

An exchange of letters between [Federal Reserve Chairman Alan Greenspan](#) and [Congressman Bennie Thompson](#) (D-MS) with comments by [Dr. Norman A. Bailey](#) (President Reagan's Chief Economist for International Affairs on the National Security Council) and [analysis from CESJ](#).



Letter to Federal Reserve Chairman Alan Greenspan from U.S. Congressman Bennie G. Thompson (D-MS). Reprinted with permission.

March 24, 1995

Mr. Alan Greenspan
Chairman
Board of Governors of
The Federal Reserve
Washington, D.C. 20551

Dear Mr. Greenspan:

Like many other Americans, including several Members of Congress, I have been increasingly distressed by the series of interest rate hikes engineered by the Federal Reserve system in recent months. The Second Congressional District of Mississippi, which I represent, is one of the poorest districts in the United States. Unemployment is almost twice the national average. Without the income opportunities that can only be produced by a much higher rate of economic growth, many of my constituents are simply being abandoned to lives of poverty and the social decay that accompanies it.

Thus, I am compelled to ascertain whether or not the Board of Governors has seriously considered other methods of achieving stable prices (a goal which I share) without stifling overall economic growth and curtailing the creation of income opportunities in the private sector for my constituents, and millions of other Americans, whose needs are clearly not being served by current policies.

Several questions come to mind. Why has the Federal Reserve taken the position that anything beyond 2 1/2 percent growth in the economy is inflationary, especially since there are millions of people still unemployed and underemployed? As you know, during earlier periods in our history, such as World War II, our economy expanded by as much as 15%. If that were possible during a time of war, why must we be limited to a mere 2 1/2 percent during a time of peace? How can you be absolutely certain that these limits, and their social costs are justified?

Further: Are there any other tools available to policy makers that would provide for adequate expansion of the private sector while also controlling inflationary pressures? Also, why is there almost total reliance upon the activities of the Federal Open Market Committee to control the flow of credit? Could the discount window be used to support levels of non-

inflationary economic growth at rates closer to those of our own past and many of our emerging economic competitors? Just as importantly, are there policies consistent with free market economics which, if pursued by the federal government, could help more Americans gain a real economic stake in our society through expanding ownership of productive assets? Are these issues even being discussed?

Given the cycle of misery enveloping the poorest Americans, the uncertainty facing millions who are in what Labor Secretary Robert Reich calls the "anxious class," and the concentration of wealth which presently characterize our country, these and other questions cry out for answers. I believe that the nation is ready for a serious debate of these issues and, as our country's central banker, you clearly must play a leading role in this discussion.

I would particularly appreciate your thoughts on why it is necessary to utilize the Open Market Committee to buy and sell Treasury paper. As a primary method of controlling the nation's money supply, I fail to see how the Open Market Committee's activities relate to fulfilling the broad credit needs of American business: The Open Market Committee certainly plays a major role in efficiently helping to meet the credit needs of government. However, I have serious doubts as to whether or not these functions should be our central bank's primary pump priming mechanism.

It is my understanding that when the Federal Reserve system was created, policy makers did not anticipate such a dominant role for the Open Market Committee in implementing our nation's monetary policies. Rather, the operation of the discount window, to replenish bank reserves by buying eligible commercial, industrial, and agricultural paper, was the primary method of ensuring adequate credit to meet the productive (as opposed to the speculative) needs of the private sector. With the discount window, the money supply would be determined by the real credit needs of the private economy as determined by the market. Credit expansion would be backed by productive assets, and would thus be non-inflationary. Moreover, no one would have the awesome task of essentially guessing the course of future economic activity in hopes of directing the course of a complex and unpredictable economy.

With a greater reliance upon the discount window, the role of the regional Federal Reserve banks and local bankers in determining the real productive credit needs of the country would be enhanced. This would be consistent with the political desire of the American people to return decision making back to the local level. Even though the debate is now over whether social programs should be controlled at the federal or local level, I can easily foresee a day when the discussion is about the supply of credit. This issue impacts the lives of Americans far more than the programs which would be decentralized by the Republicans' Contract with America. My question is, what are the pros and cons of enhancing the role of the discount window, and by consequence that of the Regional Federal Reserve banks and local bankers, in determining the amount of credit availability, as opposed to continuing to rely primarily upon financing Treasury paper via the Open Market Committee?

