CHAPTER FIVE

Some Historical Reflections on the Governance of the Federal Reserve

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Since the financial crisis of 2007–2008, there has been considerable interest in reform of the Federal Reserve System. Many blame the Federal Reserve for causing the crisis, for not handling it well, and for mismanaging the recovery. Criticisms include: keeping the policy rate too loose from 2002 to 2005 and thereby fueling the housing boom: lapses in financial regulation that failed to discourage the excesses that occurred; the bailouts of insolvent financial firms; the use of credit policy; and conflicts of interest between directors of the New York Federal Reserve Bank and Wall Street banks.

The Dodd-Frank Act of 2010 made some minor changes to Federal Reserve governance: removing the voting rights of Class A Reserve Bank directors for selection of the president and vice president of the Reserve Bank; and changing the Federal Reserve's lender-of-last-resort policy—limiting the use of 13(3) discount window lending. Some have urged that the reform process go further, e.g., Conti-Brown (2015) argued that the Reserve Bank presidents be appointed by the president while the recent Shelby bill includes requiring this change only for the president of the New York Federal Reserve Bank.[1]

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1. Similar calls for reform of Fed governance were proposed in congressional bills in 1977 and 1991, which did not pass.

A similar cacophony of criticism and calls for reform of the Fed occurred after the Great Contraction of 1929 to 1933, which President Franklin Delano Roosevelt blamed on the banks and the Federal Reserve. This led to a major reform of the Federal Reserve System in congressional acts in 1933 and 1935.

In this paper I examine the historical record on Federal Reserve governance and especially the relationship between the Reserve Banks and the Board from the early years of the Federal Reserve to the recent crisis. From the record I consider some lessons for the current debate over reform of the Federal Reserve.

Establishment of the Federal Reserve System

A signature aspect of the Federal Reserve System is its federal / regional structure and governance. The Federal Reserve Act of 1913 was passed following a long deliberation over reform of the US financial system after the Panic of 1907. The panic was the straw that broke the camel's back, following a series of banking panics that plagued the post–Civil War national banking system. The US banking system was characterized by considerable instability involving frequent banking panics since Andrew Jackson's veto of the charter of the Second Bank of the United States. Its causes included the prohibition on interstate branch banking[2] and the absence of a lender of last resort. The reform movement that followed the 1907 panic called for the creation of something like a central bank, but there was considerable opposition to a European-style central bank which had all of its financial power concentrated in the financial center. The Aldrich-Vreeland Act of 1908 created a network of National Reserve Associations, which were modeled on the plan of the private clearing houses in many US cities. Clearing houses issued a form of emergency currency ("clearing house

2. This was not the case in Canada, which never had a banking crisis (Bordo, Redish, and Rockoff 2015).

loan certificates") during panics and on a number of occasions successfully allayed the panic (Gorton 1985). The Aldrich-Vreeland Act also established the National Monetary Commission (NMC), which was to study the monetary experience of many countries and make recommendations for a reform of the US banking system.

The NMC in 1912 put forward a plan for a regional central bank system called the Aldrich Plan. It was based on an earlier plan suggested by Paul Warburg, an influential German-born banker, which was in many ways an American adaptation of the Reichsbank. The Aldrich bill called for the establishment of a National Reserve Association, headquartered in Washington, D.C. The association's branches would be located throughout the United States and serve member commercial banks. The association would issue asset-backed currency and rediscount eligible paper consisting of short-term commercial and agricultural loans for its members at a discount rate set by the national association's board of directors. The discount rate would be uniform throughout the country. The association would also be able to conduct open market operations (Bordo and Wheelock, 2010).[3]

The Aldrich plan was defeated in Congress. After the election of 1912, when the Democrats took power, it was greatly revised to include a stronger role for the government. The resultant Federal Reserve Act of 1913 represented the Wilsonian compromise, which gave a role in the system to the regional commercial banks (Main Street), the money center banks (Wall Street), and the federal government (Karr 2013).

The Federal Reserve System differed markedly from Aldrich's proposed National Reserve Association in terms of structure and governance. Rather than a central organization with many branches,

3. Neither the Aldrich plan nor the subsequent Federal Reserve Act considered adopting nationwide branch banking. The political economy of the US banking industry was very successful in blocking that reform until the end of the twentieth century. Hence, given the fractured US banking system, a regional reserve bank system was a reasonable arrangement (Calomiris and Haber 2014, Bordo, Redish, and Rockoff 2015, Bordo and Wheelock 2010).

the Federal Reserve System consisted of twelve semi-autonomous regional reserve banks and the Federal Reserve Board, which had a general oversight role. Whereas the Federal Reserve Board was made up of five members appointed by the president and chaired by the secretary of the treasury, the reserve banks were owned by their member banks and the governors (after 1935 called presidents) were appointed by local boards of directors, consisting of nine directors. Three of the directors (Class A, who were primarily bankers) are elected by the Reserve Banks; three of them (Class B, to be non-bankers) are also elected by the Reserve Banks; and three (Class C, to be non-bankers) are appointed by the Federal Reserve Board. The member banks are required to purchase stock in their local Reserve Bank.

A key difference between the Federal Reserve Act and the Aldrich plan was that the individual Federal Reserve Banks set their own discount rates (subject to review by the Federal Reserve Board), and each bank was required to maintain a minimum reserve in the form of gold and eligible paper against its note and deposit liabilities. The demarcation of authority between the Reserve Banks and the Board in Washington was not clearly spelled out in the Federal Reserve Act. This led to serious problems in the 1920s and 1930s.

The Early Years: 1914 to 1935

The Federal Reserve Banks opened their doors in December 1914 just in time for the outbreak of World War I in Europe. The war meant that the Fed faced a very different environment than its framers envisaged and consequently it changed its operations in novel ways. Because of the war, most countries left the gold standard. Also, once the United States entered the war, the Fed began discounting commercial bills backed by government securities. Also, as the war progressed the Fed pegged short-term interest rates to help the Treasury finance the war. This meant that it gave up its independence to the Treasury.

