The Federal Reserve System really is a department of the Federal Government that has been granted some independence in policy making. Within what is normally a small range of variation, the liabilities of the Federal Reserve System determine the reserve base and hence the deposit liabilities of the member banks. I take it that the continued existence of fractional reserve commercial banking is not at issue. What is at issue is whether the "posture" of the Federal Reserve System as a Bankers bank is to be maintained.

If we consolidate the books of all the government agencies, then the Treasury debt held by the Federal Reserve Banks would appear as both an asset and a liability of the government. Such internal financial arrangements are usually ignored - the debt to all practical purposes does disappear once it enters the Federal Reserve System's portfolio.

The present arrangements make the reserve base of the commercial banks reflect either loans or investments by the Federal Reserve or the Treasury's holdings of gold. In principal there is no reason why the Federal Reserve System should be able to cast up a conventional balance sheet. It could like the Treasury have only half a balance sheet. In principal the erasing of some $30 billion of Federal Reserve holdings of government debt or equivalently the substitution of some $30 billion of a special zero interest rate Treasury debt for the standard debt now held - should have no effect upon the operation of banks or the Central Bank.

Because something makes no difference in principal it does not follow that it does not in fact matter. The transformation of conventions into matters of principal is not an unknown phenomena, witness the recent controversy over the kind of metal on which coins are to be printed. The convention that the Federal Reserve System have assets equal in value to its liabilities can blunt the willingness and ability of the Federal Reserve System to fulfill its responsibilities as the lender of last resort in a time of crisis. On the other hand there is no reason to take the myth about the Federal Reserve seriously if the Federal Reserve does not take it seriously. Under these circumstances we might just as well let well enough alone.

A central bank does not need any stock of interest bearing government debt in order to engage in contractionary open market operations. It could decrease the reserve base of the commercial banks by borrowing from banks in the Federal Funds market. The distinction between Treasury debt management and Federal Reserve open market operations is trivial. In principal the Federal Reserve System could own the entire Federal debt and emit its own interest bearing debt to keep the reserve base of the Commercial Banks on target.

Much of what is called the defensive operations of the Federal Reserve System are really unnecessary in the sense that they could be eliminated by some slight changes in usages. Two changes that would help do this are (1) to allow member banks to issue currency on exactly the same terms as they now issue demand deposits and (2) to open the discount window to money market institutions such as government bond dealers and consumer credit houses.
The essential function of the Federal Reserve is to act as a lender of last resort to the financial markets of the economy as they are rather than as the Federal Reserve thinks they ought to be. The Federal Reserve - or the government - by implicitly insuring the nominal price of private liabilities against the possibility of a general pressure to liquidate prevents the development of a cumulative crisis and makes such liabilities more attractive.

When tested the Federal Reserve System failed not only as a lender of last resort to the market but even as a lender of last resort to the commercial banks. As a result of the distrust of the Federal Reserve which followed the central banking function was decentralized. Partial central banks such as F.D.I.C., F.H.A., H.O.L.C., FMMA etc. have arisen with responsibility to maintain orderly conditions in particular markets. However because the Federal Reserve controls the quantity of money, it might be necessary for the Federal Reserve system to back up these specialized institutions. Unless the Treasury intervenes, the Federal Reserve system, using bankers ideas of eligible assets might not find the instruments offered by these specialized institutions to be of high enough quality.

The Federal Reserve's broad responsibility is not to allow tangible asset prices to get far out of line with their costs of production. In order to do this it must stand ready when a deflationary crisis threatens to buy all "assets" at a price that is close to their nominal or book value.

It follows that the view that the Federal Reserve System must maintain a conventional balance sheet, and that the Federal Reserve System should hold a risk averters portfolio, can get in the way of the Federal Reserve System doing the correct thing. If the aim is to expand the reserve base you buy assets, any assets will do. If you want to peg a price you buy the assets or a closely related asset; you do not depend upon a 'perfect' oozing relationship among assets. If you want to abort a deflationary process you acquire the assets under pressure.

The other function of the Federal Reserve System, the maintenance of conditions for economic stability and growth is fulfilled with the proper change in the reserve base. There is no reason why the subsequent substitution of a special treasury instrument for whatever the Fed acquires in this process need lead to any repercussions.

On the other hand it may very well be that the public's direct and indirect holdings of government liabilities is the really relevant determinant of income. If this is so, merely increasing the size of the conventional money supply may not be sufficient to maintain income and employment. Rather what is needed is a correct rise in the public's secure outside asset, the government debt. Thus a chronic deficit, rather than the substitution of one government liability for another in private portfolios is what is needed.