Finally, I would appreciate your thoughts on the policy prescriptions needed to create greater opportunities for more Americans to become owners of income producing assets in our society. I believe that our country must pursue financial policies which assist average Americans build the wealth they need to become economically secure. Given the uncertainty about the economic future for most Americans, a good argument can be made that present monetary (and fiscal) policies have not truly addressed the public's primary concern: that is, creating stable incomes for all of our citizens who are willing and able to participate in production through their capital, their labor, or both.

One tremendous problem which cries out for a solution is the fact that most Americans simply do not possess adequate capital, via savings, to acquire a meaningful equity stake in the economy. Most Americans are totally dependent upon uncertain salaries and wages, or (given budget deficits) even more uncertain government transfers. Without positive balance sheets, millions are overburdened with consumer debt (which makes them poorer). Without savings or collateral, most Americans are denied opportunities to obtain the self-liquidating credit needed to acquire income producing property. Moreover, the present policy of relying on past savings (from decreased consumption) to finance growth further guarantees that most Americans will never accumulate the resources they need to acquire income producing property. In this regard, it seems to me that along with revitalizing the Federal Reserve's discount mechanism to ensure an adequate, asset backed, supply of credit, government should encourage financing mechanisms which tend to broaden, rather than further concentrate, the ownership of productive assets.

The Employee Stock Ownership Plan is one such vehicle. As you know, ESOPs are the only financing mechanism which allows average working Americans to establish equity positions in the businesses where they work, most importantly, even when they do not have any past savings or collateral. Credit extended through ESOPs is self-liquidating, it is paid back from the profits created by production which then produces income for its owners. With ESOPs we in effect provide the same access to productive credit enjoyed by wealthy Americans to all Americans. By encouraging such vehicles, and ensuring an ample supply of credit via the market and discount window, ownership opportunities could be greatly increased for working people who would eventually receive income from capital inputs into the economy which would supplement that from their labor inputs. The Federal Reserve could encourage this expansion of ownership by charging banks only the costs of administering this credit (maybe 1% or 2%), and encouraging banks to pass along the savings to the American people. Again, I would appreciate any thoughts you might have on this issue.

In closing, let me say that I realize that many of us have much to learn about central banking and monetary policy. However, I do know that present policies do not adequately serve the interests of many millions of citizens who are left behind, even when the economy is expanding. Present rates of economic growth are simply too anemic for the private sector to provide opportunities for many people in my district. Thousands have become dependent on government, because there simply are no

other opportunities available, except crime. It is clear that the government option is no longer politically or fiscally sustainable, nor is it socially or morally desirable. All able-bodied citizens need the opportunity to participate in the private economy, (again, through their capital, their labor, or both) and to earn enough income for a decent life from that participation. Also present credit policies only concentrate the wealth that is being produced into fewer and fewer hands. Inevitable periods of contraction only serve to exacerbate a problem which is never truly solved. We must have a new paradigm.

I believe that the country is ready for a reasoned discussion about all of our present policies. The volatility in the electorate is indication enough that the American people are tired of politics (and economics) as usual. They want genuine solutions to our problems. They want the American Dream to be restored. Just as they have turned against traditional liberalism, I have no doubt that the American people will be equally as displeased with the present policies of conservatives. The nation will be better served by a thorough discussion of all of the options available to us, especially the options in the area of monetary policy and credit. Further, we must not be afraid to question traditional assumptions, no matter how well we believe they have served us in the past. Our goal must be to build a better future.

I am very much interested in any views you may have as our nation's central banker in this regard. I anxiously await your reply.

Sincerely,

Bennie G. Thompson
Member of Congress



Letter from **Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System**, to U.S. Congressman Bennie G. Thompson (D-MS). Reprinted with permission.

April 7, 1995

The Honorable Bennie G. Thompson
House of Representatives
Washington, D.C. 20515-2402

Dear Congressman:

Thank you for your letter of March 24, in which you raised a number of complex issues related to monetary policy.

