THE BROOKINGS INSTITUTION
SAUL/ZILKHA ROOM

THE POLITICS OF THE FED: PAST, PRESENT, AND FUTURE

Washington, D.C.
Thursday, October 22, 2015

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P R O C E E D I N G S

MS. SHEINER: Good morning, and welcome. My name is Louise Sheiner, and I'm the policy director at the Hutchins Center on Physical and Monetary Policy here at Brookings. One of our main goals at the Hutchins Center is to improve the public understanding of fiscal and monetary policy.

Today's event, a discussion of Roger Lowenstein's fascinating new book, *America's Bank*, about the founding of the Federal Reserve helps us fulfill that mission. Although the book is largely about history, its themes are surprisingly modern and familiar: How independent should the Fed be? How much power should be in Washington and New York? Who should be eligible for loans and on what basis?

To quote Robert Rubin's recent *New York Times* review, "Roger's book should be required reading for anyone who's interested in the continued debate about the Fed's action and governance." But, let me add, unlike most required reading, this book is a pleasure to read and a real page turner.

So, what we're going to do today -- we're going to start off this morning -- Roger's going to provide an overview of these issues from historical perspective. We're then going to move on to a panel discussion that will be focused more on exploring the extent to which the issues from the past still resonate today. And joining us in that discussion will be Don Kohn and Sara Binder. Don is a 40-year-old veteran -- 40-year-old (laughter), he wishes -- 40-year veteran of the Federal Reserve serving as vice chair of the Board of Governors during the financial crisis. So, he knows all about pressure on the Fed. And Sarah is a Senior Fellow now here at Economic Studies at Brookings. Sarah is also, at Brookings, a Senior Fellow in governance studies and a professor of political science at George Washington University, and she has focused a lot of her recent scholarship on the relationship between Congress and the Fed.

Okay, so no more ado.

Please, Roger?

MR. LOWENSTEIN: Louise, thanks very much. And thanks obviously to the Brookings and Hutchins centers and to David Wessel today but did a whole lot to organize this.

When Paul Warburg, who I think of as the intellectual founder of the Federal Reserve, first got to this country -- he was a banker from a privileged banking family in Germany who emigrated here -- he was astonished to see that we had no lender of last resort or central reserve. In particular, he noticed in New York that every fall when they needed cash in the countryside to pay for the harvest, cash would drain out of the cities and interest rates would spike up, and sometimes it would spike to a hundred percent. And he was astonished at this, that an otherwise sophisticated economy like the United States had such a primitive financial arrangement, and he wrote a little paper suggesting that the U.S. establish a central bank like the ones he'd seen in Europe. He was quickly admonished by his brother-in-law, Jacob Schiff, who is one of the leading powers on Wall Street -- also an immigrant from Germany but one who had been in the U.S. already several decades and knew the political culture of the country better -- that he shouldn't mention this at all or his welcome on Wall Street would be very short indeed.

Warburg kept quiet for a bit, but he was, as I say in the book, something of a simmering volcano. He was seething with ideas and passionately advocated the cause of establishing a central bank.

Despite the fact that in 1907 the apparent need for a lender of last resort was quite visibly demonstrated when the U.S. had a terrible banking panic, bank runs all around New York and other cities. And, by the way, when we talk about bank runs in 1907, we mean people actually running, not like the electronic bank runs that we had, you know, against Lehman Brothers some years ago. Despite this terrible crisis, the banking system basically shut down, and they ran out of money, and many of them printed up sort of invented script to circulate in the meantime. The idea of the central bank still was taboo. In fact, in 1912 when Woodrow Wilson ran for President, he said in sum -- and I quote: "I, myself, am opposed to the idea of a central bank." And since this was exactly the opposite of what he had said to bankers in private, many of them were actually quite puzzled, and one of them said to Wilson, you know, again in private: Why did you say this? And Wilson said: Oh, you don't understand politics; it doesn't matter what I think ought to be done, I first have to be elected. Obviously that sort of understanding of politics hasn't been lost in some of the people running for office today. (Laughter)

What Wilson thought, though, he'd actually written down some years back. Wilson, until

quite recently before then, was a famous historian at Princeton University and then the president of Princeton College. He'd written a very famous history of the American government. He was an admirer of Alexandria Hamilton, the first bank. He actually said of the second bank of the United States, the one that Andrew Jackson disposed of -- he said: It's for purposes such as these, the very purposes such as these that the U.S. government was established. Only now that he was in political life, he couldn't say so. In fact, his party, the Democratic party in 1912, specifically said in its platform that it was opposed to a central bank and specifically opposed to the plan that had been offered the previous year by a guy named Nelson Aldrich, known as the Aldrich Plan -- who was Republican -- for a central bank.

Aldrich himself, who mapped out this plan, couldn't even do it in public. When he had drafted the plan in 1910 -- and some of you may know the outlines of this story -- he asked a few financiers from Wall Street to help him write this plan for a central bank, and it really became the first draft of the Federal Reserve Act. Only he didn't invite them to join him in Washington in his office or at his home in Rhode Island but to come to his private railcar at a rail siting on the Jersey side of the Hudson River where they rattled around in that railcar all the way down to Georgia and spent a week in total seclusion under the ruse that they were going duck hunting and there mapped out the first draft of the Federal Reserve Act.

So, why such secrecy and why such fear of a negative public response? The thesis of the book is that a fear of centralism, and specifically a fear of centralism with regard to banking, is sort of the original sin of American politics. It's the birthright that we carry from the revolutionary war experience. It's a birthright, I think, of our frontier experience of mistrust of bankers and particularly bankers at large institutions back East, and it's with us today in the aftermath of the financial crisis and the Feds' very strident interventions in the system, you know, more than I could have imagined, where the generation of 1913 was the fear of conferring too much power either on Washington, on government by which meant Washington, or on big banks by which they meant Wall Street.

One of the four-most opponents of the Federal Reserve Act was Charles Lindberg, the father of the aviator who was a congressman from Minnesota, and he said just before the Federal Reserve Act was enacted that it would solidify and certify and authorize what he called the money trust.

And the money trust was a euphemism for people's illusion of a vague but very menacing conspiracy arising out of Wall Street that controlled people's financial lives. And what Lindberg and many people feared was that once you had a central bank, the government would be in cahoots with the money trust, and, you know, at that point, you know, we'd all be sort of slaves. And they used this sort language that we'd be enslaved forever and so on to the money trust.

This sort of fear is the reason, obviously, that the Federal Reserve System was a federal system, why we have 12 reserve banks around the country. In fact, at the time of the drafting, they wanted to go even further in that direction. Carter Glass, who's often referred to as the father of the Federal Reserve Act -- this is the same Carter Glass who's perhaps better known today as the author of the Glass-Steagall Act later in his career -- but when Glass, who was a Virginia congressman from what we now say very conservative state, a state that didn't want much to do with federal power in the early 1900s -- when he took the first draft to Wilson, then President-elect Wilson, for a new monetary scheme, it envisioned as many as 20 different reserve institutions around the country with absolutely no, you know, federal tie-in at all. So, you know, there'd be a bank in the Southwest, a bank in the Rocky Mountain States, a bank in the Potomac -- you know, whatever. There wasn't going to be anything federal about it, and it was only Wilson with his Hamiltonian experience -- and also having been leaned on by quite a few Wall Street bankers by that point -- who said: I think we need a capstone over this. "Capstone" was his word, and capstone was what became the Federal Reserve Bank.

