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How the Fed defeated President Truman to win its independence

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In 1951, an epic struggle between a US president who stood on the verge of a nuclear war, and a central bank that was seeking to establish its right to set an independent monetary policy, resulted in an improbable victory for the central bank. President Harry Truman, at war in Korea, failed in a brutal attempt to force the Federal Reserve to maintain a 2.5 per cent limit on treasury yields, thus implicitly financing the war effort through monetisation. This victory over fiscal dominance is often seen as the moment when the modern, independent Fed came into existence.

The idea that the central bank should place a cap on the level of bond yields is firmly back on the agenda, at least in the eurozone. This week, Italian prime minister Mario Monti said that he was increasingly optimistic that his country's bond yields might soon be capped. Although he stopped short of saying that this would be done by the European Central Bank, there really are no other viable candidates to achieve this. Furthermore, many economists are arguing that this is the right policy, since Italy is now following a sustainable budgetary policy which deserves to be rewarded by ECB action in the bond market.

I have no dispute with Mario Monti, but this is dangerous territory, which lies right at the heart of a government's relationship with its central bank. Let's go back to the 1940s in the US.

In the second world war, Americans were encouraged to buy wartime bonds as part of their patriotic duty, and this they did in large numbers. It was not thought right that citizens should suffer potential losses on their bonds, so the Fed formally committed itself to maintaining an interest rate of 3/8th per cent on treasury bills, and a ceiling on government bond yields of 2 1/2 per cent. The intention was to fund the wartime deficit without accepting any increase in the cost of finance. If that required printing money, so be it. The fact that this in effect relegated the Fed to the role of a passive funding agent of the treasury was a side issue in the circumstances of the time.

After the war, US inflation rose as price controls were lifted, and averaged about 13 per cent per annum in 1947 and 1948. The Fed became concerned about the rock bottom level of interest rates, and removed the cap on short rates, which rose to 1 1/8th per cent by 1950. But the treasury insisted that the 2 1/2 per cent yield cap on government bonds must be maintained. President Truman remembered that his family had lost money on Liberty Bonds after World War I, and he did not want his supporters to suffer capital losses on their savings as bond yields rose.

President Harry Truman. Getty Images

Although Truman had balanced the budget in the late 1940s, the Korean War threatened to be long, arduous and expensive. He was in no mood to allow a bunch of bond market vigilantes, if there were any around at the time, to complicate the fight against communism.

But the Fed, led by chairman Thomas B. McCabe and governor Marriner Eccles, dug their heels in. Inflation was headed towards 20 per cent, and they were keenly aware that the bond yield cap exposed them to potentially unlimited monetary expansion as the budget deficit rose, and as investors dumped bonds to the central bank buyer of last resort. In recognising the potential links between fiscal dominance, money and inflation, they were far ahead of their time.

Governor Eccles put the matter plainly, telling Congress:

As long as the Federal Reserve is required to buy government securities at the will of the market for the purpose of defending a fixed pattern of interest rates established by the Treasury, it must stand ready to create new bank reserves in unlimited amounts. This policy makes the entire banking system, through the action of the Federal Reserve System, an engine of inflation.

But the president, characteristically, pulled no punches. He summoned the Federal Open Market Committee, and spoke in the direst language of the commander-in-chief:

The present emergency is the greatest this country has ever faced, including the two World Wars and all the preceding wars . . . We must combat Communist influence on many fronts . . . If the people lose confidence in government securities all we hope to gain from our military mobilization, and war if need be, might be jeopardized.

For good measure, the president wrote to Fed chairman McCabe, telling him that, if the Fed lifted the cap on bond yields, it was doing exactly what Mr Stalin wants.

This unleashed what was probably the greatest political battle in the history of central banking. For those interested in a story of intrigue, deliberate leaks, hospital visits, the botched firing of General MacArthur and the risk of nuclear war on the 38th parallel, the blow-by-blow account is well told here, in the dry language of two Fed historians. But the bottom line is that Truman's political position proved too weak for him to prevail over a determined Fed, which had garnered some support in Congress from Truman's Republican adversaries.

In the end, the treasury and Fed reached their famous "Accord", under which the Fed limited its future support for the bond market to only $200m, an amount which was exhausted within 3 days of the announcement. The Fed was now free to set monetary policy, but the administration exacted its pound of flesh. Chairman McCabe was forced to resign, and was succeeded by William McChesney Martin, who was thought to be a placeman who would inevitably do the treasury's bidding.

That was not how it turned out. Martin, in the words of Truman's chief economist, "double crossed" the president, and doggedly pursued the path of an independent central banker.

When chairman Martin accidentally encountered Truman on the streets of New York some years later, the ex-president greeted him with one word:
Traitor!

Whatever Truman's view, the modern Fed was born.

Times are now very different. But the independence of the central bank from fiscal dominance remains an important cause, and not one to be discarded lightly.