You asked why the Federal Reserve has taken the position that growth beyond 2-1/2 percent is inflationary. Actually, the Federal Reserve has not taken such a position.^[1] The maximum noninflationary growth of the economy depends on the circumstances. In periods of substantial slack in the economy, for example, growth can considerably exceed 2-1/2 percent without contributing to an acceleration of inflation.^[2] Indeed, from the first quarter of 1991 through the fourth quarter of 1994, real GDP expanded at an average rate of 3.1 percent without leading to a pickup in inflation. As a result of this relatively brisk expansion of output,

unemployment declined as job growth exceeded the increase in the labor force and rates of industrial capacity utilization rose as growth in industrial output outpaced that of capacity.

At any given point, however, there is in principle a level of aggregate production beyond which inflation tends to accelerate -- a level referred to by economists as "potential GDP." This level cannot be measured with any precision; we must infer it, partly on the basis of historical relationships between levels of resource utilization and changes in inflation. These historical relationships suggest that the U.S. economy is currently producing around its potential.^[3] Again, we cannot precisely determine this level. But if we were operating at rates appreciably below the economy's potential, we should be seeing a noticeable decline of inflation. By contrast, inflation rates recently have been stable or increasing slightly.^[4]

If we are indeed close to potential GDP, output can grow in line with that of potential GDP without any tendency for inflation to rise or fall. Judging the growth rate of potential output, like judging its level, is difficult, but the principles for making such an estimate are clear. The simplest way to approach this estimate is to add the growth rates of the labor force and average productivity. Demographers tell us with reasonable assurance that the labor force is likely to expand in the near term at a rate of about 1.1 percent. Assessing the likely growth of productivity is more problematic, but on balance the evidence seems to point to a rate of roughly 1.4 percent. Thus, a tentative estimate that the growth of potential GDP is around 2-1/2 percent seems reasonable.

To be sure, these estimates are rather rough, and could be somewhat in error. The growth rate of productivity, for example, is particularly variable and the estimate of 1.4 percent growth over the next few years could easily be off by a few tenths in either direction. But we have little evidence that a larger divergence is likely, ^[5] and thus it seems improbable that potential GDP growth is substantially higher than 2-1/2 percent. Nonetheless, if trend productivity growth does turn out to be stronger, the Federal Reserve would welcome such a development, for it would lead to more rapid growth in output and incomes without adverse implications for inflation. Indeed the Federal Reserve has consistently recommended fiscal policies^[6] oriented toward reducing federal budget deficits and increasing national savings, because such policies would promote private investment and capital formation, which would boost long-run economic growth without increasing inflation.

Unfortunately, even when the economy is producing at its "potential" many people are still unemployed.^[7] But attempts to run at lower levels of unemployment would only produce increased pressures on resources, a pattern of acceleration in prices and nominal wages, and economic instabilities that would in the end do more harm than good. It is true that resource utilization was much higher during World War II, but that was a temporary emergency period involving tight governmental controls over wages and prices that would not be desirable or sustainable at other times.
^[8]

You also raised several questions about the techniques of monetary policy. You asked why the Federal Reserve relies so heavily on open market operations and does not use the discount window more actively in implementing monetary policy. You are correct in noting that the founders of the Federal Reserve System did not envision that open market operations would supplant the discount window as the primary means of implementing monetary policy, [9] but they probably did not foresee the extent of the evolution of financial markets over the past eighty years.

[10] In particular, a national market has replaced numerous local markets for bank reserves and for many types of credit, and a broad, liquid market for government securities has developed. Open market operations in government securities have proved to be by far the most efficient means of controlling the volume of reserves in the banking system, contributing substantially to the ability of the Federal Reserve to promote the nation's economic objectives. [11] For example, open market operations can be used to increase the volume of reserves during a depression, thus stimulating production and employment [12] during a time when the demand for credit at the discount window may be quite slack. More generally, open market operations afford the Federal Reserve a much greater degree of control over the aggregate volume of reserves available to the banking system than would be the case were the discount window to be the primary means of implementing policy. [13]

Several of your questions about the discount window suggest that you believe the Federal Reserve should use its facilities to allocate credit [14] - that is, to subsidize or encourage certain types of lending. The Federal Reserve, however, believes that its involvement in credit allocation should be kept to a minimum. In a free market economy, the central bank should be responsible for the aggregate supply of money and credit, and the allocation of that aggregate supply should be determined primarily by market forces. [15] In general, credit is allocated most efficiently -- that is, to the highest benefit of society as a whole -- when borrowers compete for available funds based on the merits of the products they wish to finance. For a given aggregate supply of credit, loans obtained by one firm or sector necessarily come at the expense of others. [16] The central bank is not in a position to judge which potential borrowers are most deserving of loans. [17] In addition, a central bank involved in credit allocation would experience intense pressures to satisfy all demands from competing users through inflationary expansion of the total supply of credit. [18] For these reasons, any governmental decisions regarding the allocation of credit should be made by elected officials rather than by the independent central bank. [19] The Federal Reserve's primary reliance on open market operations and the relatively small role played by the discount window permit the Federal Reserve to minimize its involvement in credit allocation and improve its ability to conduct monetary policy for the benefit of the nation as a whole.