At the end of the war, in 1918, the Federal Reserve kept its discount rate low at the Treasury's behest. This fueled a massive commodities price boom and inflation. Faced with declining gold reserves in late 1919, the Federal Reserve Banks (with approval by the Board) raised discount rates. This led to a serious deflation and recession, which Friedman and Schwartz (1963) termed the Fed's first policy mistake for waiting too long to cut its rates. The recession also led to severe criticism of the Federal Reserve, causing it to cut back on the use of discount rates as its key policy tool and shifting it toward the use of open market operations.

Conflict among the Reserve Banks and between the Reserve Banks and the Board began quite early over the lack of cooperation in setting discount rates and conducting open market operations. This occurred because the Act wanted the Reserve Banks to conduct their own monetary policies to influence economic conditions in their own districts and because the Board's coordinating authority was not clear—i.e., whether the member banks had to follow the Board's instructions.

To create a coordinating mechanism, the Reserve Banks, without the Board's consent, set up the Governors' Conference in 1921 to coordinate both discount rate and open market operations. In April 1922, the Reserve Board asserted its authority and disbanded the Governors' Conference, in its place setting up the Open Market Investment Committee (OMIC) to coordinate open market operations at the national level. It was composed of the governors of the Reserve Banks of New York, Chicago, Boston, Philadelphia, and Cleveland.

As it turned out, Governor Benjamin Strong of New York became the de facto leader of the OMIC. According to Friedman and Schwartz (1963), the OMIC under Strong was very successful at stabilizing the US economy and producing what they called "the high tide of the Federal Reserve." Nevertheless, many of its actions were resented by the seven Reserve Banks that were not on the committee and by the Board, which often felt that its authority was being challenged (Eichengreen 1992). Also, although the Board had ultimate authority on setting rates and conducting open market operations, individual Reserve Banks could opt out.

Several famous examples of conflict provide a strong flavor of the steep learning curve that the system faced in its early years. The first episode was in 1927, when Strong arranged a meeting on Long Island between himself and the governors of the central banks of England, France, and Germany. At this summit it was agreed that the New York Reserve Bank would lower its discount rate to help the Bank of England in its struggle to stay on the gold standard. The Board was not part of the negotiations. After the meeting there was a vociferous debate at the Board and in the other Reserve Banks about going along with the rate cut. In the end, the Board reluctantly approved Strong's action, but the Chicago Reserve Bank held out. The Board subsequently forced Chicago to cut its rate.

Adolph Miller of the Board, the only professional economist in the system, later argued that Strong's policy fueled the Wall Street stock market boom which led to the Great Depression, a view adopted much later by Herbert Hoover in his memoirs.

The second notable example of discord was in early 1928 when New York and Chicago disagreed over raising rates to stem the stock market boom. In the end, a tightening open market policy was followed (Wheelock 2000).

The third example was in 1929 when the Board and New York disagreed over how to stem the Wall Street boom. The Board wanted to engage in moral suasion to ration credit against loans to finance stock market speculation. New York and the others on OMIC doubted such a policy would work and pushed for raising discount rates. The Board blocked New York ten times until it finally acquiesced in the early summer of 1929, when it was too late.

The fourth example was after the Wall Street crash in October 1929. The New York Reserve Bank under Governor George Harrison unilaterally engaged in open market operations to provide liquidity to the New York money market to prevent a banking panic. His actions were criticized by the Board for not following protocol. Later in November, Harrison's request to engage in further easing policy was blocked by the Board, undoubtedly worsening the recession.

In March 1930, the Board disbanded the OMIC and created the Open Market Policy Committee (OMPC). It contained all twelve Reserve Bank governors. According to Friedman and Schwartz, this was a huge mistake because the larger committee, without the leadership of Benjamin Strong, who died in October 1928, was unable to be decisive. Its defects became apparent as the Depression worsened and the Fed failed to stem a series of worsening banking panics.

By the spring of 1932, under pressure from the Congress, the Federal Reserve began a massive open market purchase program led by Harrison of New York. It was quickly successful in reversing the recession but it was short-lived. Reserve Bank governors began to worry that their gold reserves were declining toward the statutory limits. Some governors and the Board also worried that the purchases would lead to speculation, an asset price boom, and inflation. Once Congress went on recess, the purchases stopped (Friedman and Schwartz 1963, Meltzer 2003).

The final and most serious example of discord in the system was in the first week of March 1933, during the final panic of the Great Contraction. The panic, unlike the three preceding ones, involved a speculative attack against the New York Reserve Bank's gold reserves. Some argue the attack reflected the market's belief that newly elected President Roosevelt would take the United States off the gold standard (Wigmore 1987). The attack led to a depletion of the New York Reserve Bank's gold reserves toward the statutory limit, after which it would have to cease conducting lender-of-last-resort actions. The New York Fed turned to the Chicago Reserve Bank, which had ample gold reserves, and requested a temporary loan of gold. Chicago turned New York down. The Board refused to intercede. The crisis worsened and was only ended when Roosevelt took office and declared a banking holiday.

Friedman and Schwartz cite these examples in their indictment of the Federal Reserve for causing the Great Contraction. They believed that had Benjamin Strong lived, he would have effectively used the OMIC to prevent the mistakes that followed his death. They were in favor of the consolidation of power in the Board that followed in 1935.

Eichengreen (1992), using the tools of game theory, demonstrated that had the Reserve Banks and Board coordinated policy during the above examples of discord, the US economy would have been much more stable. He also supported the consolidation of the system in 1935.