The congressional debates that ran up to the legislation itself reflected these concerns. The specific issues that they debated -- should the discount rate be set in Washington or should it be set by the individual banks? -- were very much an issue of where should power lay. There was a scorching controversy also over the makeup of the Reserve Board: Should they be bankers who are elected by bankers, or should they be presidential appointees? And, by the way, that answer may seem self-evident to us today, but in 1913 there weren't a whole lot of agencies in Washington, and there weren't many agencies at all directing private industry. The Interstate Commerce Commission is the only one actually then in existence that I can think of. So, the idea that this big private industry banking should be controlled by presidential appointees was very controversial, particularly, obviously, with bankers

themselves. And there was a very lively controversy over the character of the money that this new entity should distribute. Should it be based on bank loans? Should it have the imprimatur of the United States government, which today we take for granted but then was extremely controversial? William Jennings Bryan was the foremost exponent of that, and he was over his days of being a champion for silver-backed money but still very much wanted to make sure that whatever money the new system countenanced would be distributed widely enough.

At the roots of this controversy over the nature of the money -- what sorts of paper would the Federal Reserve accept for Federal Reserve Notes; what would the collateral be behind it; and so on -- was the issue that then and now is the most controversial and goes to the heart, I think, of the Federal Reserve's mission, which is: How do you control the money supply? Who will control it? And will there be enough or too much supply? Bankers wanted the currency to be tied to the amount of so-called real bills or actual bank loans in circulation so that, as they put it, with a certain 19th century idealism, the amount of money in circulation would automatically self-adjust with the amount of business. That was their hope. It actually proved out not to work very well.

Farmers had a very different idea. Farmers wanted things like granary receipts to be convertible into money. In fact, they wanted to monetize agricultural products like cotton and wheat and so on. So -- that was because they wanted to make sure that there was an ample money supply. We saw in 2008 when Chairman Bernanke -- and 2009 -- when he expanded the list of securities that the Fed would loan against his own innovative means of, in effect, increasing the sort of securities that were monetized. That was very controversial in 2008 and 2009. I think it remains very controversial based on the bills that are in Congress today, and it was very controversial in 1913.

So, I think to summarize it, the debates then were about: Who would hold the power? Where would that power be located? What would the money consist of? And what would be the guide for limiting that money supply? Would it be bank loans? Would it be gold? Would it be something automatic, as with Milton Friedman's later suggestion that it left to a computer? Who would run this thing? And I think that's still very much at issue today.

MS. SHEINER: Thank you so much.

So, as you mention, Carter Glass was originally completely against the idea of a central bank ruled by the government, and yet it happened. So, that was kind of shocking. How were the two sides who started out so far apart able to compromise, and could such a thing happen today?

MR. LOWENSTEIN: Well, I'll answer the first part -- the second part first, because --

SPEAKER: Your mic isn't on.

MR. LOWENSTEIN: Oh, mic's not working? How about now?

SPEAKER: Yes.

MR. LOWENSTEIN: Better? I'm going to get a sore neck if I have to lean down. I'm just going to speak loudly, and tell me again if it's not working.

The second question was: Could such a thing happen today? You know, I had a sense of wistfulness as I finished the book. You're living with these characters. It was a long struggle that they had to get this thing passed. There were great differences between Republicans and Democrats; farmers and bankers; people in the Northeast, people in other parts of the country. And yet they were able to get this thing done. They arrived at some compromises -- such as federalization -- which were very much in tune with a sort essential system of government that we have. They didn't compromise on what they saw as basic principles. And the wistfulness was about in our political system as its operating or not operating today: Would we still be capable of tackling such a tough, complicated issue, different interests, and so on, and arrive at some reasonable and functional solution. And, Louise, I don't know.

You know, the politics of how Carter Glass got there -- this money trust specter loomed very large in 1912, and the Democrats felt that, and we see this today -- often issues -- they had to do something. And although the money trust was the idea that there were monopolies running wild on Wall Street.

There was a lot of collusion on Wall Street. There wasn't that much collusion in commercial banking. There were, you know, 20,000 banks or something in the country then. It was way more dispersed than, say, oil or any of the other trusts. But the Democrats had this idea they had to do something, and they just -- they quickly took all this Republican Bill that I mentioned and began to disguise it and pretend that they weren't taking anything from it.

You know, that's how Washington works sometimes. There's a political need to do something, and hopefully something will respond to what the actual problem was. And I think due to Wilson's influence and the influence of bankers who probably understood the problem better than Carter Glass, they got pretty close.

MR. KOHN: I was struck in the book -- by the way, what Louise says is right. This is a really interesting book. I'm not a typical reader -- 40 years at the Federal Reserve. It's a really interesting, well-written book, and I think we'd all benefit -- everybody, particularly in this town -- would benefit from reading it. And one of the things that struck me about the process was the involvement of the President. So, you've got to Wilson's election, and there were very sharp disagreements. There was an agreement that something needed to be done -- we don't always get that today -- but very sharp disagreements on what needed to be done. And the President took this issue and took something from one side, something from the other side, and then kept very closely involved with the negotiations, called people in, got William Jennings Bryan to really shift his position or at least not object to something he might have objected to before. So, it took that authority, the presidential authority, and its force to bring people together.

MR. LOWENSTEIN: Wilson -- you know, we tend to think of Wilson, I think, as the failed negotiator or lobbyist for the League of Nations and the Versailles Treaty and the sort of old man suffering a stroke in the height of ineffectiveness. But in 1913, he was an idealist that had really charmed the country and a constitutional scholar, literally, and really understood the mechanics. And, you know, perhaps in the same way that we remember in our lifetimes Lyndon Johnson having manipulated and moved the political process, Wilson was no slouch.

MS. BINDER: Again, kudos on the book.

MR. LOWENSTEIN: Thank you.

MS. BINDER: This was a total joy, and I learned quite a bit.

It's hard these days to defend Congress, but I'll just throw in a word while we're at praising Wilson. Just keep in mind, right?, this is the first unified Democratic party control of government in 20 years after that 1912 election, and in part we have that to thank because of Teddy Roosevelt

splitting the Republic vote. That made a difference, right? You mentioned going into a party caucus. It was --

MR. LOWENSTEIN: That very much made a difference. In fact, one scholar has referred to the Federal Reserve Act as being the result of the accident of the Wilson presidency, the accident being because, as Sarah referred to, the Democrats had only elected one President since the Civil War, Grover Cleveland, and who knows when then they would have elected another but for the fact that Teddy Roosevelt couldn't bear to see his protégé in the White House being Howard Taft. So, he ran against him, and that divided the vote. And not only did the Democrats then come to power, but there were a great many first-time congressmen in the House. I forget the exact number but more than a hundred, and they didn't have their own power base, so they were very much willing to follow the President. And when the committee chairman had trouble, Wilson called them in and was able to work his own political power.

MS. SHEINER: Let's talk about some of the components of that original compromise. In particular, you talked about the regional reserve system and sort of this idea that you'd have banks spread all over the country. So, some people now criticize the reserve system and say it's not constitutionally sound, because you have people who are not appointed by Washington having votes on monetary policy. But other people see this disaggregation as still a source of strength. So, how important do you think it is to keep that original system of the spread of disaggregated power, and how much power do you think should come back to Washington? Actually, Don, if you want to talk about how useful the Reserve System is today for monetary policy, that would be great.

MR. KOHN: I think the reserve banks play a very useful purpose in monetary policy by bringing independent perspectives to bear on the policy process. And I think of it -- in my spare time I'm an external member of the Financial Policy Committee at the Bank of England; and the external members of the Monetary Policy Committee at the Bank of England and of the Financial Policy Committee are there explicitly to get in the way of group think, to bring independent views, to make sure that the policy isn't just driven from the top and you have things coming from the bottom and other perspectives. And I think that's a really important role that the reserve banks play, because each President has his or her own

research function to back them up. They're not dependent on the Board of Governors for their research and their backup. They're not dependent on the board for promotion or something like that, so they're in place and they can bring these independent views. I think -- and they act as an outside-the-Beltway channel for communication to the rest of the world, to the rest of the country; and I think that's helpful, particularly in this day and age, to not be entirely concentrated inside the Beltway and the Board of Governors where there's so much suspicion of Washington.