I might note that it is unlikely in any case that a shift in the Federal Reserve's portfolio from Treasury securities to discount window loans (holding the total quantity of our assets fixed) would make an appreciable difference in the availability of credit to businesses. [20] To a large extent, these transactions would be offsetting -- that is, banks and other financial intermediaries would likely hold more Treasury securities in

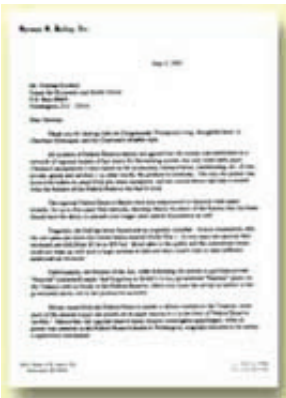
about the same degree the Federal Reserve's holdings were reduced and smaller volumes of loans in about the same degree as these credits were discounted at the Federal Reserve. [21] The terms and conditions on which credit were made available by lenders might be little affected.

Finally, you asked for my views about appropriate policies to encourage a broader ownership of capital in our society. I certainly agree that this is a worthwhile goal. [22] You mention in particular Employee Stock Ownership Plans. ESOPs have a number of attractive features in addition to a wider ownership of capital. Some research indicates, for example, that when properly designed they can improve productivity. [23] You also suggest a role for the Federal Reserve in financing ESOPs. I am aware of no research, however, that points to a shortage of credit for funding ESOPs. [24] Moreover, as I mentioned above, the Federal Reserve believes that its role in credit allocation should be kept to a minimum. I would also point out again that the Congress can make substantial contributions toward increasing the availability of credit and reducing the cost to all private users by reducing the federal budget deficit. [25]

I hope these comments are useful. Please let me know if I can be of further assistance.

Sincerely,

Alan Greenspan



Letter from **Dr. Norman A. Bailey**, former Chief Economist of the National Security Council for International Affairs, to CESJ President Norman G. Kurland.

Mr. Norman Kurland
Center for Economic and Social Justice
P.O. Box 40849
Washington, D.C. 20016

May 5, 1995

Dear Norman:

Thank you for sharing with me Congressman Thompson's long, thoughtful letter to Chairman Greenspan, and the Chairman's detailed reply.

All students of Federal Reserve history are agreed that the system was established as a network of regional lenders of last resort for the banking system, but only when bank paper ("bankers' acceptances") were based on the production, transportation, warehousing, etc. of real, private, goods and services -- in other words, the productive economy. The way the system was structured makes no sense from any other standpoint, and the record shows that that is indeed what the framers of the Federal Reserve Act had in mind.

The regional Federal Reserve Banks were also empowered to discount trade paper directly, for up to five years' final maturity, showing clearly the intent of the framers that the banks should have the ability to smooth over longer-term market fluctuations as well.

Tragically, the Fed has never functioned as originally intended. Almost immediately after the Act came into force the United States entered World War I. In two years the national debt increased ten-fold (from \$5 bn to \$50 bn). Bond sales to the public and the commercial banks could not keep up with such a huge increase in debt and there wasn't time to raise sufficient additional tax revenues.

Unfortunately, the framers of the Act, while forbidding the system to purchase private "financial" (unbacked) paper, had forgotten to forbid it to buy government "financial" paper, so the Treasury sold its bonds to the Federal Reserve, which ever since has served as banker to the government alone, not to the productive economy.

Money raised from the Federal Reserve system is almost costless to the Treasury, since most of the interest it pays the system on its paper returns to it in the form of Federal Reserve "profits." Meanwhile, the regional reserve banks became meaningless appendages, while all power was centered in the Federal Reserve Board in Washington, originally intended to be merely a supervisory mechanism.

