the act” (Kettl 1986 p. 153). At their next meeting, therefore, the FOMC had to change its policies, deciding to “release policy

³ Quite often, we hear that the three branches are “separate but equal,” which obscures a crucial point. True, the legislative, executive, and judicial branches *are* separate institutions, and they possess distinct powers of government (though overlap between them does exist). Still, one could argue that Congress has more power than the other branches—or, in any event, that the courts have less power than the other two. According to Article III, Section I, the very existence of courts below the Supreme Court depends on acts of Congress. As for Congressional-Presidential relations, Congress can remove the President from office, but the President cannot remove any Senator or Representative from theirs.

⁴ Consider how different the Fed’s experience is from the Environmental Protection Agency. The EPA is not independent from the President in the same way as the Fed, since the EPA’s administrator serves completely at the pleasure of the President. Most importantly, the federal courts have become heavily involved in the EPA’s policymaking process—with *their priorities* often taking precedent over Congress’s—but they have not done this with the Fed. For additional information about the EPA’s relationship to the federal courts, see Rosemary O’Leary’s book, *Environmental Change: Federal Courts and the EPA*.

decisions *immediately after the following FOMC meeting*” [my emphasis]. So a delay of 45-days became a delay of four to five weeks, all because of a court decision.⁵

Mostly, however, the Fed must concern itself with *two institutions*: the Presidency and the Congress. Since Presidents and members of Congress often struggle with one another, the Fed has a great deal of discretion.⁶

THE COMBINATION OF POWERS (POLITICAL PRACTICE)

Administrative agencies often combine two powers of government (executive and legislative), if not all three. Quite often, for example, administrative agencies issue regulations, implement them, and punish violators. Since we believe in a separation of powers—it is a fundamental part of the United States Constitution and our political beliefs—agencies that have all three raise questions of legitimacy.

In *Public Administration and Law*, Rosenbloom & O’Leary observe that “administrative agencies have immense power,” much of which results from “operat[ing] with authority that is legislative, judicial, and executive in nature” (Rosenbloom & O’Leary 1997 p. 55). “Most administrative agencies,” they report, have “enabling statutes that give them legislative power to issue rules and regulations.” Additionally, “these same agency statutes” provide “executive powers to investigate possible violations of law and to prosecute violators.” And, finally, these enabling statutes often provide “administrative agencies judicial power to adjudicate disputes concerning whether standards have been violated” (Rosenbloom & O’Leary 1997 p. 55).

By combining the three powers this way, administrative agencies are often attacked as a “headless fourth branch of government.” In 1937, the President’s Committee on Administrative Management made this charge, and it has been a popular attack on administrative agencies ever since. Nevertheless, many “defend the delegation and concentration of power in administrative agencies.” To many agency supporters, the combination of powers promote “agency expertise, the ability to ‘fill in the blanks’ of congressional legislation, administrative flexibility in changing times, and uniformity and predictability for the regulated community” (Rosenbloom & O’Leary 1997 p. 56). Others, too, defend these agencies by showing that none has “boundless discretion,” and “legislative limits are common.” Still others claim that “efficient regulation demands the wielding of all three types of powers” (Rosenbloom & O’Leary 1997 p. 56).

The Fed, because it has all three powers, is an important institution to study.⁷ Although monetary policy is the Fed’s most well known responsibility, its regulatory responsibility

⁵ How much difference is there between twenty-eight or thirty-five days and forty-five? Not much—which shows that the FOMC was able to use its discretion to minimize the impact of the court decision; administrative agencies do this all the time.

⁶ Additionally, as an independent regulatory agency, it has legal independence from both. But remember that this legal independence can be removed by Congressional legislation, so long as the President signs it—or, if he vetoes it, Congress overrides his veto.

⁷ A word on the Fed’s judicial power. Under the Federal Reserve Act of 1913, as amended, the Board of Governors has the power of adjudication over several important areas: suspension of a Member Bank; issuance of a cease-and-desist order under section 11 of the Clayton Act; issuance of a divestiture order against bank holding companies; disapproval of proposed mergers/acquisitions of state member banks or

is important as well. According to the Board of Governors, the Fed has several important regulatory responsibilities. First, it supervises and regulates “all bank holding companies, their nonbank subsidiaries, and their foreign subsidiaries.” Second, it supervises and regulates “state-chartered banks that are members of the Federal Reserve System (state member banks) and their foreign branches and subsidiaries.” Third, it supervises and regulates “Edge Act and agreement corporations, through which U.S. banking organizations conduct operations abroad” (Board of Governors 1994 p. 71).

Nor is this all. The Fed is responsible for four other areas: (1) “regulating margin requirements on securities transactions”; (2) “implementing certain statutes that protect consumers in credit and deposit transactions”; (3) “monitoring compliance with the money-laundering provisions contained in the Bank Security Act”; (4) “regulating transactions between banking affiliates.” And the Fed has responsibility for consumer and community affairs, for the Congress has assigned it “the duty of implementing” legislation “to ensure that consumers receive comprehensive information and fair treatment” (Board of Governors 1994 p. 71).

THE BELIEF IN LIMITED GOVERNMENT & DECENTRALIZED GOVERNMENT (POLITICAL PRACTICES)

Citizens and elected officials believe in limited government, at least as an abstract principle. Despite this general belief, the administrative state is extremely large and very powerful: it exercises authority over a wide-range of issues, such as interstate commerce, the environment, health and human services, labor relations. In a polity dedicated to limited government, the extensive authority of administrative institutions and public administrators raises serious questions of legitimacy. Even though most Americans support the administrative state’s particular functions, this does not change the *perceived* conflict with American ideals.