On the other hand, Brunner and Meltzer (1968), Meltzer (2003), and Wheelock (1991) argued that the real problem that the Federal Reserve faced wasn't structural but resulted from the theory of monetary policy it followed. They argued that the Federal Reserve as a whole followed the "real bills doctrine" and a variant of it called the Burgess-Riefler-Strong doctrine. According to this doctrine, the Federal Reserve should focus on two indicators of the stance of the economy: member bank borrowings and short-term interest rates. They argued that from 1930 to 1933, because rates were low and member bank borrowing was low, the Federal Reserve viewed its policy as largely accommodative and hence did not see the need for further loosening. Meltzer argued that Strong and most Reserve Bank governors as well as members of the Board believed in this flawed doctrine. Hence, according to them the Roosevelt consolidation of the Federal Reserve was not really necessary.

One counterfactual question that arises is: How would the structural problems of the Federal Reserve have been corrected without a major reorganization? In addition, as the above authors argue, the Federal Reserve didn't really change its (flawed) model of monetary policy until after the Great Inflation. So what forces could have pushed the Fed to improve its policymaking in the mid-1930s in the absence of the reorganization?

Reform of the Fed

The Great Contraction was blamed on the banks and the Federal Reserve, especially the New York Reserve Bank. This led to major reforms of the 1913 Federal Reserve Act. The first reform was the Glass-Steagall Act of 1932, which among other things greatly broadened the collateral that Reserve Banks had to hold against their notes and deposits, which allowed them more flexibility in their discounting policy. The 1933 Glass-Steagall Act split commercial from investment banking and created the Federal Deposit Insurance Corporation (FDIC). It also changed the name of the OMPC to the Federal Open Market Committee. The twelve Reserve Banks remained members of the FOMC; the Federal Reserve Board was given clear authority over initiating open market operations, but the Reserve Banks still had the option of opting out of actions recommended by the Board.

The most significant changes to the act occurred in the 1935 Banking Act. Much of the legislation was drafted by Marriner Eccles, Roosevelt's choice to be chairman of the Board, and Lauchlin Currie, his aide at Treasury. Eccles was a Keynesian before Keynes's *General Theory* (Meltzer 2003). Eccles wanted the federal government to control the levers of both fiscal and monetary policy to raise aggregate demand. His plan was to remove the Reserve Banks completely from Federal Reserve decision-making and make them branches of the Board in Washington. However, his bill was blocked by Senator Carter Glass, one of the framers of the original act, and so the final legislation maintained an important but subsidiary role for the Reserve Banks.

The 1935 act replaced the Federal Reserve Board with the Board of Governors of the Federal Reserve System. The president appointed seven governors, subject to Senate approval. The secretary of the treasury and the comptroller of the currency were removed from the Board. All twelve Reserve Bank presidents (demoted from the title governor) remained on the FOMC but only five could vote (one of which was the New York Reserve Bank president[4]). The other four voting presidents served on a rotating basis. The voting procedure to nominate Reserve Bank presidents was unchanged. Other important changes were to the supervision and regulation of member banks, which came under the purview of the Board, then to be delegated to the Reserve Banks. Also, the responsibility for international economic policy shifted from the New York Reserve Bank to the Board.[5]

Once the bill was passed, power irrevocably shifted from the Reserve Banks to the Board of Governors. However, from the mid-1930s until 1951, the Federal Reserve was subservient to the Treasury and monetary policy was geared to pegging interest rates at a low level to facilitate Treasury funding. The Federal Reserve acted independently only once, in 1936–37, when it doubled excess reserves to prevent the commercial banks from fueling another speculative boom. This action, according to Friedman and Schwartz, led to

4. From 1936 to 1942, New York rotated with Boston. New York was assigned a permanent place in 1942.

5. The unit banking system was left untouched. A plan by the large money center banks to allow nationwide branching was blocked by the lobby of the small banks. The compromise was the creation of the FDIC (Calomiris and White 1994).

a severe recession in 1936–37.[6] During World War II the Federal Reserve, a de facto branch of the Treasury, served as an engine of inflation to finance the war effort.

Board of Governors Reserve Bank Relations: 1951 to 2006

A run-up of inflation in the late 1940s led the Federal Reserve System to push for independence from the Treasury to be able to raise interest rates. President Allan Sproul of New York led the campaign, which was finally successful in the Federal Reserve Treasury Accord of March 1951. (See Meltzer 2003, chapter 7, and Bordo 2006 for the dramatic details.) William McChesney Martin became chairman of the Board in 1951. Under his tutelage there was considerable harmony between the Board and the Reserve Banks with the possible exception of the debate in the 1950s between the Board and New York over "bills only" (whether open market operations should be conducted only in short-term Treasury bills or also in bills of longer duration). The Board wanted bills only; the New York Fed preferred longer-dated securities. In the end, the Board won.

In the early Martin years, before 1965, the FOMC was run in a very collegial manner and the Reserve Bank members, especially President Alfred Hayes of New York, had a considerable say. The Fed was most concerned with maintaining low inflation and maintaining a balance-of-payments equilibrium to preserve the Bretton Woods system. Problems began in 1965 with the beginning of the run-up in inflation that would become the Great Inflation. Under pressure from the administration to follow expansionary monetary policy to ease the Treasury's financing of the Vietnam War

6. The Treasury's decision to sterilize gold inflows also had a negative impact on the economy (Meltzer 2003).

and President Lyndon Johnson's Great Society, the Board, whose members became increasingly influenced by the Keynesian thinking of the economics profession and the administration, followed "even-keel policies" which led to monetary expansion and a buildup of inflation (Meltzer 2010).

