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The Political Economy of Central Banking: Contested Control and the Power of Finance, Selected Essays of Gerald Epstein

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BOOK REVIEW

The Political Economy of Central Banking: Contested Control and the Power of Finance, Selected Essays of Gerald Epstein, by Edward Elgar, Cheltenham, UK & Northampton, USA, 2019, $180, 546 pp., ISBN 978 1 78897 840 8

Prior to the Great Recession of 2007–2009, the Federal Reserve embraced the orthodox monetary policy of manipulating short-term interest rates to maintain price stability. Admittedly, under the Humphrey-Hawkins Act of 1978, the Federal Reserve has a dual mandate of ensuring maximum employment as well as price stability. However, orthodox monetary economists finesse this by arguing that the only way to ensure maximum employment in the long run is to focus exclusively on maintaining price stability in the short run.

Between November 2008 and August 2014, the Federal Reserve broke with monetary orthodoxy. In its place, the Federal Reserve implemented the heterodox monetary policy of massive purchases of securities in the open market. As a result, its securities holdings increased by $3.5 trillion, to $4.5 trillion. In August 2014, the Federal Reserve then returned to orthodox monetary policy, now more precisely defined as manipulating short-term interest rates to maintain the inflation rate around 2%.

The Federal Reserve has fallen short of its ostensible inflation target, even though it could achieve it easily enough by resuming large-scale securities purchases. So why does it refuse to do so? In this seminal volume of essays written over the last 40 years, Gerald Epstein answers this question along with similar ones about the Federal Reserve's behavior during the Great Depression in the early 1930s and the Great Stagflation in the late 1970s.

In all three cases, Epstein demonstrates that the Federal Reserve's behavior was primarily determined by its independence from democratic control, and thus its dependence on the large banks. Except for the period when Franklin Roosevelt was President, the Federal Reserve has been independent of democratic control. Its independence is an enormous perk for the Federal Reserve's top policymakers. After all, without it, the Chairs of the Federal Reserve Board would not be considered the second most powerful people in the country, after the Presidents, as they often are now. At the same time, the Federal Reserve's independence leaves it vulnerable to attacks from people hurt by its policies. The Federal Reserve needs a constituency to ward off such attacks. And for historical and structural reasons that Epstein explains in this book, large banks are the Federal Reserve's constituency. The large banks lobby Congress and the White House on the Federal Reserve's behalf, make campaign contributions to politicians willing to support Federal Reserve independence, and give them high-paying jobs when they retire from politics. In return, the Federal Reserve makes monetary policies that serve the interests of the large banks.

For example, the Federal Reserve's $3.5 trillion of securities purchases during the Great Recession and its immediate aftermath came in three rounds, starting in November 2008, November 2010, and August 2012, respectively. Epstein demonstrates that the first round increased large-bank profits, especially at those banks in a position to sell their most toxic mortgage-backed securities directly to the Federal Reserve at face value, at a time when mortgage-backed securities were selling at a deep discount in the open market. The second round also increased large-bank profits but by less than the first round, and large-bank profits were even less affected in the third round than in the second largely because, by that time, the largest banks had already dumped their most toxic securities onto the Federal Reserve. Even though large-scale securities purchases were still necessary to bring the inflation rate up to around 2%, Epstein concludes that the Federal Reserve ended them because they no longer benefitted the large banks.

Epstein's analysis of the Federal Reserve's response to the Great Depression proceeds along the same lines. Prior to the Great Depression of 1929–1933, the Federal Reserve embraced the orthodox monetary policy at the time of manipulating the discount rate to maintain the U.S. commitment to the Gold Standard. The discount rate is the interest rate at which the Federal Reserve lends to the banks and the Gold Standard was an international agreement among the advanced capitalist countries to maintain a fixed rate of exchange between their currencies and gold.

In January 1932, the Federal Reserve broke with monetary orthodoxy in favor of massive purchases of securities in the open market. In July 1932, it abruptly ended its securities purchases and returned to orthodox monetary policy. Why did the Federal Reserve break with monetary orthodoxy in order to do what was necessary to end the Great Depression only to reverse course before the job was done, with the result that the financial system collapsed in late 1932 under a wave of bankruptcies, not only of banks but also of nonfinancial firms? As in the case of the Federal Reserve's response to the Great Recession, Epstein answers this question in terms of the Federal Reserve's overriding concern with large-bank profits.