The Federal Reserve, of course, has an incredible amount of authority over the nation’s economy—which I have discussed previously. Since it has so much power over both the economy and the society, it is an important institution to examine when studying administrative legitimacy.

In the United States, we believe in decentralized government too. As such, more questions are raised about the *federal* administrative agencies than the state and local ones. At the very least, many believe, the agencies at the lower levels of government are more responsive to the people than those at the federal level, and many federal elected officials do not want to involve themselves with the internal concerns of the other levels of government. Most importantly, many federal agencies actually force *elected officials* at the state and local level to act in certain ways—even in matters they feel strongly

bank holding companies; imposition of sanctions upon municipal security dealers. At the same time, the Board has a general power of adjudication under sections 2, 3, and 4 of the Bank Holding Company Act. For additional information on the Fed’s power of adjudication, see the Federal Reserve Act, chapter three entitled, “Rules of Practice for Hearings.”

⁷ Article I, Section 10 of the U.S. Constitution forbids states from coining money (Rohr 1986 p. 198).

about. So many elected officials, especially Governors and Mayors, attack the federal bureaucracy as illegitimate. By what right, they ask, do “federal bureaucrats” have to overrule the elected officials of states and localities?

How does this relate to the Federal Reserve? First, the Fed is a federal agency, so it raises more questions of administrative legitimacy (if my argument is correct) than a similar agency at the state or local level. Second, the Fed has both direct and indirect influence over states and localities—and their elected officials. The Fed has direct influence by exercising Congress’s authority to “coin money” and “regulate the value thereof,” a power the Constitution specifically forbids the states from exercising.⁸ It has direct influence, too, by regulating state Member Banks, forcing the states’ elected officials to accept its decisions even though these banks operate *within their own jurisdiction* rather than the federal. The Fed has indirect influence by affecting the policy options of state and local officials: it influences the economic environment in which they must make policy as well as how much they must spend on social welfare.

HISTORICAL BACKGROUND OF THE ISSUE

Now I discuss the historical background of the period I study—which is 1970 to 1995. While doing so, I examine three important periods in American history: (1) the controversy surrounding the First and Second Bank of the United States; (2) the Founding of the Federal Reserve System; (3) the Great Depression era.

THE BANK OF THE UNITED STATES CONTROVERSY

In the early years of our nation’s history, the First and Second Bank of the United States were major Constitutional and political challenges for American government. More than anything else, perhaps, that controversy frames the issue of the Fed’s legitimacy.

In December 1790, during the first Congress’s third session, Alexander Hamilton “submitted his plan for a National Bank” (Hammond 1957 p. 115). As Hamilton envisioned the Bank, it would be similar to the Bank of England—which conducted commercial business, while also providing essential public services. America’s National Bank would “be an important aid to the new federal government in collecting taxes and administering the public finances,” and it would “be a source of loans to the Treasury” (Hammond 1957 p. 116).

Opponents challenged the proposed institution’s legitimacy immediately. Opponents objected that “the Constitution conveyed no authority to form a bank or any other kind of corporation.” By chartering one, the federal government “would be disregarding the limitations of its powers and interfering with the rights of the states.” As a member of the House, James Madison claimed that a *national* bank “would interfere so as indirectly to defeat a state bank at the same place.” Specifically, it would “directly interfere with the rights of states to prohibit as well as to establish banks” (Hammond 1957 p. 115). Congress could not establish a national bank, Madison believed, because the Constitution was silent on its right to do so. On a *strict construction* of the Constitution, Congress was not specifically given this right, so the institution could not exercise it. Madison’s attack

⁸ Article I, Section 10 of the U.S. Constitution forbids states from coining money (Rohr 1986 p. 198).

continued:

[It] was condemned by the rule of interpretation arising out of the Constitution; was condemned by its tendency to destroy the main characteristic of the Constitution; was condemned by the expositions of the friends of the Constitution whilst depending before the public; was condemned by the apparent intentions of the parties which ratified the Constitution; was condemned by the explanatory amendments proposed by Congress themselves to the Constitution (Hammond 1957 p. 116).

Not that Madison and his cohorts were alone in attacking the proposed institution. Agrarians attacked it too. James Jackson, an agrarian representative from Georgia, argued that the bank was “calculated to benefit a small part of the United States—the mercantile interest only; the farmers, the yeomanry of the country, will derive no advantage from it.” Such attacks were consistent with a dominant ethic of the day, an ethic attacking banks as “a corrupting influence” that “would destroy the free institutions of the New World” (Hammond 1957 p. 116).

In the House, 39 Representatives voted to establish the Bank of the United States; 20 Representatives voted not to. “Most of the ayes—33 out of 39” were cast by Representatives from “New England, New York, New Jersey, and Pennsylvania,” Hammond reports. “Most of the nays—15 out of 20” were cast by Representatives from “Virginia, the Carolinas, and Georgia” (Hammond 1956 p. 117).

This legislation, which chartered the first Bank of the United States for a twenty-year period, was sent to President Washington for his signature. While deciding whether to sign it, President Washington “took all the time permitted him by the Constitution,” as he was concerned about “the constitutionality of the bill” and “consideration of his duty in relation to it” (Hammon 1957 p. 117). Because of his concerns, Washington requested the opinion of two federal officials: Thomas Jefferson, Secretary of State, and Edmund Randolph, Attorney General. Both decided, after considering the issue, that “the measure was contrary to the Constitution” (Hammond 1957 p. 117).