Having said all that, I'm uncomfortable -- but I don't know what to do about it -- with the bank ownership of the reserve banks. But it doesn't sound right that the commercial banks own an important part of the Federal Reserve System, that these important policymakers are not appointed by the President and approved by the Senate. I'm not a lawyer, so I'm not going to talk to the constitutionality of this. I think the Supreme Court has looked at it and kind of thrown the case out and said to the, I guess the Senators who are suing: If you don't like what you see, go back and change the law. But I wish I could think of ways to make sure that those independent views were represented with kind of a different structure underneath it, but I don't have a cure for that. Given how broken the presidential appointment process is and the approval process, I wouldn't want to fold the reserve banks into that; otherwise, there would be nothing but vacancies at the reserve. The reserve bank presidents -- they wouldn't serve that function.

MS. SHEINER: Sarah, does the fact -- do the reserve banks change the relationship between the Fed and Congress at all, or --

MS. BINDER: Well, the reserve banks and their sort of political consequence --

MS. SHEINER: Yes.

MS. BINDER: One thing to keep in mind is when these compromises that Roger details were made in 1913, there was no expectation that there was going to be -- I don't think -- a national monetary policy being set by the board, right?, in Washington. That monetary policy was to be set by these regional banks. It wasn't really in the terms of -- I don't think monetary policy as a -- correct me -- but I don't think it was actually a term per se, right? They were supposed to be lenders of last resort. They were supposed to be the drivers of elastic currency. But changes after the Depression when that

system really fails, right?, brings up an importance of the reserve banks so they get votes, right?, in a system that I think Carter Glass might have been pleased with.

MR. KOHN: There's no (inaudible).

MS. BINDER: Sure. There was that as well. And so I think to some extent we're dealing with the unintended consequences, right? You inherit the system, and then there are pros and there are cons, because we probably wouldn't create it that way.

MR. KOHN: 1935 was an important change, really, in the system where the FOMC as it currently exists was created. The board was given the majority on the FOMC. Unfortunately because of the appointments process it doesn't always -- right now it's 5 to 5 rather than 7 to 5. So, Congress tried to address the deficiencies with which the Fed met or didn't meet the challenges of the Depression and the problems with the decision-making by changing things and questions whether further changes are needed and how to affect them and keep the good parts without destroying them.

MR. LOWENSTEIN: On the reserve banks, I very much like that they're here now and I think they should stay. I live in Boston, and one of the people who's on the board of the Boston Federal Reserve is Roger Berkowitz, who is the owner of Legal Sea Foods, which is a very popular seafood chain up there where I go to eat all the time. So, I was asking him, you know, you sell fish, what do you know about banking. But, really, when he described it to me, who would have a better handle on wage pressures in the labor market than someone who runs 40 restaurants around New England. And so when Eric Rosengren, the Boston Bank president comes to Washington, he's hearing from people like Roger, and I think that's something that you get in a different way than you get from the statistics or whatever. I also think that politically, for the same reason that it was important to Carter Glass -- let's face it, the Fed, I think, outside of Washington has less political legitimacy today than I can remember at any time in my lifetime. I think it's a somewhat scary moment; and, you know, to further centralize it, Paul Warburg said when it was created that he wanted the Fed to be like the great monuments of Europe -- like the great cathedrals in Europe he said -- a lasting monument. And for that it would need bipartisan and national support. And, you know, it's still a federalist country. So, I think that structure is important.

MS. SHEINER: So, sort of on that note, one of the issues that comes up in the book is

the question about whether monetary policy, even if they didn't use the term back then, should be viewed as a political endeavor or a technical one. And you quote Senator Aldrich in saying, you know, that monetary policy -- these policy questions were business questions and not political questions. And I think the Fed today also sort of says that same thing, which is they get the mandate from Congress, you tell us what to do, but we will decide how to do it as if sort of, you know, they're able to make policy without politics intervening in the way fiscal policy can't.

So, one, how did that happen that the power was sort of viewed as technical; and, two, you know, is that something that's kind of at risk today -- so, if you want to say it started by, like, that idea whether or not that was an issue back then or --

MR. LOWENSTEIN: Well, Aldrich's conception was that this was -- Aldrich designed this sort of prototype plan that evolved into the Federal Reserve Act, but it was going to be a self-regulating body. You know, bankers would regulate how banks did their business, including circulating notes, which was their country's money. It was a much less national or public inception than was adopted by Wilson with the advice of people like not only William Jennings Bryan but also Louis Brandeis, who had a -- you know, they fully embodied the Progressive spirit of the times, which was, you know, banks should be run for the people or for their society as a whole. You know, it wasn't, though, till later when you had more obvious and legal manifestation of things like the dual mandate. I mean, there was only, you know, one mandate going in. It was a suggestion. There's one line in the Act where it talks about regulating the commerce of the country. So, even if you want to read into that a body with 200 economists and so on and measure an employment rate. But they didn't read that far into it.

MS. SHEINER: Mm-hmm.

MS. BINDER: But I think we can think about it this way, right? We have all these models from economists that tell us, right?, that we have central banks, independent because politicians tie their hands behind their back because they know that the policy outcomes will be better. And the beauty of Roger's book is that it's clearly that that's not what politicians are thinking when they're making the choices about how to design the Fed, right? First of all, the issues of compromise, right? Even if you wanted a totally independent Fed, and most of these coalitions didn't, right?, that's likely not what you're

going to get, because the compromise is needed. And so if you think about it, right?, and maybe this is me as a political scientist as opposed to how an economist would think about these, right?, these are the most important decisions made in a democratic society. How much employment? All right, what do we do about price stability and at what cost to generating jobs? And those -- again, I'm biased, I study Congress -- but those should be within the purview in some way at some level by a legislature, right? And so they imposed certain degrees in accountability on what the Fed is going to do, and so thinking of the Feds, a technocratic institution that's really not the way -- I mean, it's a whole -- it is as Roger said, it's a public institution.

MS. SHEINER: Mm-hmm.

MR. KOHN: Yes, but I do think in the 1970s it evolved in the direction of Congress setting the goals, stable prices, maximum employment, moderate long-term interest rates, and setting up a series of hearings to see how the Fed was doing to achieve those goals and what it was doing to achieve those goals with lots of kibitzing along the way and lots of feedback from the political process, both the administration and the Congress, particularly in the '70s, '80s on that. So, I do think -- and Congress -- so, I think Congress did know. In that case, they were kind of tying their hands. They set four-year terms for the Chair, 14-year terms for the Board of Governors. In 1978 when they talked about GAO audits -- this is under discussion now -- they said: Yes, audit everything but monetary policy, but don't audit monetary policy. So, I think in that sense, it was a conscious decision to at least have a little bit of a hands-off of the --

MS. BINDER: I think the parties of -- I mean, the odd thing about the '70s is the Democrat House passed a bill that allowed the audits of the monetary policy, of the FOMC, and that was struck out quickly by the Senate. And so these are politically contested questions for sure, even though Congress eventually draws them down to what they're willing to be responsible for.

MS. SHEINER: And how much do you think that's under pressure today with legislation like the Taylor Rule legislation. I mean, that's sort of a way of trying to say no, you can't just do whatever you want.

MR. KOHN: I think there is a line between what Roger writes about -- what should be

money; can we trust the government; can we trust the banks to create price stability; and working with the Federal Reserve to create price stability, what should be behind a Federal Reserve Note -- and today's discussion of Taylor Rules and whatnot. So, kind of to Sarah's point, I think where we've gotten in today's discussion is at least for some of the congressmen, they're not satisfied . Let's give them a goal and then ask them how they're getting to it. We want more details on how they're getting to it. We want them to adhere to a certain way of getting to it -- Taylor Rule -- and if they're not adhering to that, they have to issue an explanation. Well, bring in the GAO to look at their explanation. So, they're getting much more into the tactics and strategy of monetary (inaudible), or at least that's what they say they want to do. Those things haven't passed yet, but it's -- you're right, it's more and more in the --

MR. LOWENSTEIN: I think -- I want to point out that what's going on today, the pressure on the Fed, in Congress, and in the country is very different I think than in the '70s. In the '70s and early '80s, the pressure on Volcker -- you know, the unhappiest of Democrats -- Volcker was very understandable and rational on the part of people, the construction industry was unhappy with 15 percent interest rates, lots of consumers were unhappy. People should be unhappy when interest rates are high. Maybe Volcker was right, maybe -- you know, we can debate that, but that was a rational form of protest on the part of the people who were protesting. Today -- and I don't remember another period like this -- if you sort of look at the locus of popular or populous protest, it's coming from people who say interest rates are too low, and that's -- you know, that's really kind of curious. It's a much more ideological rather than a pragmatic protest, and to me it sort of takes us back to 1913. People just don't want, you know, this central bank. They don't want fiat money maybe or something. But it's less pragmatic, more ideological, and, to me, a little more scary.