As to the inadvisability of the Federal Reserve system "allocating" credit, it does that everyday -- the allocation is 100% to the government and 0% to the economy. A simple way to demonstrate that fact is to imagine the federal debt magically disappearing. The Federal Reserve system would have no assets (other than some gold artificially valued well below market) and thus would be unable to issue any liabilities (Federal Reserve notes and credits). There would be no money supply -- an absurdity.

Chairman Greenspan is perhaps the best Federal Reserve Chairman in history -- he has brilliantly manipulated a fatally flawed system. It is a shame he has forgotten his own previous beliefs and writings. He could have lent his great prestige to turning the system back to what it was intended to be in the first place -- the lender of last resort to the private, productive economy.

Thank you for your patience.

Yours most cordially,

Norman A. Bailey

CESJ analysis
(updated November
1999) of Fed
Chairman Alan
Greenspan's letter to
Rep. Bennie
Thompson

(Paragraph numbers
correspond to numbers

1. In his testimony before various Congressional committees in 1994-5, Fed Chairman Alan Greenspan has suggested strongly that the Fed's interest rate strategies were linked to growth rates in the economy. Interest rates would be nudged upwards by the Fed when the "target" rate of 2.5% was exceeded, based on the Fed's assumption that above that rate inflation would be triggered by tight labor markets. Without getting too technical, the 2.5% growth rate represents a combination of roughly 1.1% annual growth in the labor pool (which includes unemployed and underemployed workers and disregards those who have dropped out), plus

inserted on copy of letter from Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, to U.S. Congressman Bennie G. Thompson (D-MS).

1.4% annual growth rates in productivity (output per worker, which includes present capacity utilization rates for existing plant and equipment). Correspondingly, interest rates would be lowered by the Fed where growth declined below 2.5% and more people became unemployed. Chairman Greenspan misses the point made by others, including former House Speaker Gingrich, that the economy could grow by rates of 5% or higher without triggering inflation. (Despite three recent Fed hikes in interest rates to restrain "potential inflation," the U.S. growth rate rose to 5.5% with virtually no inflation in the third quarter of 1999 [Washington Post, November 25, 1999, p. A1].) [\[return to letter\]](#)

2. This is precisely the point made by Rep. Bennie Thompson in his letter of March 24, 1995 to Chairman Greenspan. There is and has historically been "substantial slack in the economy, especially in peacetime" (see Harold Moulton, *The Formation of Capital*, Brookings Institution, 1935, pp. 110-111, 116). The "slack" consists of (1) millions of unemployed, underemployed, and mis-employed workers and millions more who have dropped out of the workforce; (2) "morbid" technology, representing the gross failure of our financial institutions to adequately fund commercialization of on-the-shelf Space Age technologies which could radically boost the productivity of our nation's capital assets and reduce costs; and (3) under-utilized existing plant, equipment, land and natural resources.

The Fed is correct in pointing out natural limits in (1) the existing labor pool (while not being imaginative enough on how that pool could become fully employed) and (2) the rate of capacity utilization of existing productive assets. But what ESOP critics of the Fed point out (see *Curing World Poverty: The New Role of Property*, Social Justice Review, 1994, Chapters 6, 7 and 8) is that the Fed's acquiescence to the nation's exclusive reliance on wages and welfare for generating mass purchasing power causes artificial increases in the cost of American products, induces excessive underemployment, and stifles faster rates of investment in and commercialization of advanced cost-saving technologies. In turn, the Fed's policies artificially limited productivity growth in the early 1990s to 1.4%, down from past levels of 3% and higher.

Since technological change represents the main source of overall U.S. GNP growth rates (estimated by an MIT study at 80% between the years 1909-1949), Chairman Greenspan ignored the counterproductive effect of tight money and high interest rates on the rate of commercialization of new technologies needed to boost overall U.S. growth rates to 5% or higher. These higher rates would be reinforced through broadened access to profits from such new capital formation distributed broadly among American workers. High rates of investment, as Moulton reminded us, always follow high rates of consumption, and widespread ownership of productive assets plus profit sharing would create a new source for increasing U.S. consumption levels. With structural reforms in Fed policies, new technologies could be added and financed in ways that would avoid inflation, a goal which Chairman Greenspan and Rep. Thompson both support. [\[return to letter\]](#)