Jefferson admitted that the Bank “might be a convenience,” yet he did not believe it was a necessity. To Jefferson, the distinction between convenience and necessity was fundamental:

Can it be thought that the Constitution intended that, for a shade or two of convenience, more or less, Congress should be authorized to break down the most ancient and fundamental laws of the several states, such as those against mortmain, the laws of alienage, the rules of descent, the acts of distribution, the laws of escheat and forfeiture, the laws of monopoly. Nothing but a necessity invincible by any other means can justify such a prostration of laws which constitute the pillars of our whole system of jurisprudence

(Hammond 1956 p. 117).

Claims of administrative advantage, Hammond observes, seemed to Jefferson “to put an efficient working of the governmental machinery before the maintenance of a simple society composed as wholly as possible of individual human beings and as little as possible of institutions” (Hammond 1957 p. 117).

Hamilton did not accept Jefferson’s argument, which he believed “would be fatal to the just and indispensable authority of the United States.” To Hamilton, the Constitution established a national government that *could govern*. Consider Hamilton’s view of the federal government’s authority to establish a national bank:

Now, it appears to the Secretary of the Treasury that this general principle is inherent in the very definition of government and essential to every step of the progress to be made by that of the United States; namely, that every power vested in a government is in its nature *sovereign* and includes, by force of the term, a right to employ all the means requisite and fairly applicable to the attainment of the ends of such power and which are not precluded by restrictions and exceptions specified in the constitution, or not immoral, or not contrary to the essential ends of political society (Hammond 1957 p. 118).

In the end, President Washington signed the legislation on February 25, 1791 (Beckhart 1970 p. 5). But that did not end the controversy, as we will see.

Although the First Bank of the United States had accomplished a great deal—including “handling the fiscal agency functions for the government in a particularly satisfactory manner” and serving effectively as the “principal holder of the government’s accounts”—Congress did not renew its charter in 1811. By so doing, Congress made the War of 1812 more difficult to finance (Beckhart 1970 p. 8).

Opponents of rechartering, Rowe reports, expressed “the continuing objections that had beset the bank at the time the charter was granted in 1791, including the contention that the granting of a charter to such an institution was unconstitutional” (Rowe 1965 p. 16). The state banks were more opposed to recharter than to original charter; their objections had grown considerably. No matter how high-minded these objections sounded, however, they resulted “partly from jealousy over the government deposits in the bank and partly because of the bank’s refusal to accept notes of nonspecie-paying state banks” (Rowe 1965 p. 16).

Despite the controversy over a national bank, demands were made for another one “within three years after the expiration of the First Bank of the United States” (Rowe 1965 p. 16). In January 1815, Congress approved a charter for the Second Bank of the United States; President Madison vetoed that (Beckhart 1970 p. 9). Madison objected to this legislation, Hammond reports, because “the government was left out” of it

(Hammond 1957 p. 232).

He said the capital proposed for the Bank was insufficient to enhance the public credit by giving a lift to the market prices of government bonds. The Bank would be ‘free from all legal obligations to cooperate with the public measures.’ Moreover, it could not be relied on ‘to provide a circulating medium,’ without which, he said, taxes could not be collected, ‘nor to furnish loans, or anticipations of the public revenue’ (Hammond 1957 p. 232).

In the end, Hammond concludes that Madison supported a Second Bank of the United States, but “not this one” (Hammond 1957 p. 232). While vetoing this legislation, Madison urged Congress to “hasten to substitute a more commensurate and certain provision for the public exigencies.” When Congress heard that the War of 1812 was over, though, its members were “so elated . . . [they] left their seats without waiting for an adjournment, and they could not again be induced to consider the question of a national bank during that session.” Indeed, when legislation conforming to Madison’s specifications reached the floor, it was “killed by indefinite postponement” by a vote of 74 to 73 (Hammond 1957 p. 232).

In December 1815, President Madison urged Congress to do “something about the currency” (Hammond 1957 p. 232). “The benefits of a uniform national currency,” Madison urged, “should be restored to the community.” Since the banks “were still not redeeming their notes,” Congress had three options. It could accept the state banks’ notes. It could accept a national bank’s notes. Or it could accept the government’s notes. Secretary of the Treasury Alexander J. Dallas urged Congress to establish a Second Bank, arguing this was the “best and perhaps the only adequate resource to relieve the country and the government from the present embarrassments” (Hammond 1957 p. 233).

On January 8, 1816, John C. Calhoun introduced a bill to establish a Second Bank of the United States. “It was intensively debated, for though the Republicans had got over the worst of their factitiousness, the Federalists were uncompromising,” Hammond observes. What happened—*finally*—was that both the House and the Senate passed Calhoun’s legislation, and President Madison signed it on April 10, 1816.

The Bank’s constitutionality was a prominent issue in 1791; it was one in 1811. Amazingly, however, the constitutionality of the Second Bank was not an issue in the debates of 1814, 1815, and 1816. “President Madison put the matter clearly and magnanimously,” Hammond reports, “when he *waived the question of a national bank’s constitutionality, which he had been the first to press twenty-five years before*”[my emphasis] (Hammond 1957 p. 233). According to Madison, any debate over the Bank’s constitutionality was “being precluded . . . by repeated recognitions, under varied circumstances of the validity of such an institution, in acts of the legislative, executive, and judicial branches of the government.” The Bank’s administrative legitimacy, moreover, was “accompanied by indications in different modes of a concurrence of the general will of the nation” (Hammond 1957 p. 234). Except “for a few diehards who said

little and were attended to still less,” Madison’s view was accepted (Hammond 1957 p. 234).