During these years the Federal Reserve Bank of St. Louis under President Darryl Francis played an important role as a "maverick" Reserve Bank.[7] Francis and his research director, Homer Jones (former teacher of Milton Friedman at Rutgers University), adopted the modern quantity theory views of Friedman and continually criticized the Board for its inflationary policies based on its targeting of "net free reserves" (excess reserves less borrowings) and the targeting of short-term interest rates to control the "tone and feel of the money market." Researchers at St. Louis presented powerful evidence against the free reserves doctrine (Meigs 1976). They made a strong theoretical and empirical case for the Fed to focus on targeting monetary aggregates and total reserves. They argued that if the Fed controlled the money supply, it could reduce inflation. Francis and Jones's advocacy did not sway the Board in the 1960s. Indeed, some members wanted to stifle dissent and have the entire system speak with one voice. But this was not strictly enforced, either by Martin or by his successor, Arthur Burns (who was considerably less forgiving of dissent).

Monetarist ideas began to influence the Fed during the 1960s and 1970s when the research staff at the Board, following St. Louis's lead, began to present monetary aggregates data, and in the Humphrey-Hawkins Full Employment Act of 1978, when Congress required that the Fed present successively lower target ranges of money growth to gradually reduce inflation and to justify significant departures from the targets. The St. Louis approach was

7. Francis's predecessor at St. Louis, D.C. Johns, was also a pioneer advocate for monetary targeting in the 1950s, as was President Malcom Bryan of the Atlanta Fed. See Wheelock (2000) and Hafer (1997).

finally vindicated in 1979 when President Carter appointed Paul Volcker as chairman of the Board with the mandate to break the back of inflation and inflationary expectations. Volcker took a page from the St. Louis script, drastically cutting money growth and allowing interest rates to rise dramatically in a clear departure from the Fed's traditional targeting of short-term rates.

After the Volcker shock, inflation and inflationary expectations dropped by the mid-1980s. Other seminal contributions to the monetary policy debate in the 1970s and '80s that came from the Reserve Banks included rational expectations and the vertical Phillips curve (Mark H. Willes in Minneapolis); the case for a price level and /or an inflation target, which came from Cleveland (W. Lee Hoskins); and the case against Federal Reserve participation in exchange market intervention on the grounds that it conflicted with credibility for low inflation, which came from Richmond (J. Alfred Broaddus) and Cleveland (Jerry Jordan). Thus, the Reserve Banks had a strong voice in the making of policy during the Great Inflation and the Great Moderation.[8]

The Financial Crisis and Beyond

The Crisis of 2007–2008 was managed by the FOMC and the New York Reserve Bank. They quickly developed extensions to the discount window mechanism to overcome the problem of stigma (the term auction facility) and many facilities that provided credit to the sectors of the plumbing that lay beneath the shadow banking system. They also extended the Bretton Woods–era swap network to the central banks of the advanced countries and prevented a global liquidity crisis (Bordo, Humpage, and Schwartz 2015). During this

8. In this period, President Gary Stern (Stern and Feldman 2004) raised a growing concern about the rise of "moral hazard" in the Fed's lender-of-last-resort policy, which since the Penn Central bailout in 1970 and that of Continental Illinois in 1984 had established the "Too Big to Fail doctrine." Also see Bordo (2014).

period several Reserve Bank presidents (Jeffrey Lacker of Richmond, Charles Plosser of Philadelphia, Thomas Hoenig of Kansas City, and Richard Fisher of Dallas) expressed their concerns over the growing use by the Fed of credit policy which is a form of fiscal policy, over the bailouts of insolvent non-bank financial intermediaries and the general extension of section 13(3) of the 1935 Banking Act, which allowed the Board of Governors to extend the discount window to non-banks in the face of "unusual and exigent circumstances." They were concerned that these policies posed a threat to the Federal Reserve's independence.

After the crisis, these issues were brought up in the Financial Crisis Inquiry Report of 2010. Another issue that got considerable play was a conflict of interest between the directors of the New York Reserve Bank and some Wall Street firms after it was disclosed that a director of the Fed simultaneously was a partner at Goldman Sachs. Another critique of the New York Fed's governance was the close connection between Fed leaders and Wall Street. This reflects factors such as a common financial culture and the revolving door between staff and officials at the New York Fed and Wall Street. This makes it difficult to keep an arm's-length distance between the central bank and the financial markets. This has been a perennial critique that goes back to the clandestine Jekyll Island meeting held in 1910 that created the original Aldrich Act.

As a consequence, the Dodd-Frank Act of 2011 made a significant change to the voting procedures of the Board of Directors of the Reserve Banks. No longer would Class A directors (bankers) be allowed to vote for the president of the Reserve Bank.

Other reforms relevant to the Federal Reserve that came out of Dodd-Frank were the prohibition of 13(3) lending to large non-bank financial institutions and a requirement that the Federal Reserve could only use 13(3) to rescue groups of institutions after clearance by the Treasury.

There has been a continuous backlash against the Federal Reserve since the crisis. Congressman Ron Paul called for abolition of the Fed and a return to the gold standard and free banking. Other members of Congress have advocated auditing the Fed's monetary policy deliberations and requiring the president of the New York Bank to be appointed by the US president subject to Senate approval—a move that would strengthen the administration's influence on the Board. Peter Conti-Brown, a lawyer, argued at a recent Brookings Institution conference (March 2015) that the Federal Reserve Act was unconstitutional because the president of the United States had to go through two layers of bureaucracy to remove a Reserve Bank president for cause. To do so would involve, first, requesting the Board of Governors to request the removal to the Reserve Bank's board of directors; and then the Reserve Bank's board of directors would have to agree.