MR. LOWENSTEIN: Yes.

MS. SHEINER: That's such a -- when I was reading the book, one of the questions I had was, like, so, because we always think, like, exactly as you said that, you know, that Alan Greenspan said, the Fed is supposed to take away the punch bowl. The pressure is that they're going to have too easy money, and now this political pressure is that, you know, people are upset that the money is so easy, and so you wonder are they actually building their self-interest. But I think, as you said, you sort of

saw that right at the beginning, which is there's almost a moral dimension to money and fear of inflation. And similarly, people are so worried about inflation now, they hadn't seen it. Well, they had really not seen it, you know, back then; and yet, still, that was sort of the worry, that we were going to have a lot of inflation. And, you know, do you find that kind of surprising or not that surprising?

MR. LOWENSTEIN: I find it the temper of the times, that we were talking in the other room before the session about what's going on in the House of Representatives today, and the majority party basically has been unable to pick a speaker, because they're divided on whether or not they want to shut down the Federal Government. Those aren't, you know, pragmatists at work; those are people who are maybe very much in tune with the Jeffersonian idea of small government and, you know, this is all about ideology right now.

MS. SHEINER: Mm-hmm. Don, were people at the Fed surprised at how much pressure they were getting from, like, people thinking that there was going to be so much inflation when there hadn't been, or was that just something that we're used to, sort of that?

MR. KOHN: I thought people -- remember, I left in September of 2010, so I had experience with QE1, as it's now known. (Laughter) Before 2 and 3. And I guess I was a little surprised not only from the public but also from academia. I can remember going to conferences in the spring of '09 -- April, May of '09 -- so this is after the announcement had been made we want to take the balance sheet up by, I don't know, 850 billion or trillion something. It wasn't -- in today's world, it doesn't sound that big; at that time, it did. And there were any number of academics who -- so, in conferences from Stanford to Princeton and in between -- Zimbabwe, Weimar -- it's not whether this is going to cause inflation, it's when. And I think people had been used to thinking about the size of the Fed's balance sheet and leading directly to or closely tied to a future rate of inflation, and that's not what happens at the zero -- at the end liquidity trap at the zero bound. And I think this infected, to some extent -- to considerable extent -- the political discourse. If I think about the Republican presidential primaries of three years ago, it was all about the Feds debasing the currency, right?, and we're going to get inflation, and, if anything, inflation has gone down since that discussion occurred, and the currency has risen since that discussion occurred. And I guess maybe what's a little surprising is that there doesn't seem to be --

oh, maybe I shouldn't be surprised, but it's naïve of me to be surprised that the facts haven't seemed to get in the way of some of these arguments and discussions.

MR. LOWENSTEIN: Well, it's just a matter of when, like they say.

MR. KOHN: Right, that's it.

MS. SHEINER: Let's talk about the wording "elastic currency." So, the original Fed charter was too (inaudible) elastic currency. So, what do they mean by that exactly?

MR. LOWENSTEIN: I think it's useful to divide the 19th century into two parts. The first part was the early part of the 19th century when there was no national apparatus at all. You went to Indiana, you opened up a bank, you got some deposits, you issued notes. That was money. And, you know, hopefully the notes circulated far and didn't come back for a long time, and you didn't have to redeem your debts. And these banks might inflate, they might go bust. It was willy-nilly. It was, you know, frontier times. And owing to the exigency of the Federal government having to raise money in the Civil War but also recognizing a need to normalize things, the country went on a very new type of format, in marked auto format for the first time, really, which was the National Banking Act or, really, two Acts in 1863 and 1864, and that very much regulated the issue of national bank notes or currency. All sorts of rules on the collateral you had to own, the amount of reserves, in return for which you had the privilege of issuing notes. So, the one thing that people had seen in that system which wasn't satisfactory -- one of the things was the lack of elasticity. The supply of notes was governed by all these rules, and they weren't easily changeable, and they weren't changeable at all in the short term. So, when they said "elasticity," they meant: Hey, money's tight; we need more of it, and we don't have the means to do it. That's the idea they were getting at.

MS. SHEINER: How do we think the actions of the Fed during that national crisis related to the original charter? So, was that a way, Don, do you think, of providing elastic currency? Is that how you see it? Or is it something different or something they didn't envision?

MR. KOHN: I think several aspects of what we did, perhaps not so much the QE or (inaudible) asset purchase part but the discount window part I think were a natural evolution from the way -- the reason the Fed was founded. So, when the elastic currency, as Roger said -- what happened was

that the demand for currency (inaudible), and there wasn't a compensating increase in supply, so the price would rise, as he explains in his book. And this happened a lot in the fall of every year because of the produce coming to markets and the farmers needing to pay workers, et cetera, to harvest the fields. And so often, the crises, as in 1907 but others as well, would occur in the fall, because if you had something bad happening in the economy together with the seasonal tightness, everything got magnified. So, I think a key aspect of this was instead of allowing of the original Act and certainly what the Fed was trying to do was instead of allowing the increased demand for reserves or currency to drive up its price, meet it with increased supply to keep the price down, to keep the interest rates down.

If I think about even the very beginning of the crises, August 2007, the first thing you observed was the interbank interest rates, so the Fed set an interest rate in its Open Market Committee -- can't remember what it was, 5, 5¼. The interbank interest rate -- that interest rate started to rise above the Fed's goal, and there was upward pressure in a number of dimensions because the demand for reserves and the demand for currency, demand for liquidity was so strong relative to supply, and we saw that one of the first things we needed to do was to meet this demand if only to enable the FOMC to retain control of its policy rate and not have an unexpected tightening come into the market. So, yes, I think - and again of course this happened in the fall of '08 after Lehman Brothers -- their huge flight to liquidity and tremendous upward pressure on private interest rates and interbank rates and a drying up of the interbank market, and I think that's exactly the kind of panicky situations for which the Fed was founded to protect Main Street from the problems in the financial sector.

Now, we didn't -- we weren't entirely successful in that regard, obviously. There was a very, very deep recession. But that certainly was what we were trying to do. We were trying to meet those demands so households and businesses would keep their access to credit and we could protect Main Street from the problems that were going on in the financial sector by supplying an elastic currency, in effect.

MS. BINDER: How do you think the founders of the Fed would view the Fed today and view the actions during the financial crisis?

MR. LOWENSTEIN: Yes, that's a good question. I think on any of the specifics they'd

either be surprised or confused or perhaps even uncomprehending. I mean, the structure of the Fed is so much bigger. The role -- not only of the Fed but of the government and the economy in so many ways -- is bigger. You know, QE2 -- that would have been QE anything -- would have surprised them. And, by the way, I think the fiat money would have deeply disturbed them. It was a very core belief that money had to be backed by something. Even William Jennings Bryan wanted silver-backed money, not just, you know, printed out, you know, scripts so to speak. But if you get away from those specifics and if Warburg had come back and seen that unlike in 1907 and the panic a hundred years later, this time there was one central body that recognized there was a serious liquidity problem and it met it vigorously and repeatedly and in earnest. I think he would have approved. I think he would have said that's what we wanted us to do.