Indeed, the constitutionality of the Second Bank, according to the authoritative *Legislative History of the Bank of the United States*, was discussed only twice during the Congressional debates. In one instance, Rep. Robert Wright, who was from Maryland, had originally opposed recharter in 1811 on constitutional grounds. In the 1816 debates, though, he argued that it was constitutional because the Supreme Court had “often recogniz[ed] it” as so (Hammond 1957 p. 234).

Despite the initial consensus in favor of the Second Bank, it was, if anything, much more controversial than the First. While President, Andrew Jackson attacked the Second Bank as a “monster.” In colorful language, Jackson described it as “hydra-headed,” an institution corrupting the “morals of our people” as well as our “statesmen” and threatening “our liberty.” Ultimately, the Bank subverted the “electoral process”—and if left unchecked, it could “destroy our republican institutions” (Remini 1967 p. 15).

The controversy began, however mildly, during the 1828 Presidential election. Although the Bank was not a *major political issue* in the campaign, some believed the Bank was aiding the National Republican Party, to which President John Quincy Adams belonged. Serious accusations were made, for example, about the Bank’s influence in Kentucky, where the Bank was supposedly spending money “to persuade roughnecks and river bums to vote for Adams” (Remini 1967 p. 50).

Nicholas Biddle, the Bank’s President, did not respond to these charges adequately. Instead of conducting an impartial investigation, trying to determine whether they were true or not, he appointed a “committee of the men from the very local branches under attack to submit a report.” As expected, their report concluded the branch banks had acted properly (Remini 1967 p. 51).

Biddle’s failure to give satisfaction to a genuine grievance repeatedly cited in Kentucky was his first mistake. In fairness it should be stated that he was extremely anxious to keep the Bank out of politics. Only his branch officers were not as circumspect as he, and when they were accused of political favoritism Biddle defended them despite contrary evidence. A little later, Biddle compounded his first mistake by his negative response to a second complaint (Remini 1967 p. 51).

Once Jackson became President, he attacked the Bank vigorously. In his very first address to Congress, sent in December 1829, President Jackson attacked the Bank’s constitutionality as well as its effectiveness. “Both the constitutionality and the expediency of the law creating the bank are well questioned by a large portion of our fellow-citizens; and it must be admitted by all that it has failed in the great end of establishing a uniform and sound currency” (Remini 1967 p. 62). But Congressional committees disagreed. In the Spring of 1830, the House Ways and Means Committee affirmed the Bank’s constitutionality. It reported, too, that the Bank “had provided a

currency even more uniform than specie.” The Senate Finance Committee, for its part, reached the same conclusion. Actually, its report “glowed with praise for the Bank”—though this is not surprising, since it was written by Biddle himself (Remini 1967 p. 67).

Biddle reprinted these reports with glee, distributing them throughout the country. While doing so, too, Biddle attempted to “insinuate himself into the Jackson [inner] circle,” but he was not successful. By being such a strong advocate for the Bank, in fact, he only increased Jackson’s desire to rid the country of it. In Remini’s account, the stubbornness of the two men—Biddle, the President of the Bank; Jackson, the President of the United States—was largely responsible for the Bank’s demise. As late as 1830, Remini observes, Jackson would have approved recharter if Biddle accepted some modifications to the Bank. “If a bill were to pass both houses, renewing the charter of the Bank of the United States, with certain modifications, the President would not withhold his approval,” the inner circle told Biddle. Biddle, for his part, was unwilling to accept any modifications, at least none significant enough to address Jackson’s concerns (Remini 1967 p. 70).

By 1831, after an embarrassing Cabinet shuffle, Jackson seemed ready to compromise once again. In his Congressional message that year, the President reported he would accept the legislature’s decision about recharter. Because he was unwilling to repudiate his earlier position on the bank—his basic beliefs, he insisted, had not changed—Biddle was not satisfied. Rather than leave the issue to Congress’s “discretion,” the Bank President believed that Jackson should actively support recharter. Obviously, Jackson would never do that: to do so would be “too abject a surrender” (Remini 1967 p. 74).

Biddle’s major mistake was requesting recharter in 1832, four years before it was necessary to do so. It was this request, Remini argues, that “wrecked all hope for a peaceful solution to the issue and forever doomed his institution.” According to Senator Willie P. Mangum, “by deferring its application to next Session . . . I have no doubt with but slight modification (to save appearances) it would have met with Executive favor” (Remini 1967 p. 75). By raising the issue in an election year, the Bank’s opponents had the “final piece of evidence that the monster was indeed a political agency quite prepared to tamper with the electoral process to get what it wanted,” Remini observes.

The application for recharter was submitted on January 6, 1832. At first, the Bank seemed to have won—despite strong opposition from Jacksonian Democrats, both Houses agreed to recharter it. But this victory was short-lived; President Jackson vetoed the Bill. The issue, his veto message shows, was not just the President’s relationship to the Bank, but the President’s relationship to Congress. Before the Bank controversy, Presidential vetoes were justified on *Constitutional grounds*. Only if Presidents believed a Bill was unconstitutional would they veto it. But in this case, President Jackson advanced political and social and economic arguments as well as Constitutional ones (Remini 1967 p. 80).

As a policy matter, the Bank was a “monopoly” conferring “artificial privileges . . . titles, gratuities, and exclusive privileges to make the rich richer and the potent more powerful.” Even worse, foreigners held much of its stock, which offended Jackson’s nationalist tendencies. As a Constitutional matter, Jackson rejected the Supreme Court’s decision in *McCulloch v. Maryland*, where the Bank’s constitutionality was upheld.