3. This is contradicted by Harold Moulton in his book, *The Formation of*

Capital (pp. 87, 116). Moulton observed that in the periods from 1869 to 1873, and again in the great expansion period of the early 1880s and 1920s, we added large quantities of industrial machinery and railway equipment, yet there remained a considerable amount of idle labor. As pointed out above, there is still considerable "slack" in the U.S. economy which present income maintenance policies supported by the Fed fail to convert into productive activity. And, contrary to what most economists would have predicted, price levels declined by about 65% during periods of America's greatest industrial expansion, from 1865 to 1895. (Ibid.)
[\[return to letter\]](#)

4. The failure to achieve declining price levels is at least partially caused by the Fed in its policy of monetizing Federal deficits and failing to lower interest rates for productivity-expanding technologies which could add a major new and non-inflationary source of consumption incomes for American workers under a "new social contract" based on widespread ownership and profit sharing. If U.S. growth levels increased without inflation (which they could under the proposed "new social contract"), budget deficits could be eliminated by higher taxable incomes and reduced Welfare State costs. [\[return to letter\]](#)

5. An increase in productivity growth is unlikely only if current Fed policy continues to stifle higher rates of investment. See comment #2.
[\[return to letter\]](#)

6. The Fed always casts blame on Congress' fiscal policies, instead of offering monetary and interest rate innovations that would promote private investment, national savings and capital formation, as suggested by Rep. Thompson. [\[return to letter\]](#)

7. This is a self-fulfilling prophecy shared by those wedded to conventional schools of economic thought. [\[return to letter\]](#)

8. While it is true that during World War II the government imposed tight controls over wages and prices, there were many "escape hatches." For example, many employee "fringe benefits" were introduced during the war which were not counted as taxable compensation, including pension plans, health insurance, etc. Furthermore, tax policy could have countered the inflationary pressures of wartime growth. What Chairman Greenspan ignores is that, with 13 million of the most able-bodied Americans removed from the labor pool to fight the war, U.S. growth rates climbed from depression levels in 1940 to over 13% annually during the war, and that while most of the production was for weaponry, many Americans at home had higher consumption levels during all-out war than before the war. It is worth noting that the Federal Reserve discount rate during the war never exceeded 1%, greatly facilitating bank loans to expand U.S. industrial capacity.

The main point in Rep. Thompson's letter was to call the Chairman's attention to a wartime discount rate policy which could encourage new sources of peacetime consumption incomes, faster rates of peacetime investment and savings, and faster rates of overall peacetime growth, without inflation. Chairman Greenspan missed the point. [\[return to letter\]](#)

9. What Chairman Greenspan glosses over is the main reason the Fed abandoned the discount window: our entry into World War I. The war then, as it has in all later wars and extreme national emergencies, produced Federal deficits because of Congress' reluctance to pass on the costs of the war to the taxpayers. The Fed reinforced these deficits by its willingness to monetize Treasury paper (representing public sector deficits and growth) in ways that increased its dependency on Wall Street bond peddlers. This allowed the Fed to stop monetizing private sector growth through Main Street banks tapped into the discount windows of each of the 12 regional Feds, which thereby lost their original roles as regional development banks, able to match the liquidity needs of local enterprises with local growth potentials. We moved from decentralized access to capital credit for the productive private sector, to highly concentrated control over credit for public sector growth. We also moved gradually from a currency backed by private sector debt paper to a currency backed by growing public sector debt paper. [\[return to letter\]](#)

10. This evolution of financial markets from Main Street to Wall Street is not as beneficial as Chairman Greenspan seems to suggest. Wall Street is geared to speculation and gambling. Main Street banks are more geared to long-term investment by local entrepreneurs and workers. Wall Street raises money in ways that make the rich richer and the poor poorer. Wall Street does nothing to broaden the ownership of capital or to decentralize economic power; it does the opposite. [\[return to letter\]](#)

11. See response #10. Chairman Greenspan seems to suggest that Wall Street bond peddlers and currency speculators are doing a good job in running America. A growing number of Americans are becoming disenchanted with the results. (See W. Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country.*) [\[return to letter\]](#)