MS. BINDER: I mean, the counter, alternative way of thinking is that, look, the monetary policy became the only game in town, certainly, after the end of stimulus. And I don't get the sense from the origins of the Fed that they ever would have imagined a world where fiscal policy didn't have some role to play. And granted fiscal policy itself looked quite different, and of course there was no government debt, barely, in 1913. So, the world looks quite different. But the idea that the Fed would be called on to be the game in town to single-handedly, really, hold up the economy might have terrified Carter Glass.

MR. LOWENSTEIN: Well, I would take issue with that in this sense, which is I don't think it was accepted then that it was Congress' or the government's job to bail the country out of recessions. Grover Cleveland -- so, the recession of 1893-'4, '5, '6 may have lasted four years. Very severe depression. The President, Grover Cleveland, said it's up to the people to take care of the government, not vice versa, and he meant it. I mean, he was -- and he was a Democrat. But, you know, infrastructure programs, stimulus bills, that wasn't on the agenda then, so I don't know, what --

MS. BINDER: It looked different, right -- roads, canals, bridges.

MR. LOWENSTEIN: Yes.

MS. BINDER: Just infrastructure looked great. For sure the size of the federal government was something in transition at that time.

MR. KOHN: Interesting aspect of our actions in '08, '09 was that we ended up being the

lender of last resort for the world. So, the swap lines that we set up with foreign central banks, given the globalization of finance and the very heavy reliance on the U.S., and the shockwaves from what was going on in the U.S. out to the rest of the world, and the demand for dollars and dollar liquidity all over the world, the Fed ended up, via its swap lines with the other central banks, lending dollars to commercial banks all over the world. That they surely would never have anticipated.

MS. SHEINER: Yes, that's interesting. Let's talk about closeness to Wall Street. So, some people think that the Fed first failed to see the excesses in the financial system because they were too close to Wall Street, and then they thought they were too quick to engage in bailouts because they were too close to Wall Street. And, you know, this is a critique that obviously goes back, as you described, to the duck hunting -- you know, Jackal Island. So, can you tell us a little bit more about how the tensions played out back then and how they resolved those to some extent or not?

MR. LOWENSTEIN: You know, I mean, I think it's a very natural fear that people had that if you're going to have the government involved in banking, it's going to have to dealing with bankers. It's probably going to be dealing most with the larger bankers. Will that corrupt their point of view? Even before the Fed was created and rather before it was even in conception, the Treasury Secretaries began to sort of try their hand at acting -- playing central banker, and they would -- as revenues came in from the tariff, which was the main source of government revenue, they would deposit these revenues in various banks around the country. And Secretary Gage in the (inaudible) year was highly criticized, because the bulk of the deposits kept going into a few banks in New York, and one time in the very end of the 19th century he made deposits in banks all around the country. I have a list -- Omaha, Cincinnati, Atlanta, New Orleans, all arounds the country. But he regretted that or lamented that what would these banks do when they got deposits from the government but moved the monies someplace where interest rates were higher, which would be in New York. So, you know, the money ended up in New York anyway, and he said money is as fungible as water and will find its level just as quickly.

I don't think it's possible for the government to be involved without, you know, without some sort of partnership with large financial institutions; and that, then and now, bothers people.

MS. SHEINER: Mm-hmm. So, do you -- so I think the Fed has become very conscious

of the fact that that bothers people and maybe has limited how much communication it has with Wall Street, and to what extent do you think that's an impediment to the Fed knowing what's going on and using expertise? Have they sort of been so worried about the politics of that that they have limited it?

MR. KOHN: I don't think it's hard to find out what Wall Street's thinking, and there are lots of channels for that. I do think it's very important that the Federal Reserve understand the markets and that that understanding be broader than just through the Federal Reserve Bank of New York -- which is the Fed's window into the markets -- and tracks it. And so I think it's important for the Federal Reserve Board and for reserve banks outside of New York to have financial expertise and to understand it, and if I think about leading up to the crises and in the crises some of the people who saw the problems coming and understood what was going on best were the bankers on the Federal Reserve Board -- Sue Baise, Betsy Duke. They kind of understood that something was wrong and wasn't working right. And so I think it's really -- not everybody on the Federal Reserve Board should be a PhD economist. I think you need a variety of expertise, and the same is true out in the reserve banks. You do have a Dennis Lockhart. You have the new person in Dallas, who has expertise in the financial area, and I think it's important to have that. I don't know that you need to have a lot of long (inaudible) meetings with Wall Street people. You get their input in any case.

I do think, on the closeness to Wall Street, it has been a problem for the Fed and in the political environment, and a huge amount of resentment of what are characterized as bailouts but of loans that we made when I was in there I would have characterized as acting as Bagehot wanted us to act to supply liquidity in a crisis. Some of the feedback from that, the blowback from that, I think is reflected in Dodd-Frank, and the extra -- the resolution of systemically important institutions giving the regulators a tool to fail these institutions hopefully in an orderly way, the extra capital requirements mandated by that Act, the Volcker Rule, which limits the activities of these large banks. So, I do think they're -- that blowback was in there.

What's a little puzzling is that you have protests today, or people are unhappy today, and they want to do more to the large banks, and some of the people who want to do more in the large banks also want to repeal Dodd-Frank. It's not clear to me how all this fits together.

MS. SHEINER: Sarah?

MS. BINDER: And I guess -- and I think it is unfortunate for the Fed. Those battles from Dodd-Frank, as you suggested, are still going on. And if all the efforts to think about Federal Reserve reform today -- the one with Vitter from the far right and Warren from the far left -- over how are you going to change the emergency lending powers in a 13-3, I think that's a live issue; and the ways in which they're thinking of changing it give Congress a fair amount of power. If the Fed makes these emergency loans to an institution that doesn't fit the new definitions under the Bill, then Congress would have to approve the ability to keep lending.

So, these problems haven't gone away. And I think if anything they've intensified until one of the parties makes its choice.

MR. LOWENSTEIN: I think it's remarkable that the Fed having saved the system, Congress in these various Bills that Sarah and Don are alluding to is earnestly working to make sure they can never save the system again. But when you talked about the New York proximity problem, I think there's a more earnest question about it, not after the crisis struck, but looking at what the New York Fed did or didn't do in terms of regulating banks -- and other Feds, for that matter, right? I mean, there was, you know irresponsible mortgage lending going around the country, and I think there's a good study to be written on capture or not. But that's, to me, a real question.

MR. KOHN: Right. Some of the -- a number of the issues were more, actually, spread around the country in terms of mortgages than they were in New York, and often by state-regulated mortgage brokers for example.

MR. LOWENSTEIN: Right.

MR. KOHN: I think one of the real problems for the Fed -- interested in hearing Sarah talk about this -- is there is a perception that the Fed has more power and authority than it has and more responsibility. So, if you asked who was responsible for financial stability, both in the past and currently, most people who have any thoughts on this matter would say it's the Federal Reserve. But I think the Fed's authority is mostly bank holding companies and a few systemically -- a very few systemically important other institutions. It needs to work with the SCC and the CFTC and other regulators. If it goes

beyond that, it's a very complex set of regulations. So, I do worry that still people think the Fed can do things that it really can't do and authority isn't equal to the responsibility, and that's a recipe for future problems.

MS. SHEINER: So, to what extent is what Roger said true, which is that the Fed wouldn't be able to do again what it did during the financial crisis, both because of Dodd-Frank and because of the fear that any time it would make some big something, Congress would react?

MR. KOHN: Oh, I think it's a big problem, and I think the restrictions are already there on lending to non-bank institutions that were put in Dodd-Frank worry me. So, you have to get the approval of the Secretary of Treasury. The Secretaries that I've worked with would all be fine, but I don't know what a future Secretary is going to be like. You have to -- and that puts it into the political sphere, the lending end of the political sphere, the transparency aspect. So if you lend to -- even now if you lend to a non-bank, the name of that institution goes to Congress that week. The Federal Reserve can request -- anonymity can request that this information be held confidential.