The authority of the Supreme Court must not . . . be permitted to control the Congress or the Executive when acting in their legislative capacities, but to have only such influence as the force of their reasoning may deserve (Remini 1967 pp. 82 – 83).

Congress was outraged. Jackson’s veto, in Webster’s view, was an egregious abuse of Presidential power. Although Congress passed a law and the Supreme Court had upheld it, the legislation is “no law at all, if he, in his good pleasure, sees fit to deny it effect; in other words, to repeal and annul it” (Remini 1967 p. 84). Clay agreed, arguing that the veto power “is an extraordinary power . . . not expected by the convention to be used in ordinary cases” (Remini 1967 p. 85). Despite their condemnation, the veto was upheld. Neither the House nor the Senate could muster the two-thirds necessary to override it (Remini 1967 p. 87).

The Presidential election of 1832, everyone recognized, would settle the matter once and for all. If Jackson was reelected, the Bank was dead. If he was not, a Congress dominated by Jackson’s opponents could recharter the Bank, and a new President would accept it. In their campaign rhetoric against the Bank, Remini reports, the Jacksonian Democrats “cleverly broadened the scope of their appeal to embrace larger issues.” Voters had a simple choice: vote for Jackson, the People, and Democracy *or* vote for Clay, the Bank, and Aristocracy (Remini 1967 pp. 99 – 100).

As we all know, Jackson was reelected. Nonetheless, Remini claims the Bank controversy hurt him. By vetoing the Bank’s recharter, he precipitated a financial crisis in many communities. This financial crisis, in turn, “undoubtedly ate into his majority,” which was smaller in 1832 than 1828 (Remini 1967 p. 106).

Soon after being reelected, Jackson decided to remove the government’s deposits from the Bank. The President decided, he told his Cabinet, to “strangle this hydra of corruption” once and for all (Remini 1967 p. 109). Jackson wanted the federal government’s deposits in the state banks, not the national one. Why? He worried that the Bank would use “the three remaining years . . . to upset the verdict of the election.” By removing the government’s deposits, it would be more difficult for the Bank to do so. Then, too, it was a question of power—removing the deposits would give Jackson “greater control over the direction and operation of the government,” which would “strengthen his position as President” (Remini 1967 p. 111).

But many Cabinet Secretaries and top advisors were unsupportive of the whole idea. Ultimately, this conflict led to a serious crisis in public administration, one raising a fundamental question: What is the proper relationship between administrators and

Presidents? In this case, the question was especially serious, since the Bank's charter vested authority to remove the government's deposits in the *Treasury Secretary* rather than the President. Complicating matters still further was the House's declaration, on March 2, 1833, that the government's deposits at the Bank were not just safe, but should remain there (Remini 1967 p. 111).

In any event, Secretary of Treasury McLane opposed removing the deposits, so Jackson "promoted" him to Secretary of State. As the new Treasury Secretary, Jackson appointed William J. Duane, who was a "leading opponent of the Bank" (Remini 1967 p. 115). Shortly after taking office, though, Duane began to question whether the deposits should be removed. In September 1833, the President ordered Duane to remove the deposits. On September 20, 1833, Duane refused to comply with the President's order. And he decided not to resign over the issue.

When Duane informed Jackson of this decision, the President was upset. The Treasury Secretary, Jackson insisted, "is merely an executive agent, a subordinate" of the President. As a result, the Secretary owes his allegiance to the President. "In this particular case," Duane responded, "Congress confers a discretionary power, and requires reasons if I exercise it. Surely this contemplates responsibility on my part" (Remini 1967 pp. 123 – 124). After considering his options, Jackson decided to fire Duane. His replacement was Attorney General Taney, who ordered the deposits removed.

Even at this point, Biddle was determined to gain recharter. In response to Taney's action, he convinced the Board of Directors to curtail loans "throughout the banking system" (Remini 1967 p. 126). Because of this decision, the nation's economy suffered badly. The Bank's President, Remini reports, hoped to "squeeze until the suffering became unbearable, and in so doing break the 'ties of party allegiance' to win recharter" (Remini 1967 p. 126). In truth, this was a major political mistake. To those who believed the Bank was a political monster, Biddle's action only strengthened their case.

Yet the controversy dragged on, with many members of Congress condemning Jackson's and Taney's actions. During the controversy over the Bank, Congress debated some of the most important issues in public administration. By asserting absolute control over public administrators, Clay feared, Jackson was steering the polity toward "concentration of all power in the hands of one man." Similarly, Clay argued that Jackson's authority came only from the Constitution and the laws—not popular election, as the President claimed (Remini 1967 p. 138).

In February 1834, the Senate rejected Taney's nomination as Treasury Secretary, rejected his reasons for removing the deposits, and censured the President. Not surprisingly, Jackson retaliated with a strong message—which not only condemned the Senate's interference "with this exercise of Executive power," but also claimed the executive power was vested *solely* in the President's hands. Nothing could have more inflamed Daniel Webster, who was widely regarded as the "expounder and defender of the Constitution." Responding to Jackson's message, Webster insisted that Cabinet Secretaries were not "*his* Secretaries," as Jackson claimed [Webster's emphasis] (Remini

1967 p. 145). This “astounding assertion,” Webster argued, leads to “one responsibility, one discretion, one will” (Remini 1967 p. 145).