Conti-Brown makes his case based on a Supreme Court decision in 2010. He proposes to make the Reserve Bank presidents subject to summary appointment and dismissal by the Board of Governors and require that the Reserve Banks become branches of the Board of Governors, i.e., he wishes to go back to the original Eccles Plan of 1935.[9] Doing so would, as Carter Glass realized eighty years ago, make the Board a direct agent of the federal government.[10]

Does the case against the Reserve Banks make economic sense? To this author it does not. History suggests that the federal/regional nature of the Fed is one of its great sources of strength. Reserve Banks have long brought fresh viewpoints to the policymaking table. The

9. His second best solution is to make the Reserve Bank presidents subject to presidential appointment.

10. Richard Fisher (2015) proposed reforms to Fed governance more favorable to the Reserve Banks, including: rotating every two years the vice chairmanship of the FOMC away from the New York Fed to all of the Reserve Banks; having the systemically important financial institutions (SIFIs) supervised and regulated by Federal Reserve staff from a district other than the one in which the SIFI is headquartered; and giving the Reserve Bank presidents an equal number of votes as the Washington-based governors, except for the chairman.

Reserve Bank research departments, starting with St. Louis in the 1960s, have been behind many of the positive improvements that have occurred in Fed policymaking. These include the ending of the Great Inflation, the Great Moderation, and the advent of credibility for low inflation and the inflation target. These improvements before 2002 greatly enhanced the independence and effectiveness of the Fed.

In addition, the Reserve Bank presidents continue to bring valuable and diverse information and opinions to FOMC meetings that would not be as readily available if the committee consisted entirely of US presidential appointees (Goodfriend 2000). The Beige Book contains valuable real-time information that might be lost if the Reserve Banks had their powers significantly curtailed.

One wonders if a monolithic central bank with its board appointed by the US president could have made these accomplishments. The experience of other advanced country central banks in the twentieth century suggests not. The Bank of England, the Banque de France, the Bank of Japan, and the Bank of Canada were subservient to their treasuries until after the Fed made its historic changes in the 1980s, which served as an example to them. The only two exceptions were the Swiss National Bank, which has always had a culture of price stability and also a federal structure like the Federal Reserve (Bordo and James 2008) and the Bundesbank, which was founded based on the stability culture of maintaining stable money (Beyer et al. 2013).

Some Lessons from History

The key lesson that comes from this historical survey is that the federal/regional structure of the Federal Reserve should be preserved. The Reserve Bank presidents should not be made US presidential appointments subject to Senate confirmation or subject to summary appointment and dismissal by the Board of Governors.

This would only make the Federal Reserve System more politicized and would greatly weaken its independence.

Federal Reserve power was greatly increased by the Dodd-Frank Act, which put the chairman of the Fed on the Financial Stability Oversight Council. It has the power to designate non-bank financial entities as systemically important financial institutions (SIFIs) and to require stress tests administered by the Federal Reserve.[11] In addition, the Federal Reserve, like other central banks, has elevated the goal of financial stability (to head off asset price booms and other sources of systemic risk that could lead to a financial crisis) to the same level as its traditional functions of preserving macro-stability and serving as lender of last resort. To accomplish this new mandate, the Fed would use new tools of macroprudential regulation. This increase in power, in a sense creating a financial and economic czar, by itself poses a threat to the Fed's credibility and independence and to American democracy.

This is not to say that reforms to the Federal Reserve are not necessary. Above all is the need for improvements in governance and safeguards against conflicts of interest (especially at the New York Reserve Bank). Other areas for reform include: the recognition that the structure of US banking has changed radically since 1913 toward a more concentrated, universal, nationwide branching system; the more rapid turnover of Federal Reserve governors (ever since the Great Inflation reduced their real incomes), which undermines the longer-term perspective toward policymaking which the original framers hoped for; the revolving door between the governors and the financial industry, which makes them more subject to regulatory capture; and the withering of many of the Reserve Banks' original functions (e.g., check-clearing), reflecting ongoing financial innovation. Another reform long overdue is to geographically redistribute the Reserve Banks to reflect the

11. The Dodd-Frank Act also created the Consumer Protection Agency, which is housed at the Board but is not subject to its control.

massive changes in the distribution of the US population since 1913.[12] Many of these reforms would increase the Fed's accountability and provide less radical remedies to the Fed critics than downgrading the regional Reserve Banks. They would also strengthen the voice of Main Street within the Fed, in counterbalance to Wall Street and federal power.

An independent Federal Reserve committed to maintaining low inflation and macro-stability and to serving as lender of last resort is a safeguard against economic instability and a prerequisite to sustained economic growth. Following rules-based monetary policy and lender-of-last-resort policy would greatly enhance that outcome.

12. Belongia and Ireland (2015) posit that the number of Reserve Banks could be reduced from twelve to five (Atlanta, Chicago, Dallas, New York, and San Francisco), all of which are major financial and business centers. Also, they would make the presidents of these five Reserve Banks permanent voting members of the FOMC.

COMMENTS BY MARY KARR

I should say, "And now for something completely different." I feel a little bit in the minority here as I am the only non-economist and lawyer in the room, so I take a slightly different tack. I also, since I am a current employee of the Fed, feel compelled to say that these are my own views and not the views of the Reserve Bank of St. Louis, Jim Bullard, or anyone else. And having said that, I think that Michael's paper really presents quite an informative summary of how legislation in the aftermath of financial crises has changed the structure and role of the Federal Reserve System. When I refer to the Federal Reserve System, I am collectively referring to the Board of Governors and the twelve Reserve Banks. And I am in overall agreement with much of what he has to say—actually, almost all of what he has to say. His focus is on the Fed's core monetary policy mission, and the discussion of the contribution of individual Reserve Banks, particularly since the sixties, strongly supports the role of independent voices within the Fed. I think you got a little bit of that today from John and Charlie when they talked about the Reserve Bank FOMC prep process and the kind of free-for-alls that tend to go on in research departments as they debate policy outcomes.