12. This is a surprising admission by Chairman Greenspan that he, too, has become a Keynesian, notwithstanding his reputation as a follower of Ayn Rand and a supporter of the Austrian school of free market economics. Ayn will be turning over in her grave, especially over the Fed's decisions to play around with interest rates to restrain economic growth. Chairman Greenspan should know as well as anyone that Keynesian fiscal and monetary policies did not lift America out of the Depression. It took World War II to rescue the U.S. economy, as suggested in our responses #8 and #9. [\[return to letter\]](#)

13. The main problem with the discount window as used prior to World War I was that it generated productive credit for people who were already "haves", not the 95% of the people who were economic "have-nots" (in the sense they owned few or no shares of the enterprises borrowing money from commercial banks.) Hence, the discount window operation contributed nothing to raise consumption incomes for working people, leaving the bulk of Americans increasingly relegated, in order to meet their income needs, to inherently inflationary wage systems or the Welfare State—both of which de-motivate people and reduce the economy's ability to produce consumable wealth.

But as Harold Moulton pointed out (*The Formation of Capital*, p. 42), "the

demand for capital goods is a derived demand—derived, that is, from the demand for consumption goods." If the discount window were used to finance new plant and equipment through such wealth-spreading alternatives as leveraged ESOPs, this "social tool" of the Fed would enable workers to supplement their market wage rates with profits, which, in turn, would enable workers to "save" to repay their stock acquisition loans and thereafter receive non-inflationary property incomes to supplement their wages.

Thus, by small changes in Section 13 of the Federal Reserve Act, the Fed's discount mechanism could become a powerful tool for stimulating consumption increases simultaneously with capital increases, each reinforcing the other (The Formation of Capital, page 74). This is the key to sustained economic growth without inflation. Increased supply and increased demand would grow together, eliminating the slack at the discount window mentioned by Chairman Greenspan. [\[return to letter\]](#)

14. This is a straw man fabricated by Chairman Greenspan. In paragraph 3 on page 2 of his letter to the Chairman, Rep. Thompson explicitly stated that "With the discount window, the money supply would be determined by the real credit needs of the private economy as determined by the market." The next paragraph on page 2 stated, "the role of the regional Federal reserve banks and local bankers in determining the real productive credit needs of the country would be enhanced. Nowhere did Rep. Thompson suggest centralized allocation of credit by the Federal Reserve. Indeed, the present operation of the Fed's Open Market Committee is the ultimate in centralized allocation of credit by the Central Bank, and the wrong kind of credit at that.

Rep. Thompson's suggestions were clearly aimed at local, decentralized allocations of credit and would rest wholly upon the commercial bank's traditional role in scrutinizing the financial feasibility of every project for which ESOP (expanded ownership) financing is being sought before making the loan. In no way would Rep. Thompson's proposal inject political considerations in the decision to extend credit. The local bank would have that power exclusively. Certainly, a Fed policy favoring more equal access to capital credit for all Americans does not interfere with the local banker's right to make or deny any particular loan request based on the banker's judgment as to whether or not the loan will be self-liquidating and the collateral will be sufficient in the event of default. [\[return to letter\]](#)

15. Rep. Thompson's letter agrees that the market should determine allocations of credit. However, Chairman Greenspan seems to suggest that the supply of credit is limited to existing accumulations of savings. Not only is this not so, but every time the Fed monetizes Treasury paper (representing Federal deficits) it ignores the market and creates a new supply of money and credit. When a person uses a credit card to meet his consumption needs, he "creates" credit not dependent on existing savings or past accumulations; the credit will be repaid out of future savings. The same thing applies when the government enabled World War II veterans to buy homes on credit with no down payment, with loan insurance provided to cover the bank's risk of default. These uses of credit were not

Rep. Thompson's proposal to de-link economic growth from the slavery of past savings is superior to each of the above examples of credit creation for the following reasons: (1) his is aimed wholly at productive uses of credit (i.e., self-liquidating credit) as opposed to non-productive uses of credit (i.e., consumer loans, loans for speculation, credit to cover government deficits—credit to pay for a thing not intended to pay for itself); (2) his is for assets to be used exclusively in the private sector and would be justified wholly by projected future earnings of the enterprise acquiring the assets; (3) his would be approved by local commercial banks; (4) his would promote supply-side growth linked to a non-inflationary source of consumption incomes; (5) his is not dependent on the past savings or reduced current consumption incomes of the beneficiaries of the new capital credit; and, most important, (6) his would broaden citizen participation in the ownership of productive assets and the profits expected to be generated from the enterprises using those assets.

