Some Historical Reflections on the Governance of the Federal Reserve

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1. **Introduction**

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. Many criticize it for how it was handled and for how the recovery has been managed. 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 and to 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]

A similar cacophony of criticism and call for reform of the Fed occurred after the Great Contraction of 1929 to 1933, which President Franklin Roosevelt blamed on

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

the banks and the Federal Reserve. It 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.

2.**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 U.S. financial system after the Panic of 1907. The panic was the straw that 'broke the camels back 'following a series of banking panics that plagued the post civil war National banking system. The U.S. 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 include the prohibition on inter state 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

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

the plan of the private clearing houses in many US cities. Clearing houses issued emergency currency 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, DC . 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).

The Aldrich plan was defeated in the Congress and 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, 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.

The Federal Reserve bank boards of directors consist of nine directors three of whom (including the chairman and vice chairman) , are appointed by the Federal Reserve Board (class B) and six (three bankers (Class A) and three others(non bankers, Class C) are elected by the Reserve Bank's member banks. 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.

3. **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 U.S. entered the war the Fed began discounting commercial bills backed by government securities, a type of collateral not permitted in the original act which led to a revision . 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(the member banks approved by the Board) raised discount rates which 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 towards the use of open market operations Conflict between 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 Governor's Conference and in its place set 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 " The High Tide of the Federal Reserve". Nevertheless many of its actions were resented by the 7 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.,

A number of famous examples of conflict gives 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 in 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 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 if such a policy would work and pushed for raising discount rates. The Board blocked New York 10 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. It was 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 towards the statutory limits. Some governors and the Board also worried that the purchases would lead to speculation , an asset price boom and inflation. Once the 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 the newly elected President Roosevelt would take the U.S. off the gold standard (Wigmore 1987). The attack led to a depletion of the New York Reserve bank's gold reserves towards the statutory limit, after which it would have to cease following lender of last 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 Franklin Delano 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 that 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.

Eichengreeen (1992) , using the tools of game theory demonstrated that had the Reserve banks and Board coordinated policy during the above examples of discord that 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 the theory of monetary policy followed. They argued that the Federal Reserve as a whole followed the real bills doctrine and a variant of it called the Burgess Rieffler 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, that the Federal Reserve viewed their 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 policy making in the mid 1930s in the absence of the reorganization?

4. **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 amongst other things greatly increased the collateral that Reserve banks had to hold against their note and deposits which allowed them more flexibility in their discounting policy. The 1933 Glass Steagall act split commercial from investment banking and created the FDIC. It also changed the name of the OMPC to the Federal Open Market Committee. The 12 Reserve banks remained members of the FOMC and 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 Mariner Eccles, Roosevelt's choice to be Chairman of the Board, and Laughlin Currie, his aide at Treasury. Eccles was a Keynesian before Keynes's, General Theory (Meltzer 2003). He wanted the federal government to control both the levers of 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 Carter Glass , one of the framers of the original act and so in the act that was passed the Reserve banks maintained an important but subsidiary role .

The 1935 act replaced the Federal Reserve Board by the Board of Governors of the Federal Reserve System. The president appointed 7 governors, subject to senate approval. The secretary of the Treasury and the Comptroller of the Currency were removed from the Board. All 12 Reserve bank Presidents (demoted from the title governor) remained on the Board but only 5 could vote (one of which was the New York Reserve bank). The other four voting presidents served on a rotating basis. The voting procedure to nominate Reserve Bank Presidents was not changed, Other important changes were to the supervision and regulation of member banks which became 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.

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 a severe recession in 1936-37. 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.

5.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 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, longer dated securities), which 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 Hayes of New York, had a considerable say. The early Martin Fed was most concerned with maintaining low inflation and maintaining 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 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 build up 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'.[3] 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

[3] Francis 's predecessor at St. Louis, D.C. Johns was also a pioneer advocate for monetary targeting in the 1950s as was President Malcom Bryant of the Atlanta Fed. See Wheelock 2000, and Hafer, !997

controlled the money supply they 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 Act of 1977 , when the 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 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 and drastically cut money growth and allowed 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 (Willes in Minneapolis); the case for a price level and /or an inflation target which came from Cleveland (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 (

Broaddus) and Cleveland (Jordan). Thus the Reserve banks had a strong voice in the making of policy during the Great Inflation and the Great Moderation.[4]

6. 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 TAF) 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 period several Reserve bank Presidents (Lacker of Richmond, Plosser of Philadelphia , Hoening of Kansas City and 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

[4] In this period President Gary Stern (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 1974 and that of Continental Illinois in 1984 had established " Too Big to Fail doctrine" . Also see Bordo (2014)

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 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 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 Congressman have advocated auditing the Fed's monetary policy deliberations, requiring the President of the New York bank to be appointed by the 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 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 Board of Directors would have to agree.

He makes his case based on a Supreme Court decision in the Enron case in the 1990s. He proposes that all of the Reserve bank presidents become presidential appointees and 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 . Doing so would ,as Carter Glass realized 80 years ago, make the Board a direct agent of the Federal Government.

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 policy making table. The Reserve Bank research departments , starting with St. Louis in the 1960s have been behind many of the positive improvements that have occurred in Fed policy making. 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 of the Fed.

One wonders if a monolithic central bank with its board appointed by the President could have made these accomplishment. 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).

7.Some Lessons from History

The key lesson that comes from this historical survey is that the federal/regional structure of the Federal Reserve should not be tampered with. The Reserve Bank Presidents should not be made Presidential appointments subject to Senate confirmation. This would only make the Board of Governors more politicized and would greatly weaken its independence.

Federal Reserve power was greatly increased by the Dodd Frank bill which made the Chairman of the Fed the head of FSOC, the Financial Stability Oversight Council. Also the new Consumer Protection agency is housed in the Board. This increase in power, in a sense creating an economic czar, by itself poses a threat to Fed independence and to American democracy

This is not to say that reforms to the Federal Reserve are not necessary ,including improvements in governance and safeguards against conflicts of interest. Another reform long due is to geographically redistribute the Reserve banks to reflect the massive changes in the distribution of US population since 1913.
An independent Federal Reserve committed to maintain low inflation, macro stability and to serve 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.

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