Now, think of yourself as an institution that needed to borrow -- well, I think everybody's thought processes went there. I remember a guy from an insurance company. I asked this person why they weren't participating in the securitization program that the Treasury and the Fed had put together to support securitizations. This was right after the auto folks had come into Congress and flown their private planes, and this is an insurance company of Hartford, and he said: My boss told me that if he had to ride his bike to Washington and appear before Barney Frank, I was fired, so we're not participating in that program. (Laughter)

I think the politicians -- there's been an overreaction. I think we did -- we, the Fed, did what we needed to do, and also on the FDIC program. So, the guarantee of deposits -- that's subject to a Congressional veto already, so in effect the Congress said to the authorities -- the FDIC and the Fed: You supply too much liquidity in this panic in an effort to stem the panic, and we are going to put constraints on you. And I think that's a problem. And then as Sarah says, they're thinking about even further constraints.

MS. SHEINER: Sarah, is there anything that the Fed could do to sort of stop this

animosity, or is this something that's just going to have to play over time or wait for the economy to just beat so strong that people love the Fed again?

MS. BINDER: Well, there's certainly the value of improving the economy, right?, because Congress's attention to the Fed is pretty counter-cyclical itself, right? There's no electoral gain to paying attention to the Fed when it comes, but we might as well just take credit and go along, right? Is there any hope for the Fed? (Laughter)

MS. SHEINER: I guess two things. I see my colleague Phil Wallach back there who's written about the Fed's ability to push the bounds of what is legal. People will disagree and I won't go there, but it is possible in the heat of another -- up to another AIG, another -- right?, that creative ways are found to stay within the limit of the law. But I -- yes, so there are possibilities that there's more leeway than expected.

And the other thing to keep in mind, and this won't make you feel any better either, but Congress doesn't like to be blamed, right? Members of Congress don't want to blamed, and if it really looked like, at the critical moment, that they were standing in the way and would get the blame, I think some of these restrictions would disappear. It seems hard to fathom that Congress would act so quickly. But a little blame avoidance kind of concentrates the powers sometimes.

MR. LOWENSTEIN: Do you mean, Sarah, like in the case of the TARP, which wasn't strictly the Fed, but they voted down. I think the DOW fell 700 points that day. Every thought matters, and --

MS. BINDER: Yes, I had my split screen go, and I had C-Span -- it's always on, but that's all right. And then I had the DOW, right?, seven points (Laughter). It does focus the mind for members who have to go home and be blamed for it.

And having said that, they found a way to sweeten the deal, right? There's all sorts of stuff in TARP that had nothing to do with TARP.

MS. SHEINER: Okay, let's move now to -- yes, got lots of questions, right. So, we have a microphone that's going to be coming around. When you get the microphone --

Let's take this gentleman right here. Will you please stand up, identify yourself, and ask

a question? Brennan will pass mics around.

MR. GLUCK: Thank you. My name is Peter Gluck.

This has been a very interesting conversation, all the more so because last week Brookings hosted a program with John Taylor and William Dudley, and it was interesting to listen to them go back and forth at each other very similarly (laughter), one taking a very pragmatic view, Dudley saying look at the results of the economy, and Taylor, of course, saying that the interest rate never should have been zero and should have been 2.5 percent -- is what he said -- using his formula. So, I'm wondering if any of you can conjecture what would have been the practical results all these years if Taylor's Rule had been used.

MR. LOWENSTEIN: My view would be we would have had higher unemployment, a deeper, longer recession, and come out even weaker than we did. So -- and then I've been on panels with John, who's a friend of 20 years, more than 20 years standing, in front of Congress, and he said -- I don't think he said 2½; I think he said 1½ or something, but anyhow I think if interest rates had been higher the dollar would have been stronger; our exports would have been weaker; the cost of capital would have been higher; the stock market would have been lower, house prices would have been slower to recover. So, I think you get into these unusual situations, which are never contemplated within the universe that the Taylor Rule was describing, and you've got to do these unusual, unconventional monetary policies.

Part of John's point is the unpredictability of policy. So, his view is that because it was unconventional and unusual, that unpredictability, that uncertainty itself put a damper on the economy. But I think there were just a lot of things putting a damper on the economy and that you had one agency, the Federal Reserve, who said: We have a legislative mandate -- stable prices, maximum employment; and, damn it, whatever it takes -- Ben's words -- we're going to go after that mandate. Whatever else was going on in the economy, "we're going to do that" I think was a stabilizing factor, and I think following -- having higher interest rates would not have reduced uncertainty; if anything, it might have increased it.

MR. KIRSCH: Hi, my name is Michael Kirsch.

I'm real excited to read your book, Roger. I just got it. And my question is about the

views of H. Parker Willis, and I know you talk about it in the book, but I want to ask you about his writings in 1934 and 1936 about the origin of the Fed. Don said that the Fed was created to protect Main Street against the problems of the financial sector. And I was curious -- Parker Willis said that the elastic currency provisions in the original Federal Reserve Act where they specify no discounts for securities, and then he says the reserve requirements dropping them from the 25 percent cash requirement of the National Banking Act almost in half was actually to give that liquid credit of the banking system to the investment community. And he says: We would preserve the independence of the commercial banking system. And I didn't realize that that might have been some of the formation of views behind the creation of the Fed, and he and Glass seem to be very much opposed to the change of the eligibility discount requirements in the '30s, and I was wondering why they were so opposed to that. But it seems like it might have been that the Fed should be very independent of the investment community.

So, I was wondering what you thought about Willis --

MR. LOWENSTEIN: The drop in the reserve requirements was something that Warburg lobbied for vociferously. I don't think it was because he wanted to give a favor to Wall Street or to the investment community. In his conception, money was just locked up pointlessly, because banks had to have this what he considered to be a very high level of reserves compared to what they could loan out. And when the Aldrich Commission went to Europe, they kept asking bankers in various countries: What are your reserve requirements? How much do you need in the till versus, you know, what you've got out there. And it was barely an issue to the Europeans. They didn't pay this attention that the U.S., under this very rigid set of rules the National Banking Act, paid.

And Warburg -- Glass and Willis were extremely political. They were somewhat paranoid about -- they were paranoid about who would take the credit, get the credit for -- they wouldn't let their bills circulate for a long time. Finally, Wilson ordered that a copy of the Bill or a digest of the Bill be provided to Colonel House, his political guy, and House got -- and this is well into the administration. You know, everyone wants to know what's going to be in this Bill. The White House finally gets a digest of it, and they gave it to Warburg, and Warburg was about to get on a ship for Europe but, in typical Warburgian fashion, he wrote, like, a 13-page critique of it in, you know, six hours, and one of the points

in it actually was that the reserve requirements be reduced.

Willis was absolutely furious. You know, he said -- I can't remember the exact quotation now, but something like: This is just, you know, Wall Street at it again or something. But he adopted the suggestion. He was very malleable at taking suggestions; he was just very ungenerous about giving the credit for them. (Laughter)

I don't know about his -- you know, later -- of course he became Secretary of the Federal Reserve. He continued to spar with Warburg. Warburg was one of the first governors, one of the original governors, and they continued to be at odds. They wrote very unkind things about each other in their memoirs. I don't know about what he did in the 1930s.

MR. KOHN: One way to think about these reserve requirements and the desire to lower them is before the Fed all the banks were self-insured against runs, and they had to hold enough reserves and enough liquid assets that if there was a run they could meet it without failing -- or that was the hope they could. And I think Warburg's conception was: When you've found the central bank and you central reserves and you create a lender of last resort, a place wasn't conceived of that but a place to take your ill-liquid paper. You need to hold so many non-working -- in some sense, the lender of last resort creates the ability to hold fewer of these non-working reserves, and you can -- and the banks can put more to work.

