The Making of the Modern Federal Reserve

The Unsung Role of the Twelve Reserve Banks

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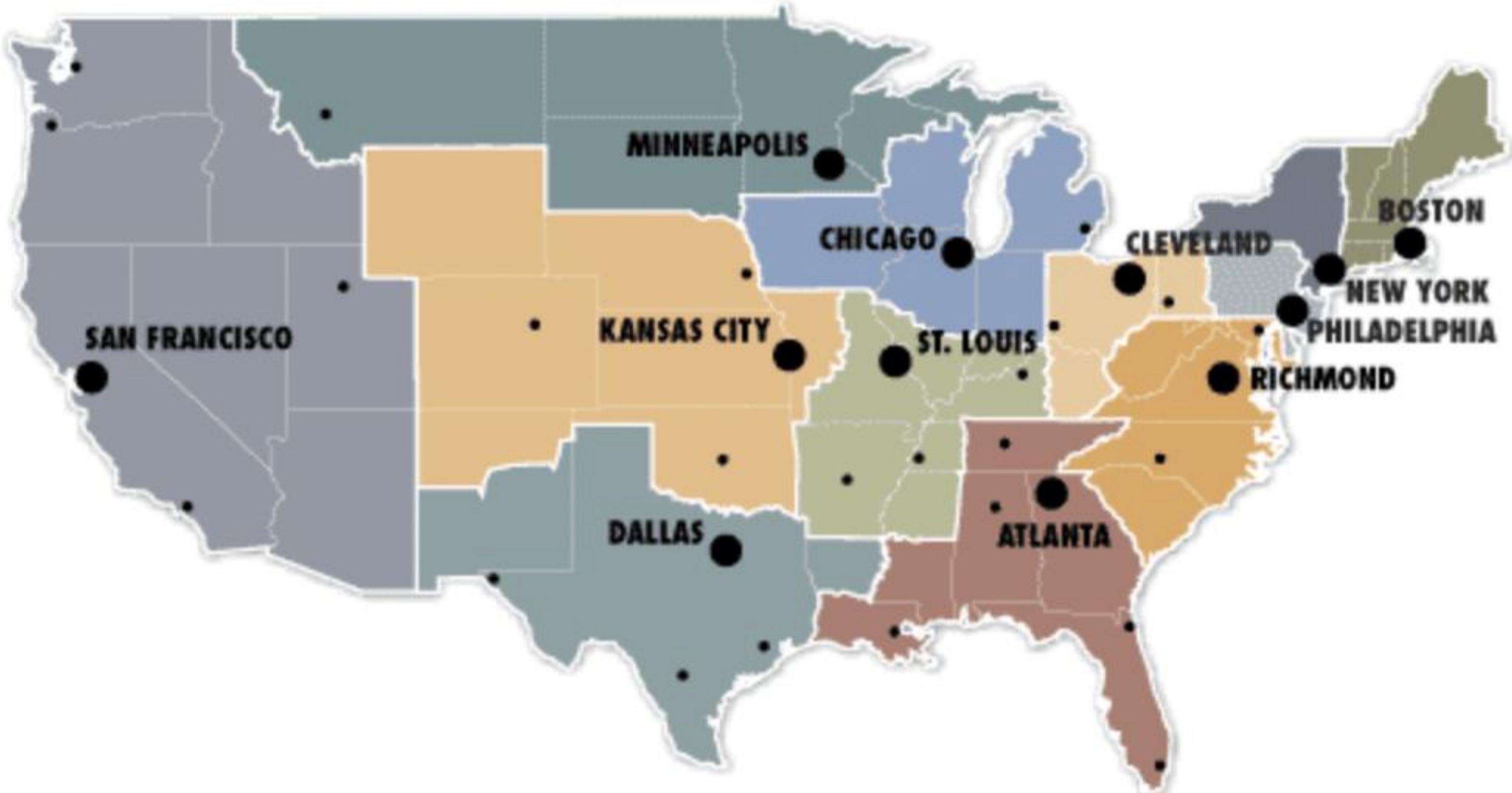
The Decentralized Federal Reserve System



Map of the 12 Federal Reserve Districts, Federal Reserve Bank of St. Louis, https://www.stlouisfed.org/about-us/federal-reserve-map

A look back: Banking Act of 1935

Context: Parallels to current moment

- FDR took a very expansive approach to executive power, willing to push against and even cross constitutional bounds
- Supreme Court: Served as an important check on his ambitions
- 1935: *Humphrey's Executor* (and only two cases in which SCOTUS struck down laws on grounds that they violated the nondelegation doctrine)
- FDR presidency and responses to his presidency transformed the federal government

Process:

- Reform effort initiated by FDR prompted by Marriner Eccles
  - "The Eccles bill strikes chiefly at the autonomy of the Reserve Banks under the existing law" *The Washington Post*, June 9, 1935
- House – passed bill quickly, albeit with a heated minority that claimed the reforms to the Fed were more suited for a dictatorship than democracy
- Senate – months of hearings, largely orchestrated by Carter Glass, Chair of the Senate Banking Committee, in an effort to derail or fundamentally revamp the bill