The problem which led to the Federal Reserve's large-scale securities purchases in January 1932 was that the large banks had responded to the stock-market crash in October 1929 by calling in their loans to everyone who had suffered losses, then using the funds thus obtained to build up portfolios of investment-grade securities. Epstein shows that large-bank loans dropped from 70% to 50% of the banks' earning assets, with their securities holdings rising proportionately.

What made this a problem was that, in September 1931, Britain abandoned the Gold Standard. Speculators betted that the United States would follow suit, so they rushed to sell dollars for gold at the fixed rate in anticipation that, when the Federal Reserve allowed the price of gold to rise in dollar terms, they would profit by re-selling the gold for the depreciated dollars. The speculators made a bad bet. Instead of abandoning the Gold Standard, in October and November 1931 the Federal Reserve defended the dollar price of gold against the speculators by raising the discount rate two percentage points. The Federal Reserve thus put a bear squeeze on the speculators, forcing them to unwind their positions in gold at the same fixed rate of exchange with the dollar that they had built them up at. But the drama triggered a collapse of the bond market, taking down with it the value of the securities held by the large banks. Epstein demonstrates that, in January 1932, the Federal Reserve decided to relieve the pressure on the large banks by purchasing their now toxic holdings of securities.

By July 1932, the large banks had managed to substitute for their most toxic securities the only safe asset that remained available in large quantities—the government's three-month Treasury bill. Epstein shows that the large banks' holdings of Treasury bills increased to 23% of their total securities holdings, making them largely dependent on the interest rate on Treasury bills for their profits. To help the banks out by propping up the interest rate on Treasury bills, Epstein demonstrates that the Federal Reserve halted its own purchases of securities.

In short, the Federal Reserve responded in the same way to the Great Depression and the Great Recession. It purchased large quantities of securities when the large banks needed help getting toxic securities off their balance sheets, then stopped the purchases when the large banks were better served by keeping the interest rate up on the securities they still held. Nonetheless, at least so far, the consequences have been very different. Since August 2014, the financial system has become increasingly fragile but has not collapsed. In contrast, after July 1932, the financial system collapsed, cumulating with the newly-elected Roosevelt administration declaring a Bank Holiday upon taking office in March 1933.

Roosevelt was outraged that the Federal Reserve had prioritized the interests of the large banks at the expense of the financial stability of the system as a whole. Consequently, the Roosevelt administration, with the support of solid Democratic majorities in both the House of Representatives and the Senate, reduced the Federal Reserve to the status of a bureau within the Treasury Department. In this way, monetary policy was subordinated to fiscal policy, rather than to the interests of the large banks. For example, the Federal Reserve was compelled to finance World War II by buying sufficient government bonds to keep the interest rate on them from rising above 2.5%.

Throughout the Roosevelt administration, the large banks fought rearguard actions against the subordination of monetary policy to fiscal policy. For example, Epstein argues that, without the lobbying, campaign contributions, and sinecures to retired politicians provided by the large banks, World War II would have been financed at 1% rather than 2.5%.

Nonetheless, it was not until the Truman administration that the large banks were able to help the Federal Reserve regain its independence, with the Treasury-Federal Reserve Accord of March 1951. For example, Epstein focuses on the activities of Russell Leffingwell, Chair of J.P. Morgan. Leffingwell was a major Democratic campaign contributor who helped finance Truman's rise to the presidency. Consequently, Leffingwell had easy access to Truman's White House. In fact, the day before the Accord was announced, Epstein recounts how Leffingwell spent thirty minutes with Truman in the Oval Office, persuading him to throw his support behind the Accord even though up until that time Truman had been adamantly opposed to it.

In his analysis of the Federal Reserve's response to the Great Stagflation of 1973–1979, Epstein also emphasizes how the Federal Reserve acts in the interests of the large banks. In this case, what the large banks needed was help maintaining their position at the center of the international financial system. Epstein argues that the principal purpose for establishing the Federal Reserve was to help the large banks in this regard. For example, Epstein focuses on Senator Carter Glass, Republican from Virginia, who was the principal architect of the Federal Reserve Act of 1913. Epstein quotes Glass as saying that his goal in establishing the Federal Reserve was "to assist powerfully in wresting the scepter from London, and eventually making New York the financial center of the world."