And that creates, of course, a moral hazard problem, because now the banks are dependent on the government in the form of the Federal Reserve for their liquidity insurance, so you need supervision, and supervision was part of the Federal Reserve Act, too. That was a toughening supervision. So, that went with the lender of last resort.

MR. SELGIN: Hi, George Selgin, CATO, Center for Monetary and Financial Alternatives.

Mr. Lowenstein, I enjoyed your book a lot, too. Nevertheless, I remain one of those naïve souls who doesn't think the Fed was a good idea. I'd like to offer four points for the opposition -- quick ones -- for your response.

First of all, back in 1913, there was no consensus in favor of central banking around the world. As you note in your book, there were 20 countries then that had central banks. That was about a

third of them, and even in those countries there were long debates in many of them between the proponents of centralization and critics. And there were some very good arguments on both sides. Very good book by Barry Smith, written in 1935 on this topic.

Bagehot, just to give you one more example -- we think of him as the great exponent of the lender of last resort today, but he was a critic of central banking. He said that the Bank of England should act as a lender of last resort, but he also said it would have been better if they had never created this privileged institution that ended up centralizing all the reserves. He's very emphatic about it. So, no consensus.

The point here is you didn't have to be haunted by the ghost of Andrew Jackson to be a critic of central banking. That ghost wasn't, of course, a factor in Europe. And I don't think it was the only thing behind the critics of the Fed or centralization in the United States. That's one point.

Second point -- I'll try -- I'm sorry, I think I may be the only person in the room, so the -- there were countries that did very well without central banks. Scotland is a famous example, but Canada is more pertinent here. They had no central bank till '35. They didn't have any of the crises. They actually had a better record for stability than France, England, and Germany, which were the countries that were emphasized by Aldrich and Company, and if you go back and read newspapers from back then you'll see there were constant articles about how we should adopt the Canadian system. The critics of the Aldrich Plan, the asset currency movement, which was pre-Aldrich, which you write about very well -- those guys were looking at the Canadian example. They had perfect elasticity, because there were no restrictions on note issue, and what they were arguing for, as you know, was deregulation to achieve the elasticity and stability that they desired. Getting rid of those Civil War era bond deposit requirements was one component, which financed the Civil War, by the way, and allowing banks to branch, which would have eliminated the correspondent accounts and the piling up of reserves in New York. So, there was a rational alternative. It was not defending the status quo. Aldrich was for that, as you know, up until 1908.

MS. SHEINER: Let's let Roger respond to that.

MR. SELGIN: Okay, I've got two more that I'll just mention. (Laughter)

MS. SHEINER: Let people go ahead

MR. SELGIN: Okay, all right, sorry.

MR. LOWENSTEIN: I guess I disagree that there wasn't a consensus at least in the commercial nations of the world. There were -- I don't how many formal nations, you know, existed then, but in all of the advanced commercial nations in Europe that I'm aware of there was a central bank. Aldrich, when he went over there, was anything but a biased observer. He was leaning the other way and was impressed by what he saw. I think it was a late-in-life genuine conversion. You would rather have independent banks issuing bank notes with no regulation.

MR. SELGIN: The banking system worked very well with very little regulation, and so did some others. You have to remember that most of the countries (inaudible) long before for fiscal (inaudible) England to invade France and pay for it, France because of Napoleon leaving a piggy bank. So, it didn't have anything to do with stability in the history of central banking in most of those countries.

The reason Wall Street got together -- they pushed Aldrich -- again, this is all in your book -- with Aldrich you're looking at it and starting with the premise that the Fed was just peachy keen. Aldrich -- what Wall Street was worried about was French banking eliminating the correspondent system, which was piling up money in Wall Street, and it was a very important source of revenue for them.

MR. LOWENSTEIN: Let's get to a question --

MR. SELGIN: They were worried about --

MR. LOWENSTEIN: Let's get to a question.

MS. SHEINER: Yes.

MR. LOWENSTEIN: I know you're writing review and, you know, let's --

MR. SELGIN: No, I --

MR. LOWENSTEIN: So, let's get to a question.

MR. SELGIN: The point is don't you think that the fact the Federal Reserve protected this correspondent business even allowed it to flourish more than ever, and that's because that's what the Aldrich people wanted and that's --

MS. SHEINER: All right, right.

MR. LOWENSTEIN: George, you're not asking a question.

MR. SELGIN: Why don't you see the Fed --

MR. LOWENSTEIN: Why don't you agree with (inaudible)? That's the question.

(Laughter)

MR. LOWENSTEIN: "Why don't" -- no, George, "Why don't" is not a question. I think my -- no, no, I'm going to answer it. I'm going to answer (inaudible) with that.

I know you're writing review. You blogged about it. I think monetary policy is properly a public responsibility, properly independent from immediately elected legislators and so on. But I think it was very good to entrust that to a board. I also take issue that I went in thinking peachy-keen, but I looked at what was going on in the 19th century in this country. But you can't smile. You have to hear me, you know, take it on faith.

MR. SELGIN: No, no, that's fine.

MR. LOWENSTEIN: Okay, okay.

MR. SELGIN: I'm sorry about if I --

MR. LOWENSTEIN: So, we disagree.

MS. SHEINER: All right, another question? In the back there? Brennan.

LARRY CHECKO: Thank you. Larry Checko. That's going to be a hard act to follow.

There's a notion afoot, and I think it's more than a notion, but for the sake of argument let's call it a notion -- that the big banks have captured the Board -- the Reserve Board -- and how can you capture something that you already have ownership in? And can you clarify that for me. I mean, maybe I'm wrong, but I'd like to know, and if --

MR. LOWENSTEIN: The banks don't own the Board. The Board is appointed by the President and confirmed by the Senate.

MR. CHECKO: The Board -- okay, but the reserve.

MR. LOWENSTEIN: The banks own the reserve banks.

MR. CHECKO: Well, maybe that's where my question goes then.

MR. LOWENSTEIN: Not the Board of Governors, and I think this was Wilson's genius, right?, to put the capstone, to split the responsibilities, to have the governmental unit here in Washington

appointed by the President, confirmed by the Senate. So, the banks accepted the -- well, the banks don't own the Federal Reserve Board. They own the banks, and the banks do not make regulatory policy. The banks supervise, subject to the supervision of the Federal Reserve Board, but by law the regulations around that supervision are made by the Federal Reserve Board in Washington just to get around that problem.

As I said before, I think there's a perception problem here having to do with the banks and the Federal Reserve. And in fact Dodd-Frank tried to deal with that to some extent by taking the bankers on the boards of directors out of the decision to appoint a president. And remember, the president has to be approved by the Federal Reserve Board. So, basically it's a two-key process with the political appointees in Washington having the ultimate control over the system.

MS. SHEINER: The gentleman right up here. Brennan?

MR. ODI: My name is Antony Odi. I had the very, very, good fortune to marry into the family of Senator Robert Latham Owen, the founder, not yet mentioned. From what I know -- and you'll know much more -- of Owen's positions, he and Glass could hardly be more contrasted. Yet when you say this was a political compromise, Owen was a regressive from Oklahoma. He founded and ran a community bank and hated Wall Street, regarded Glass as a cat's paw of Wall Street, and the two men continued to hate each other until their dying day. Maybe you have something to -- I mean, I'll read the book as well.

MR. LOWENSTEIN: Oh, that's basically true. Curiously enough, they were born in the same town in Lynchburg. But Owen's family -- or Owen got to Oklahoma and did a lot of things out there, became a lawyer, operated in real estate and so on. And this -- an inaugural senator when they became a state in 1907. He was basically Williams Jennings Bryan disciple, so, on issues such as should the Federal Reserve Board have bankers on it, elected by bankers, or presidential appointees he went with Bryan -- presidential appointees. Should it be U.S.-backed or issued or money? Brian and Owen said yes, and Glass was a conservative reformer, a conservative Democrat of the day. He thought it should be, in effect, bank money. So, they -- and Owen was somewhat resentful of Glass for cutting him out of the loop and then went ahead, you know, with his own Bill, which was just another headache for Wilson to

deal with. So, no, that's correct.