No matter how important the Whig’s principles were, they were fighting a losing battle. As the economy continued its downward spiral, popular opinion became increasingly hostile to the Bank—which was, quite rightly, blamed for the panic. On April 4, 1834, the House passed four resolutions, and these “spelled the doom of the bank” (Remini 1967 p. 166). First, the House declared that the Bank “should not be rechartered.” Second, the House declared the deposits “ought not to be restored.” Third, the House declared that the deposits should be placed in the state banks. And, lastly, the House approved a Committee “to examine the Bank’s affairs and investigate the reasons for the panic” (Remini 1967 p. 166).

In the 1836 elections, the Democrats gained control of Congress, both the House and the Senate. The Senate’s newly triumphant Democrats, as one of their first acts, voted to erase President Jackson’s censure from the record. “Nothing was left the unfortunate Bank,” Remini observes (Remini 1967 p. 174). The Second Bank of the United States was dead.

THE FOUNDING OF THE FEDERAL RESERVE SYSTEM

After the Bank of the United States debacle, it took almost eighty years before the nation would address the issue again. By passing the Federal Reserve Act of 1913, Moore observes, Congress “ended more than 100 years of debate—often bitter—over how the United States should handle its monetary affairs” (Moore 1990 p. 1). Beckhart agrees: “The history of banking reform from 1791, when the United States Bank was established, to 1913, when the Federal Reserve Act was passed, was long and tortuous” (Beckhart 1972 p. 25).

The Federal Reserve Act of 1913 was a product of its time—politically speaking. The classic political questions of “who gets what, when, and how” were both explicitly and implicitly subject-to-debate, with individuals from the South and West long fearing “domination of powerful eastern bankers” (Kettl 1986 p. 18). In consequence, the Federal Reserve Act emerged as a compromise solution to the nation’s banking problems.

The nation’s banking problems were serious. First, its money supply was inelastic, so it “could not expand or contract with the nation’s needs.” This problem, in turn, was partially the result of federal requirements and partially the result of the limited money supply. The federal government, for example, made national banks “back their notes” with a fixed supply of government bonds. The supply of gold and silver, too, varied little. Unfortunately, the demand for money “varied with the season of the year”—and *that* was especially true in agriculture (Kettl 1986 p. 18).

Second, the banking system could not “mobiliz[e] money in crises,” as bank deposits were hierarchically arranged (Kettl, 1986). Small country banks made deposits in larger city banks, which “deposited their reserves with a larger New York bank” that “lent out their idle cash, most often to investors in the stock market” (Kettl 1986 p. 19).

The nation's banking system, more than anything else, was not designed for recessions. During the Panic of 1907, the third largest bank in New York City failed, causing "runs" on other banks. In response, rural banks "demanded currency for their deposits" and after "the New York banks restricted payments on the accounts, citizens everywhere hoarded currency" (Kettl 1986 p. 19). The nation's economy suffered: unemployment increased; the national product dropped; the price level fell (Kettl 1986 p. 19).

Congress responded by forming the National Monetary Commission, whose members surveyed Europe's banking systems. The United States, they concluded, "suffered from inadequate cash reserves, an inflexible supply of currency, and the lack of any agency to facilitate the exchange of cash and checks between regions" (Kettl 1986 p. 19). So we should establish a National Reserve Association like the European central banks, an agency to serve as a "bankers' bank." If this institution had been established, it would have "discount[ed] loans (that is, buy loans from banks at a discount from their face value, to supply more money for further loans)" and "create[d] an elastic note issue (which would expand and contract with the economy)" (Kettl 1986 p. 19). It would have been an extremely decentralized institution as well—consisting of fifteen regional associations divided into smaller local associations (Kettl 1986 p. 19).

Under this plan, the federal government would have had little control over the nation's financial system, with federal representatives occupying only four of its governing board's fifty seats. Not surprisingly, the bankers saw this as the proposal's prime virtue, and the Republican Party agreed. In 1912, the GOP's presidential candidate, William Howard Taft, gave the plan his full support. But not the Democrats: their presidential candidate, Woodrow Wilson, strongly opposed the plan—saying, like other opponents, that it would only strengthen the bankers' control of the nation's finances. Wilson and the Democrats "rejected the concept of bankers' control . . . and argued instead for banking reform, under government control, and free from the money trust" represented by the banks in New York City (Kettl 1986 p. 20). Could the lines between Wall Street and Main Street have been drawn any clearer?

In 1912, Wilson was elected president. After taking office in 1913, he worked with Senator Stephen Carter Glass (D-VA) to create a banking system "based on federal control through an independent regulatory body like the Interstate Commerce Commission" (Kettl 1986 p. 21). According to Wilson, the nation could do one of two things: "Either . . . give the central control to the bankers or give it to the government" (Kettl 1986 p. 21).

But the bankers would not accept defeat just yet. At least, they thought, the federal government should establish a minimal number of Reserve Banks, since many reserve banks would require a strong central board to bring order to the system. In this age of decentralized government, the bankers were, in effect, arguing that the agency could neither fulfill its mission nor conform to American beliefs with more than a few Reserve Banks. Populists, for their part, rejected this idea, favoring "a larger number [of Reserve Banks] to dilute the influence of eastern financial centers" (Kettl 1986 p. 21). Congress reached a compromise solution: the final law called for a minimum of eight and a

maximum of twelve reserve banks. The Federal Reserve Act of 1913 passed “on a near-party-line vote” (Kettl 1986 p. 21).