After World War II, the large U.S. banks did indeed wrest the scepter from the large British banks by replacing the Gold Standard with the Bretton Woods System. Whereas under the Gold Standard the currencies of all the advanced capitalist countries were pegged to gold at a fixed rate, under the Bretton Woods System only the dollar was fixed to gold at a fixed rate. The other advanced capitalist countries then pegged their currencies to the dollar at a fixed rate.

As part of the transition from the Gold Standard to the Bretton Woods System, international trade was converted to a dollar basis. That is, oil and the other major commodities traded in world markets are denominated in and exchanged for dollars, even when the commodities are bought and sold by countries with currencies other than the dollar. Rather than holding gold, all the advanced capitalist countries were thus compelled to hold dollars both as the reserves necessary to maintain their fixed exchange rates with the dollar and for the sake of engaging in international trade. This was an enormous boon to the large U.S. banks. They were the primary source of the dollars needed for international reserves and international trade. And the large U.S. banks would supply the needed dollars only if it was profitable for them to do so.

However, the Bretton Woods System was a disaster for the large U.S. manufacturers. This was because the Roosevelt administration had responded to an insurgent labor movement by legalizing unions so that workers could bargain collectively with the large U.S.

manufacturers. After World War II, unions were strong enough to demand and receive higher nominal wages for their members. In order to preserve their profit margins, the large manufacturers would pass on the higher wages in higher prices for their output. Therefore, in order for the large U.S. manufacturers to maintain their competitive position in world markets, it was necessary for the higher prices to be reflected in a lower value of the dollar in foreign exchange markets. But it was not possible for the dollar to depreciate under the Bretton Woods System of fixed exchange rates.

The result was a steady erosion of the position of the large U.S. manufacturers in world markets. Whereas at the end of World War II they produced 60% of the world's manufactures and almost 30% of manufactured exports were from the United States, by the early 1970s the U.S. share of world manufactures had been cut in half and its share of manufacturing exports had fallen to 13%.

In August 1971, the Nixon administration came to the aid of the large U.S. manufacturers in a way that directly threatened the position of the large U.S. banks in the international financial system. That is, Nixon unilaterally abandoned the convertibility of the dollar into gold at a fixed rate. In March 1973, the other advanced capitalist countries followed suit by eliminating their pegs to the dollar at fixed rates. The Bretton Woods system was thus replaced by the current system of flexible exchange rates. Henceforth, it appeared that large U.S. manufacturers would be able to pass on higher nominal wage costs in higher prices for their output without undermining their international competitiveness because the dollar would depreciate to reflect the degree to which the price level was rising in the United States more rapidly than it was in other advanced capitalist countries.

It didn't turn out that way. Instead, between September 1977 and September 1978 the dollar went into a freefall in foreign exchange markets, losing more than 56% of its value against the Swiss franc, 42% against the yen, and 19% against the German mark. These declines did not reflect the degree to which the price level was rising in the United States more rapidly than it was in other advanced capitalist countries. What they reflected was a crisis of confidence in the dollar-based international financial system.

In particular, the Organization of Petroleum Exporting Countries was actively seeking to sell its oil for currencies other than the dollar. Western European countries were establishing the European Monetary System to exchange goods and services between themselves for their own currencies rather than dollars. Even the Carter administration was expressing sympathy for creating a world money—Special Drawing Rights issued by the International Monetary Fund, to supplant the dollar. Consequently, speculators were placing bets that the dollar would decline by enough to reflect not just relative price-level changes between the United States and its major trading partners but also the dumping of dollars out of the foreign exchange reserves of OPEC, the members of the nascent European Monetary System, and other countries willing to hold Special Drawing Rights rather than dollars.

Between November 1978 and June 1982, the Federal Reserve responded to the crisis of confidence in the dollar-based international financial system by increasing the discount rate into the double-digits, from 6.5% to 14%. It ratcheted up the discount rate in three rounds, starting in November 1978, October 1979, and September 1980, respectively. It was only with the third round that the speculation against the dollar stopped, ushering in a decades-long period of confidence that the Federal Reserve will do whatever is necessary to maintain the dollar-based international financial system. It turns out that the credibility of the Federal Reserve in this regard is just as strong a foundation for the large banks' position at the center of the international financial system as was the Bretton Woods System of fixed exchange rates.