So I think the question facing us is how best to retain independent voices. Assuming independent voices are a good, which I do, how best to retain those within the Fed. Prior legislation, as particularly as Michael has described it, addresses structural reorganization, and usually the context has been some further centralization of authority in Washington as a means to improving monetary policy and supervisory outcomes. But even among economic historians and economists, as I've listened today, there is still debate as to whether issues related to the Fed's conduct of monetary policy were a result of structural defects or mistakes in theory. And as he further notes, mistakes of theory have persisted throughout the history of the Fed, at least until the Great Inflation and maybe until today. Some would argue that they still persist. My background is in law, not economics, so I can't address those issues, and I'm not even going to try to. But my role in the Reserve Bank—and I've been at the bank since 1991 as general counsel and also as corporate secretary—so my career at the Fed has focused in large degree on issues that relate to Reserve Bank governance and the relationship of the Reserve Banks to the Board of Governors.

So as Bordo notes, the system was, is, and always will be a creature of legislative compromise, unless Ron Paul has his way, and we're abolished. And I would note that Ron Paul has been arguing that from long before the most recent financial crisis.

So that those who are interested in the Fed operate with a base of knowledge, I will contribute a few observations of my own about system governance. In my view, the structure of the Federal Reserve System ultimately reflects sensitivity to the problem of having a central monetary authority in a federal system of government and in a democratic system of government. So Congress to date has maintained a central bank that isn't [central], as my friend and colleague Dave Wheelock has noted. And as Mike pointed out, it has an independent agency in D.C., the government part of the Fed. It has the financial center part of the Fed on Wall Street, and other Reserve Banks located throughout the country to preserve independent voices from Main Street.

Where do we get our political accountability? Well, the independent agency in Washington has significant control over the operations of the Reserve Banks. And through that control, we remain accountable to the Board, the entity whose governors are subject to presidential appointments and Senate confirmation. So some examples of that control are found in the Federal Reserve Act. I think Mike mentioned general oversight and supervision of the Reserve Banks, which goes back to the beginning. Another power that goes back to the beginning is the power to remove any officer or director of the Reserve Bank. We all serve at the pleasure of the Board of Governors.

Additionally, Reserve Banks' powers were based on the powers of national banks under the National Banking Act. So as Mike noted, Dodd-Frank amended a provision to provide that only the Class B and C directors—those who may not be bankers—now appoint the Reserve Bank presidents and first vice presidents. This process illustrates again that the Fed is a creature of delicate balances. Those appointments have to be approved by the Board of Governors of the Federal Reserve System. Once again, the Reserve Bank Board is accountable to an authority that has political accountability directly as a federal agency.

And then in further overlapping control, the [members of the] board of directors of each Reserve Bank are directed to supervise and, at least in the St. Louis Fed bank, do direct and supervise the bank. There's this myth that bankers control the Fed, and the Fed was created by—and to benefit—bankers. But from the beginning, there has been a complex scheme for the selection of Reserve Bank directors that is not well understood. Directors are classified into groups and serve staggered terms of three years. By Board policy, they're limited to two terms. So after six years—maximum seven if they fill in a vacancy—they're termed out of office. The elected directors, the three A's and three B's who are elected by the member banks, are each selected by subgroups of the member banks. Each Reserve District groups its member banks into small, medium, and large. And each of those groups selects one banker and one non-banker to the Reserve Bank board. So the charge that the Fed exists or is dominated by the large banks is based on a fundamental misunderstanding of Reserve Bank governance. Of the nine directors on each Reserve Bank board, only three may be bankers. And of those three, only one may come from among the largest banks in the district. So when the Federal Reserve System was created, I think the bankers shared my view and actually lobbied the drafters for the creation of an entity called the Federal Advisory Council. Each Reserve District appoints one banker, who cannot be a director, to serve for three one-year terms on an advisory council that meets with the Board of Governors four times a year to advise on questions related to the economy and banking regulation.

Mike concludes by suggesting that Reserve Banks' locations might deserve review since they were based on the economy and the population in the United States as it was in the beginning of the last century and, obviously, that's changed quite a bit. Some might consider that beneficial. This may not be necessary, because in addition to the twelve banks, the Reserve Banks have addressed geographic and economic changes in multiple ways going back to the beginning of the Fed, principally through a network of twenty-four branch offices scattered around the country, each with its own advisory board of seven directors—seven or five, I guess, in the case of Minneapolis—who provide input into the economy.

He also notes that perhaps improvements in governance and safeguards against conflicts of interest might be desirable. My only reaction to that, as someone who has thought about this for a long time, is that I'm not sure whether the perceived failures of governance and the perceived conflicts were structural and thus subject to legislative correction. I would submit that they weren't, but that's my personal opinion. And with that, I've concluded.

GENERAL DISCUSSION

PAUL TUCKER: This has been fascinating listening to this, and I have a question to both of you. Listening to Mary's account of how the regional Federal Reserve Bank heads are constituted, I find it hard to recollect a speech by any Fed chairs about these subjects. That strikes me as odd. Why not talk about the design of the regime, about governance, as well as about the economic conjuncture, etc.?

MARY KARR: I think it's complex. And I think it's not a subject that very many people care about. A few years ago—and I'm trying to remember when it was—the GAO [Government Accountability Office] was directed to do a study of Fed governance, and they came around and they interviewed people in every Reserve Bank, presidents, board secretaries, about governance. And they had exactly the same reaction that you did, Paul, which is, "Gee, we didn't understand all this stuff. Why don't you be more effective at telling your story?" I don't have a good answer for that. It is complex. And I think one of the answers is probably that not very many people care. Michael?

MICHAEL BORDO: Yes, but since the crisis, suddenly they did care.

KARR: Yes, they care for a little while.

TUCKER: So I think my point is, any organization that is so powerful knows that things are eventually going to go wrong. And they know that questions about governance are going to come up. And you try to do the best you can so things don't go wrong. But you have to try all the time to make sure that your organization is understood, so that you get criticized for the right things rather than based on misunderstandings.