So much for the political background: How did the Fed’s proponents legitimate the institution? To President Wilson, the Federal Reserve was *legitimate*—that is, it had a right to govern and was appropriate for a constitutional democracy like ours—for several reasons. First, it would allow the country to achieve an important objective, providing “accommodations which are going to secure us in prosperity and in peace” (Kettl 1986 p. 22). Actually, the Federal Reserve was so important to Wilson that he “later ranked it among the greatest achievements of his administration” (Kettl 1986 p. 22).

Second, Wilson emphasized the neutrality of the Fed’s officials—which is not surprising because, while a young Progressive, he grounded public administration in neutral competence and technical expertise. “The power to direct this system of credits,” he argued, “is put into the hands of a public board of disinterested officers of the Government itself who can make no money out of anything they do in connection with it.” Meeting with bankers who opposed the Federal Reserve Act, Wilson asked them: “Will one of you gentlemen tell me in what civilized country of the earth there are important government boards of control on which private interests are represented?” To provide these private interests with some representation, however, Wilson “suggested the establishment of a federal advisory council, composed completely of bankers, that would meet periodically with the reserve board to advise on policy” (Kettl 1986 p. 21).

Similarly, Wilson made a *public interest* argument, one emphasizing how little control private and regional interests would have over the Fed’s policies. “No group of bankers anywhere can get control,” the President said. At the same time, “no one part of the country can concentrate the advantages and conveniences of the system upon itself for its own selfish advantage” (Kettl 1986 p. 22).

The Federal Reserve Act was very vague, which immediately raises questions of legitimacy. (If we are using a vague statute to create an administrative institution, so the argument goes, how do we know what it will do? How can we say it has a right to govern? How can we say it is appropriate for a constitutional democracy like ours, where power is supposed to be defined, checked, and balanced?) Actually, the vagueness did not concern the Fed’s proponents, largely because they “did not view the Fed as a powerful central bank” (Kettl 1986 p. 22). To the Fed’s supporters, it was legitimate—an appropriate institution for a constitutional democracy like ours with a right to govern—because it would not have *too much influence*. The supporters believed this to be the case, it seems, because they assumed that the Fed’s job would “be relatively scientific and automatic” (Kettl 1986 p. 22). Indeed, the supporters “saw it more as a public utility whose function was simple: the reserve banks would expand and contract the supply of money with the economy’s seasonal demands, while the Federal Reserve Board would oversee the system’s policies” (Kettl 1986 p. 22).

Such arguments are, I believe, one way for people (elected officials, for example) to legitimate an administrative institution—especially in its early stages. In this case,

elected officials accepted the Fed's right to govern precisely because it would not have *too much* governing authority. They believed it was appropriate precisely because its responsibilities would be technical, not political.

When administrative institutions are first formed, arguments about their “scientific,” “technical,” “apolitical,” and “nonpolicymaking” natures are more likely to be advanced than after they have existed for a while, especially if they are important agencies. Examining the Federal Reserve today, no one can seriously claim that it is like a public utility—an administrative institution with little discretionary authority, if any. As a result, to legitimate the Fed now, people must present strong normative arguments. But this was not so when the institution was created, a difference we must recognize.

THE GREAT DEPRESSION

The Great Depression and the Banking Act of 1935: each of these, in its own way, forever changed the Fed. A worldwide economic crisis, the Great Depression precipitated the rise of Hitler in Germany and Mussolini in Italy. In the United States, unemployment reached 25% of the labor force; wages declined drastically; poverty was widespread.

What *caused* the Great Depression? Economists disagree. For some, the Fed is largely to blame for the crisis. If it had entered the open market, purchasing a substantial amount of government securities, the Great Depression would have been nothing more than a mild recession. That view, of course, is most persuasively argued by Milton Friedman.

To a certain extent, Friedman and the other critics—many of whom are Monetarists—are right. Even Carl Moore, an economist and Vice President for Operations at the Federal Reserve Bank of Dallas for 32 years, acknowledges that “it seems incomprehensible that the Fed did not take some aggressive action to stimulate the economy.” At least, it seems incomprehensible when “viewed from the 1990s” (Moore 1990 p. 78).

No matter how strange the Fed's inaction may seem, there are good reasons why it failed to act. First, influencing the business cycle—which is widely accepted as a role of the Fed today—was “not one of [its] original purposes” (Moore 1990 p. 76). In the 1920s, the Fed *did* use open market operations to “modify shifts in gold and swings in interest rates,” but using these to stabilize the business cycle “was an idea yet to be accepted as a role for the Fed” (Moore 1990 p. 76).

Second, even if the Fed had purchased government securities in substantial amounts, it may not have prevented the Great Depression. In 1930, the Fed's holding of securities relative to GNP “was less than 1 percent.” By 1980, by contrast, that ratio was *5 percent* (Moore 1990 p. 76). At first, these seem like small differences. In truth, the increased ratio is very significant—the Fed, because of it, could affect the economy much more in 1980 than 1930. At the same time, few people in the 1930s wanted to borrow money. So no matter how many reserves the Fed created or how low it pushed interest rates, the economic effect may have been minimal at best (Moore 1990 p. 76).

Third, the Fed lacked the *institutional mechanisms* necessary to deal with a crisis this serious. For the most part, Kettl observes, the Fed “had no institutional point of view . . . [during] its first twenty years.” Lacking institutional perspectives and institutional mechanisms, the Fed could determine neither “which problems were its problems” nor “which solutions best solved which problems.” As a structural matter, the Fed was “simply disorganized,” consisting of twelve Reserve Banks that not only made their own decisions, but did so without regard for the nation’s needs as well. Even worse, conflict between the Board in Washington and the Reserve Banks in the twelve districts was common, so the Fed had no unifying purpose. “Without such unity, the Fed was doomed to destructive conflict and drift,” Kettl contends (Kettl 1986 p. 43).