Meanwhile, Epstein argues that the large U.S. manufacturers abandoned their desire for a depreciating dollar to offset their passing on of higher wages in higher prices. The reason was twofold. First, by the late 1970s, the large manufacturers had become boom weary and wanted a recession that was deep enough and long enough for high unemployment to undermine the ability of unions to demand higher nominal wages. The policymakers at the Federal Reserve calculated that an unemployment rate of 9% or more for about 2 years would accomplish this goal. The large U.S. manufacturers got what they wanted. The Federal Reserve's high interest-rate policy from November 1978 to June 1982 caused a double-dip recession, first from January to July 1980, then from July 1981 to August 1982. And the unemployment rate hovered at or above 9% for the duration.

The boom weariness of the large U.S. manufacturers is illustrated by the career of G. William Miller. He resigned as CEO of Textron in order to take over as Chair of the Federal Reserve Board. In that role, Miller launched the Federal Reserve's high interest-rate policy in November 1978. When Chrysler was the first major causality of the high interest-rate policy—the market for its cars dried up in the face of the prohibitive interest-rate costs for auto loans, Miller resigned as Chair of the Federal Reserve Board in order to take over as Secretary of the Treasury. In that role, he led the ultimately successful effort to make the government's bailout of Chrysler contingent upon new contract negotiations with the United Automobile Workers that would include nominal wage concessions. The Chrysler contract then became the model for renegotiating other major collective bargaining agreements. By the time the Federal Reserve eased monetary policy in June 1982, givebacks by unions of nominal-wage gains previously obtained had become the norm in collective bargaining agreements. Epstein concludes that, because of its independence from democratic control, the Federal Reserve is capital's weapon of choice against labor.

The second reason why the large U.S. manufacturers abandoned their desire for a depreciating dollar is that they have become financialized, as Epstein calls it. That is, the large U.S. manufacturers have become more like banks, purchasing assets with borrowed funds in order to increase their return on equity. The financialization of large U.S. manufacturers has been institutionalized by tying the compensation of top corporate executives to the stock prices of their firms. Corporate executives now receive most of their compensation in the form of stock options with a strike price set at the current price of stocks. If corporate executives can raise the stock price, they are able to exercise their stock options for an immediate profit. And they can raise the stock price simply by issuing more debt.

For example, assume that a financialized corporation issues $90 of bonds for every $10 of capital that it has. It can then purchase $100 of earning assets for every $10 of capital. If the return on assets is 1%, then the return on equity, or on capital, is 10%, which is what matters to stock-market participants. If the corporation then starts issuing $190 of bonds for every $10 of capital that it has, and purchases $200 of earning assets for every $10 of capital, then the same 1% return on assets constitutes a 20% return on equity. The corporation's stock price will jump to reflect the doubling of the return on equity, and top corporate executives can profit handsomely by exercising their stock options, even though all that has happened is that the corporation has increased its leverage ratio, or the ratio of assets to capital, from 10 to 20.

Of course, in the process the corporation has become more fragile financially. Whereas at first the assets of the corporation could fall by 10% in value before wiping out the corporation's capital and forcing it into bankruptcy, after the increase in the asset-capital ratio, the assets of the corporation can only fall by 5% before wiping out its capital. Such financial fragility is why the financial system collapsed during the Great Depression, and it will be the most likely cause of another financial collapse, especially if it is triggered by a high

interest-rate policy implemented by the Federal Reserve to defend the dollar-based international financial system or to keep workers from gaining enough strength in tight labor markets to demand and receive nominal wage increases.

In sum, the historical, theoretical, and empirical research that Epstein presents in this book provides a heterodox alternative to the orthodox refrain that the Federal Reserve is motivated by a desire to manipulate short-term interest rates in order to maintain price stability in the short run and maximum employment in the long run. By focusing on the Federal Reserve's independence, the position of the large U.S. banks at the center of the dollar-based international financial system, the boom weariness and financialization of large U.S. manufacturers, and the conflict between capital and labor over the terms of the employment relation, Epstein has developed a theory of the determinants of the Federal Reserve's behavior that should be required reading for anyone interested in heterodox monetary economics.

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