KARR: Well, I think so, too. When I came to the Fed in 1991, the big book about the Fed was *Secrets of the Temple*.[13] The mood internally was: keep your head down and don't say much. And that was before we released results of any kind of monetary policy action. The FOMC met, and the market guessed what it did. I've seen a lot of change since 1991, and we've been moving in all kinds of ways toward greater transparency. I'm not always sure—as someone pointed out later—that transparency equals clarity. This is an area where we haven't done as much.

WILLIAMS: I just Googled "GAO report, Federal Reserve." Here is the headline by ABC News on the GAO report: *Federal Reserve Report Rife with Conflict of Interest.*

KARR: Which one was this?

WILLIAMS: That's the 2011 GAO report. So what actually happens when people talk about this in the media, is they take everything they can find, and we read through this, and basically try to find what the story is.

TUCKER: The UK's not so different. [Laughter.]

WILLIAMS: So it is one of these issues. We go out, and we explain the purposes and functions. We do all this stuff, and here is the GAO, which is coming out and saying this is a very good system. But it's actually reported as "rife with conflicts of interest," because there are bankers on the board and stuff like that. If you Google it, all of our speeches and the things that we talk about are not going to show up. But the GAO report does.

GEORGE SHULTZ: I listened, Mary, to your reassuring comment about how people get appointed to the regional banks. It was very reassuring. So it eases my worry about independence of the regulator and the regulated. But I did have an experience that sticks with me. When the New York Fed was open, I had a candidate. Alan Greenspan and I had the same candidate. We

13. William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country* (New York: Simon & Schuster, 1989).

talked about it. And we both knew the Secretary of the Treasury. We never even got in the conversation. We were totally out of it. The New York financial people appointed the guy. There was no question about it. They got their man.

KARR: I can't speak for the presidential selection process at the New York Fed. I can only speak for the process that I've seen in my own Reserve Bank. I've seen two, and in each case our board was very active in seeking the best possible candidates, communicating directly with the Board of Governors about the search process as it went forward. Clearly, the Board of Governors and the Reserve Banks have to agree. There are some interesting stories—maybe you know them, Michael, as the historian—about lengthy stalemates in some Reserve Districts over appointments where the board of directors and the Board of Governors could not come to an agreement. It's an interesting thing.

CHARLES PLOSSER: So George knows, you can't get appointed as president of a Federal Reserve Bank without the Board of Governors approving it. They have ultimate veto power. So even if the bankers on the New York board of directors wanted someone in particular, the Board of Governors had to be complicit in some sense.

KARR: Absolutely. They have a veto.

PLOSSER: So the standoff is the rare case.

KARR: Yes, where you have a board of directors who has the fortitude to withstand pressure from the Board of Governors for a while.

SHULTZ: Alan Greenspan and I, we couldn't even get in the conversation.

KARR: Was he chairman then?

JOHN TAYLOR: This is when he was chair.

KEVIN WARSH: So this is just my experience of the last period. It is true statutorily that the appointments are subject to the approval of the Board of Governors, so candidates like John would come through as they are. But my experience suggests that it would be very difficult, and it would be reasonably unprecedented in modern times, for the Reserve Bank's preferred choice not to ultimately be accepted by the Board of Governors.

KARR: But I think there's a long dance that goes on to get to that point with some governors and staff and Reserve Banks.

UNKNOWN SPEAKER: I was going to say, it seems like if you look after this crisis and after the New York crisis, and you see these criticisms of the Reserve Banks, it's just one Reserve Bank. It's New York. And in 1933 it was New York, even though there was all this tension going on in New York. But the focus of the populace was against New York. And the focus of the populace today is against New York. So there is something about New York, and it's because Wall Street's there, etc. So the question is: What is the evidence that New York is the bad hat? I don't know.

TAYLOR: A lot of people think there's evidence.

PLOSSER: It is true that New York is different. And there are lots of ways one could characterize that. Paul's question was: Why isn't there more effort to educate the public about the Federal Reserve System?

The very last speech I gave as a president was titled, "An Appreciation of the Fed's Twelve Banks." It was about a lot of those subjects. And actually I gave more than one such talk, but it happened to be the last one. So I think your question is an interesting one, which is: Why haven't you seen Ben [Bernanke] or Janet [Yellen] or [Paul] Volcker or whoever, people at the Board of Governors, more proactive in describing the strengths of the system? I think it goes back to what Michael described as the long history of tension between the Board of Governors and the Reserve Banks. There are many people at the Board of Governors who view the Reserve Banks as a nuisance, who would just as soon see us go away. And that tension is not a recent phenomenon—it has been there for a long time. I think there's part of the institutional ethos or culture at the Board and in Washington, that they're not anxious to defend the system as it stands and particularly the Reserve Banks. So it's kind of up to the Reserve Banks to defend themselves in many cases. In fairness, Ben, on occasion, did that. But it's rare. When the governors are pushed, they tend to do that. So I think the Reserve System ends up making that problem for itself, which I think has a long history and is unfortunate.

JOHN COCHRANE: This seems like a question ripe for international comparison. Let's ask Paul: Are you convinced? Do Scotland, Wales, and Northern Ireland each get their own bank and maybe the Channel Islands too? I got a chuckle out of Paul, I think. The Bundesbank did a pretty good job as a single bank. So, do other central banks, that do not have this complex organization and regional structure, do better or worse than the Fed? Europe seems to be heading in our direction, actually. They have a European Central Bank and many national central banks. But I don't get the sense that the central banks of Greece and Italy are founts of great ideas in macroeconomics in the same way that St. Louis and Minnesota have been.