MS. SHEINER: In the back there, Brennan. Back. Wait, that one.

MR. HORNE: Hello, my name is Patrick Horne. I work for the Mercado Center.

My question is: Moon-Friedman famously noted that while interest rates are not -- when writing about the Great Depression noted that low interest rates don't automatically mean easy money, and similarly when Joan Robinson said that, well, Weimar, Germany couldn't have had easy money because of high interests. Economists now make fun of her for that. But it seems to be the reason people criticize the Fed right now for the low interest policy is that they're worried that low interest rates automatically mean easy money and inflation. Should economists look at the Fed or other central banks, and if they should why aren't they? Sort of explain how non-low interest rates at least aren't necessarily a good indicator of monetary policy and perhaps (inaudible) like M2 or (inaudible) GDP even might be a better indicator of that. Just wonder about your thoughts.

MR. KOHN: Well, I think the Fed has tried to make that point that interest rates might not be that low relative to the interest rates you need to get the economy moving in a more vigorous way. And you have a situation -- and Janet Yellen has given speeches on this -- you have a situation in which you have various forces holding back the economy. Some of them are secular. Some of them are cyclical in nature -- debt people restructuring balance sheets and whatnot, tight fiscal policy, et cetera, that are keeping the interest rate that you need very, very -- in order to get the economy back to full employment -- very, very low. And it's these outside forces that the Federal Reserve is responding to with its very, very low interest rates. And Ben Bernanke is someone else in a Brookings blog who has said this as well.

So, I think the Fed is trying to do that, trying to explain why they think the interest rates have to be so low in order just to get the economy back to full employment, why they think it'll go -- those interest rates will rise slowly. Chair Yellen, as I say, has talked about that.

There's been a lot of discussion of nominal GDP targeting among central banks and among academic observers. The Bank of Canada -- we referred to Canada earlier -- has looked into this, for example, and others as well, and I think there just are a lot of problems. It's not really a subject for

today. Money growth has been pretty decent, actually, 6 percentage points or so over the last few years.

So, I think the Fed has tried to explain why these low interest rates need to be that low and why they may not be as expansionary and the balance sheet may not be as inflationary as you might think from some of these past histories. They could happen in a successful (inaudible).

MS. SHEINER: You're right, this is not exactly an issue for today. I'm going to make a plug for an event that we're having on October 30th, which is exactly about the equilibrium real interest rate, and (inaudible) say what is that interest rate that would get the economy to (inaudible), why is it so low now, and what do we think it's going to do in the future. So, if you're interested, come back.

Questions. Up there?

MR. CONDON: Thank you. Chris Condon from *Bloomberg News*.

Quick question for all the panelists. There's a Bill proposed by Richard Shelby's committee that would include, among many other things I'm sure you're aware, a proposed commission to examine potential structural and other changes to the Fed. What do each of you think of that? Could that be a constructive forum for new proposals, or do you think, perhaps like the Fed does now, that it's more of an opportunity for mischief?

MR. LOWENSTEIN: Just -- there are two proposed commissions, I guess, and one of them is by Brady in the House, and I think that's the more far-reaching one. I think Shelby's is more discretely in the role of the reserve banks, but I don't know.

Sarah, would you know that or --

MS. SHEINER: I think Shelby's was pretty broad.

MR. LOWENSTEIN: Okay.

MS. SHEINER: And Brady's had some policy prescriptions as to where it's going to.

MR. LOWENSTEIN: Okay.

MS. SHEINER: But I think one of the questions is what's the makeup of the commission, right? How far-reaching is the information-gathering going? To put it in perspective, Congress has periodically, over the Fed's hundred-year history, not necessarily convened outside commissions like they did, right?, in advance of creating the Fed? But review it, right? The Fed 25 -- well, 25 is a little sketchy,

Depression and all -- the Fed at 50 years, the Fed at 65, and so these periodic reviews I always think are a valuable exercise if they're conducted in a way where there's some sort of balance of participants, in this case balance across -- typically across parties.

MR. LOWENSTEIN: I worry about -- I'm more familiar with the one in the House Bill, because I had to testify on it a couple months ago, and I'm, frankly, concerned that it starts with an agenda. It's not just let's convene a bunch of experts and figure out whether there are any changes needed. It starts with -- it's highly partisan, twice as many Republicans as Democrats. It includes a reserve bank president, so they've already announced what they want the result to be. It doesn't include a member of the Board of Governors. The remit is very vague, and it doesn't require the members of the Commission to be experts in the Federal Reserve in any way. So, it feels to me like a political push in a particular direction favored by the Republicans rather than a real attempt to say are there improvements that can be made in the system now that it's, you know, reached a hundred years. There was a commission on money and credit at, I guess, the 50th anniversary of the Federal Reserve, but that was actually Congress couldn't get its act together there. It was convened outside of Congress but manned by experts. The head of the American Economic Association nominated some people, et cetera, and produced a report that I remember having to read in graduate school in the late '60s that had a lot of valuable stuff in it but nothing happened, actually, as a result of that commission. So, I think you've got to define the remit. You've got to make sure of their expertise, and you've got to make sure they go in there with an open mind, and then something might happen. Something constructive might happen.

MS. SHEINER: Up here. Brennan?

MS. DAVIDSON: Hi, thank you. Kay Davidson from the *Wall Street Journal*.

Roger, you talked at the beginning about how the Fed's political legitimacy is sort of at an all-time low or lower than you've seen it. You know, do you think that that's undermining the Fed's effectiveness right now? And do you think -- I guess this is a question for all of you -- and do you think that the Fed can or should do more to try to improve that perception?

MR. LOWENSTEIN: They could probably answer better than I could on the effectiveness. I don't think it has, but I think -- you know, legitimacy is important, and it's sort of too easy

for, I think, someone like me, a writer, a sort of Beltway or city person or something to sort of, you know, scoff at populace disdain or something. But legitimacy is important, and ultimately, you know, you do get Andrew Jackson or something when you get -- you don't want an institution that is distant or feels distant or is irresponsive or feels irresponsive to the larger public. This is a democracy. So, whether or not its effectiveness has been hampered, which I don't see -- you know, I think that's important. I mean, I think I'd be worried about it if I was on the Fed.

MS. BINDER: I would just add that, I mean, reputations of public agencies matter, and I think they matter in particular for the Fed who's part of it. As I understand it, the way they make monetary policy is to communicate it and to have markets and others believe that they're going to follow through in what they're doing, and the more challenges you get to the choices they make, I think it's harder for people to believe that the Fed is going to stick to a particular course. And, granted, that may be difficult to choose the course. But if I think all these public opinion polls of chairs -- I think public angst about the Fed. I think it does, to some extent, affect the Fed's ability to be effective.

MR. KOHN: Yes, I don't think it's a problem. I totally agree with Roger and Sarah. And I think the Federal Reserve needs to continue and amplify its efforts to explain itself to the public and to the Congress. And I know from reading the *Wall Street Journal* that Janet Yellen has spent a lot of time on Capitol Hill, but I think that needs to continue, and the explanation to the wider public also needs to be done. So, Bernanke, famous leaders on *60 Minutes* twice, and that kind of forum I think is useful to reach at least a slightly wider public.

I don't think the problems have really affected the Fed's effectiveness so far, and I think seeing markets react very sharply to perceptions of changes and what the Fed's intentions might be, and I think they'll be able to raise and lower interest rates -- raise -- can't lower much but raise interest rates when they want to. But I do worry about times of pressure. I do worry about continuing support, as Sarah says, and times of crisis and limiting the Feds' room to maneuver already, which has happened in legislation. And without public support, it would be even more difficult to even take advantage of the scope that you do have. So, I think it is a problem.

MS. SHEINER: Well, on that optimistic note (laughter), please join me in thanking Roger

for his book and our panelists.

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