Other authors agree. In *Reform of the Federal Reserve System in the Early 1930s: the Politics of Money and Banking*, Sue C. Patrick discusses the problems created by decentralization. In 1923, the Washington Board established the Open Market Investment Committee to “coordinate purchases and sales of government securities by the twelve district banks and to bring such operations into line with general monetary policies.” But because of the Fed’s decentralized structure, this Committee—which the Board replaced with the Open Market Policy Conference in 1930—could not effectively coordinate the policies. Neither the Open Market Investment Committee nor the Open Market Policy Conference, the Reserve Banks recognized, was mentioned in the Federal Reserve Act of 1913. Before the Banking Act of 1933, for example, the OMPC had to “receive reserve board approval before it could undertake any operations.” In the process, the committee executing the OMPC’s decisions made “open market sales and purchases” only “on behalf of district banks choosing to participate” (Patrick 1993 p. 6).

Personalities were important as well: the Fed “lacked central leadership” after the New York Reserve Bank President, Benjamin Strong, died in 1928. Unfortunately, the New York Reserve Bank’s President “did not have the stature to influence the OMPC.” Although the Washington DC Board attempted to “determine system policies during the late 1920s and early 1930s,” the Reserve Banks “controlled open market decisions.” The Reserve Banks’ independence, in turn, “led to conflict within the OMPC about whether to purchase government securities in 1930 and 1931” (Patrick 1993 p. 13).

In response to these institutional failures, Congress passed the Banking Act of 1935. According to Carl Moore, author of *The Federal Reserve System: A History of the First 75 Years*, this Act “made more changes . . . than had been made in the previous 20 years or would be made in the next 55” (Moore 1990 p. 88). More than any other legislation, the Banking Act of 1935 created the “modern Fed,” the more centralized, powerful, and independent institution we have today.

Consider the most important changes. First, the Banking Act of 1935 removed the Comptroller of the Currency and the Secretary of the Treasury from the Board, which strengthened the Fed’s independence from the executive branch. Second, it created the Federal Open Market Committee (FOMC). The FOMC strengthened the Board’s power not just because all seven Governors served on it, but because every Reserve Bank was “required to participate in the[se] transactions.” Obviously, the Board did not receive

absolute control over open market operations—five Reserve Bank Presidents, along with the Governors themselves, serve on the FOMC. Relatively speaking, however, the FOMC enhanced the Board’s power significantly. Third, it provided the Board with “authority to change member bank reserve requirements to twice the current rate but not lower than the rate on the day of this act.” Fourth, it made some cosmetic changes: the Federal Reserve Board, based in Washington DC, became the Board of Governors; the Governor and Vice-Governor became Chairman and Vice-Chairman respectively, both of whom would serve four-year terms. Fifth, while the Reserve Banks’ Boards would continue to appoint their Presidents, the Board of Governors would have to approve these officials’ appointments as well (Moore pp. 88 – 89).

If these changes had been made in the 1920s rather than the 1930s, President Roosevelt believed throughout his term, the Fed could have moderated the Great Depression (Moore 1990 p. 91). No one knows for sure. We just know the changes were not made in the 1920s, and the Depression developed into a first-rate catastrophe. Tragically, it took a world war to end the Depression.

During the Great Depression, yet another event strengthened the Fed—no longer would it be housed in the Treasury Building. Instead, the Fed moved, in 1937, into a brand new building. Why, a skeptic may argue, is the *Fed’s new building* important? First, having its own building reduced the Fed’s “dependence on the Treasury.” Before 1937, it was a mere “tenant” of the Treasury, so it had trouble exercising “adequate independence” (Moore 1990 p. 92). Afterwards, it was no longer a tenant, which eventually increased its independence greatly. Second, the new building helped the Fed cultivate its image *as a legitimate power center*. This image, one of the strategies the Fed’s officials have used to legitimate themselves and their institution, will be important in the pages that follow.

FROM THE GREAT DEPRESSION TO 1970

Before moving to 1970, when my study begins, it is important to briefly discuss the Treasury-Fed accord and the Chairmanship of William McChesney Martin, two events from the 1950s. During World War II, the Fed agreed to support the Treasury’s bond market, maintaining certain interest rates for Treasury bills—3/8 percent for the shortest-term obligations (ninety days) and 2 1/2 percent for the longest-term obligations (twenty to twenty-five years). Referred to as “the peg,” this agreement ensured that “no Treasury offering would fail during the war” (Kettl 1986 p. 59). After the war, however, the Treasury wanted the Fed to continue supporting its bond market. The Fed, for its part, was concerned not only that this would be inflationary, but also that it would undermine its independence.

This conflict lasted until 1951, when the Treasury Department and the Federal Reserve finally reached an accord on the issue. Because of the accord, the Fed would no longer have to support the Treasury’s bond market, though the institution did agree to “ease the transition to an unpegged market” by “support[ing] the market for a short period” (Kettl 1986 p. 74).

At the time, William McChesney Martin was Assistant Secretary of the Treasury, the department's principal negotiator of the accord. Shortly after the accord was announced, the Fed's chairman, Thomas McCabe, resigned. To fill his unexpired term, President Truman appointed Martin—who served as Chairman until 1970, becoming one of the Fed's most revered leaders.

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