The defense so far has been that the Fed was set up as it is to disburse political power regionally, and to keep the fragmented banking system alive. Here the comparison with Canada is apt, as it's often said Canada has a single banking system, and that it has therefore had far fewer crises than the United States. Canada also does not have this system of regional central banks. The US system then evolved into geographically separate macroeconomic research departments that came up with independent ideas. This evolution was not at all part of the original idea. But I'm also skeptical that lots of federally supported macroeconomic research, by full-time federal government employees, is the best way to produce distinct and innovative ideas.

To sum up, international comparisons would be useful. As far as I know, no other country does it our way, and it's not obvious that our outcomes are so much better than those of every other country.

ANDREW LEVIN: Well, just two comments. The first is, having been outside the Fed now for the last several years and talking to people in the outside world, I can say that the Fed oftentimes comes across as very defensive. The answer always seems to be: "Well, if it ain't broke, don't fix it. It's been working that way for a hundred years." And of course, Mike Bordo is a good friend of the Federal Reserve System, so if his paper concludes that it would be a good idea to revisit these questions for the first time in a hundred years, that conclusion should be taken very seriously. And I really wish that the Federal Reserve would voluntarily look into these issues and conduct its own studies, publish those studies, and give serious consideration to how things could be improved.

And this also connects to what Kevin said about the size of the FOMC. I think that having nineteen participants around a table makes it pretty difficult to have a truly deliberative process. Now if the Federal Reserve Bank presidents all got together and voluntarily said, "We could shrink from twelve down to seven," one significant benefit would be to improve the deliberative quality of the FOMC's decision-making process. That would be exactly the kind of constructive approach that I wish we would see sometimes.

My second comment is that a federal judge made a ruling in a Freedom of Information Act case on March 31. It was an important ruling that bears directly on these constitutional issues. Specifically, the FOIA has an exemption to safeguard the relationship between banks and their supervising agencies. And the Federal Reserve Board actually pleaded that exemption, and the federal judge granted it. Here are the exact words of the judge:

"As the Board points out, the fact that it can require examination of the Federal Reserve banks is no different than any other financial institution subject to mandatory supervision by a federal regulator. . . . If a financial institution cannot expect confidentiality, it may be less cooperative and forthright in its disclosures. There's no reason to believe the Federal Reserve Banks would not react the same way."

Now maybe the plaintiff will appeal that decision, and the appeals court will overrule the judge's verdict. But the fact that FOIA only applies to federal agencies and not to the regional Federal Reserve Banks is a real problem. Every federal agency has an inspector general, but the Federal Reserve Banks do not, and that's also a serious problem. And so again, the Fed should voluntarily be looking at ways to move forward with constructive reforms and not just keep repeating, "This is the way we've always done it."

PETER FISHER: I had seventeen years at the Fed and five of them in the legal department. The supervisory work the Reserve Banks do on other banks is done under authority of the Board.

KARR: I think he's talking about a request to review the Board of Governor's examinations of Reserve Banks.

FISHER: That's the Board keeping stuff confidential, not the Reserve Banks keeping stuff confidential.

KARR: But that's the Board relying, probably at the request of the Reserve Banks—

LEVIN: Unfortunately, I'm not an attorney. But if you read the judge's verdict, he certainly seems to be saying that a Federal Reserve Bank may be less cooperative and forthright in its disclosures to its supervisor, meaning the Board of Governors, and it's kind of shocking to see such an opinion coming from a federal judge.

FISHER: But that's an argument a Board of Governors lawyer made to the judge.

KARR: Yes.

TAYLOR: So I just have a question. The broader, difficult issue is about regulatory capture, and there are many ways that can occur. There's the revolving door, for example, but the appointment process is one that people worry about. It seems to me that the checks you're describing are formally there, but there are many other influences that can affect appointments, and they do.

KARR: There are.

TAYLOR: We know it, and George has given an example.

KARR: There are, but I think New York is a different case. And I can't speak about the New York Fed and potential regulatory capture. We've certainly seen accusations of that from former examiners in the press over the last couple of years. For most of the Reserve Banks, I would say—and John and Charlie, chime in—but the supervision of financial institutions is a delegated function from the Board. One of the things that the Board has done in the aftermath of the financial crisis is reasserted itself in the supervision of the largest financial institutions and decreased the amount of delegation and the amount of freedom of action of entities like the New York Fed. And I think part of that is to deal with this perceived issue of regulatory capture. For the rest of us, I would argue, who aren't in New York and supervising the money center banks, it's a much different issue. I suspect that was true in Philadelphia and maybe San Francisco. Our Reserve Bank presidents are not involved in supervision. The Board of Governors, by policy, now wants to be involved in the hiring and firing of a senior supervisory officer, as I recall. Isn't that correct, John?

WILLIAMS: Yes.

KARR: So there have been some changes to try to address some of these issues by the Fed itself.

BORDO: I want to pick up on something that John Cochrane said which I think is really prescient. When the Federal Reserve was founded we had a unit banking system, totally fragmented. We had it until the 1990s. Now we have moved in the direction that other advanced countries have long been with nationwide branch banking. In the United States, it is not quite nationwide branch banking, but it is getting there. An implication of this is that one of the original purposes of the Federal Reserve Act was for the regional Federal Reserve Banks to oversee and conduct monetary policy with their local member banks and serve as semi-autonomous central banks. This was because of the fact that capital markets were not integrated and so there was a case for separate regional monetary policies. By contrast, today we have a fully integrated nationwide capital market and we have nationwide banks mainly headquartered in New York. Now who is in charge? The New York Fed? So in a sense we are back to the earlier 1920s struggle between the New York Fed and the Board. The other Reserve Banks are kind of peripheral to this game. And that is where some of today's governance problems come from.

SHULTZ: Let me tell all you New Yorkers something. We're different! We're not like Washington, we're not like New York. San Francisco's different! [Laughter.]

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