As Moulton points out, it is not necessary to reduce consumption to finance new investments. Because consumption incomes are necessary to buy the consumer goods that new capital goods will ultimately produce, forcing people to reduce their consumption incomes to finance new capital assets limits growth and works against the long-term viability of the new investments. Chairman Greenspan does not seem to understand this point. [\[return to letter\]](#)

16. See response #15. Chairman Greenspan is thinking in "zero-sum game" terms which ignore the fact that the basic purpose of a central bank is to "create money," and that as long as the new money is used productively to create new wealth, the result will be non-inflationary. [\[return to letter\]](#)

17. As already noted in response #14, the central bank would not be the judge of which borrowers are most deserving of loans. The local bank would play this role. We should be reminded that the Fed used its discount window to bail out the too-big-to-fail Continental Illinois Bank when it got into trouble; the Fed refused to offer the same help to Freedom National Bank of Harlem. [\[return to letter\]](#)

18. Again, the central bank would not be involved in credit allocation. If a local bank makes bad loans to ESOP companies, the regional Fed could refuse it access to its discount window and, if the pattern persists, the Fed could de-list the local bank from membership in the Fed. [\[return to letter\]](#)

19. It would be a bad idea for either elected officials or the central bank to allocate credit. [\[return to letter\]](#)

20. Rep. Thompson did not suggest that the Fed's total assets be fixed. His proposal would increase bank credit as U.S. productive assets increased with private sector paper (representing growth of real wealth) rather than having non-productive Treasury paper (representing past deficits that present and past taxpayers pass on as burdens to future generations) standing behind the U.S. currency. And as expanded ownership loans are

repaid that new currency would be taken out of circulation. Absurd as it may seem from an accounting standpoint, it should be noted, present Fed policy create government liabilities (new currency) backed by other government liabilities (Treasury paper) that are treated by the Fed as "assets". [\[return to letter\]](#)

21. If the Open Market Operation of the Fed were eliminated, or if it were shifted to the Treasury, Treasury paper would still be sold in domestic and foreign capital markets. In fact, Rep. Thompson's proposal by opening up a new and deeper reservoir of capital credit, would free up already accumulated savings for the acquisition of Treasury paper, and perhaps, to the advantage of federal taxpayers, at lower interest rates. [\[return to letter\]](#)

22. This is an historically important admission by Chairman Greenspan. Never before, to my knowledge, has a Chairman of the Federal Reserve System advocated "broader ownership of capital" as a national goal, as was called for by the Joint Economic Committee of Congress in 1976. Unfortunately, Chairman Greenspan missed the point of Rep. Thompson's letter, that the Fed could play a positive role in promoting this goal. [\[return to letter\]](#)

23. It is also useful to have Chairman Greenspan's positive comments about ESOPs and their capacity, when properly designed, to improve productivity. Former Fed Chairman Paul Volcker also made positive comments about the ESOP, wondering why more had not been adopted. Neither could conceive that the Fed could help encourage ESOPs by an innovative use of the Fed's discount mechanism and a special discount rate set to cover the Fed's costs of servicing ESOP loans, perhaps 1% or less. [\[return to letter\]](#)

24. As the ESOP Association can verify, the growth of ESOPs has hit a plateau. When Congress in 1984 created a special tax incentive to banks making loans to ESOPs, the rate of new ESOP formations skyrocketed. When Congress later added a condition that limited such loans to companies where workers held at least 50% of the voting shares, ESOP formations fell off a cliff. What Rep. Thompson is proposing—setting up a special discount rate for ESOP loans—would cause another takeoff of ESOPs and would have no negative impacts on the budget, as did the first subsidy to banks. [\[return to letter\]](#)

25. The use of the discount window to encourage leveraged ESOPs would help reduce Federal budget deficits in many ways. It would encourage accelerated rates of private sector growth, without inflation, and would involve no taxpayer subsidies. In fact, it should raise the level of taxable incomes for meeting the legitimate costs of government, while reducing demands for government spending on unemployment and welfare. It would put the Fed and the Congress in a win-win situation and would go a long way toward building a stronger, freer, and more just American economy in the future. [\[return to letter\]](#)