1935: Marriner Eccles v. Carter Glass

On removal

- Eccles: “It seems to me to be *immaterial* whether a Governor has or has not a technical right to stay on the Board, if the President prefers to have someone else as Governor, because no person who is qualified for that position would choose to remain in these circumstances.”
- Glass: “Well, I will say quite frankly that I do not think that question [of at-will removal] is one of vital importance; far from it… I think it is more important for him to appoint good members than to have the power of removal.”
- Witnesses recognized the importance of the issue, relevance of *Humphrey’s Executor* and were better informed with respect to existing law

Real fight: Authority and autonomy of the Reserve Banks

- Eccles: Reserve Banks should have only a consultive role on the FOMC and Board should review and approve Reserve Bank leadership every year
- Glass: Defended the status quo and the autonomy and authority of the Reserve Banks, to the maximum extent possible
  - Used hearings to build narrative about the dangers of giving executive too much control over monetary policy and how Reserve Banks could serve as a check

Structure of the Federal Reserve System

Board of Governors

- Seven governors appointed for staggered 14-year terms
- All governors are nominated by president and confirmed by the senate
- Can only be removed “for cause”
- Chair ,Vice Chair (and, since 2010, Vice Chair for Supervision) are nominated from among the governors to serve four-year terms

Reserve Banks

- Presidents chosen by Reserve Bank Board, which consists of three bankers, three industrialists, three community leaders chosen by Board (but bankers excluded from process 2010)
- Board approves the selection of presidents every five years and otherwise has meaningful oversight authority over the Reserve Banks

Federal Open Market Committee

- Up to twelve voting members
  - All sitting governors, so DC-based board has majority IF all of the seats are filled
  - New York Fed president plus four other Reserve Bank presidents vote at every meeting

Design does not secure independence

1936 – 1951: Fed operated with only independence from Treasury

- More pronounced during WWII but true even beforehand
  - "That the Federal Reserve has been in no meaningful sense 'independent' of the Treasury and the administration over at least the past decade should be obvious to any observer."
  - "Modern large-scale government financial operations in war and peace and recognition of government fiscal policy as a powerful contra-cyclical stabilization instrument *have swept away the old concept of central bank independence*… In action and in official statements, the Federal Reserve has fully acknowledged this fact."
  - G.L. Bach, A Further Note on Bank Supervision and Monetary Policy, 5(4) The Journal of Finance 421 (1950)

Administrative State Evolved Apart from Fed

Developments in administrative law helped secure legitimacy of independent agencies generally generally

- 1941: Attorney General's Committee on Administrative Procedure, aka the Acheson Committee
- 1946: Administrative Procedure Act
- World War II
- 1947 – 49: Hoover Commission

"The battle over fundamentals had ceased. The federal administrative process was secure."

- Kenneth Culp Davis, 1951

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1951 Accord: Years in the making

Congress: Sen. Paul Douglas, Chair, Subcommittee on Monetary, Credit and Fiscal Policies

- Questionnaires and Hearings (1949-50)
    - Raymond Gidney, President, :Cleveland Fed: “disturbed by the extent to which people in key managerial positions in banks, insurance companies, trust companies, and elsewhere in the financial and business world, to say nothing of the lay public, appear to have accepted the doctrine that an invariable maintenance of Government bond prices at or above par is essential to the financial soundness of the country.”
    - John Peyton, President, Minneapolis Fed: “much can and has been done through informal consultation, the almost inevitable result has been that Treasury preferences have been accorded excessive weight”
- The Douglas Report (1950)
    - “The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war …
    - [W]e believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be… significant”

1951 Accord: Years in the making

Inside FOMC: Allan Sproul, President, NY Fed

- "The question today is what *we are going to do in our sphere of primary responsibility*, not what we are going to recommend to the Treasury…"
- Sproul argued that the Fed should abandon its commitment to the peg and it "should advise the Treasury that this is what we intend to do—not seek instructions."

Meeting of the FOMC, Aug. 18. 1950

Making the case to the public, Chester Davis, President, St. Louis Fed

- "Every one of the steps to enforce a restrictive money policy is painful and hard to take…. The agency that tries to meet this responsibility can never be popular."
- Acknowledges that more restrictive monetary policy would make credit more expensive—for both the government and private parties.
- But this "increased cost, which could be counted in millions, should be weighed against the total cost to the government and the public involved in further inflation, which would be counted in billions."

The Function of Monetary Controls: Address before the 317th Meeting of the National Industrial Conference Board, Chicago, Illinois, November 16, 1950

From the 1951 Accord to Independence

- Democratization of the FOMC
  - Banking Act of 1935 as first implemented:
    - Allan Sproul credited populist Congressman Wright Patman with saying, "Congress gave this great power of directing open market operations of the Federal Reserve Banks to twelve men, the twelve men gave it to five, the five gave it to one, and it ended up in the hands of Wall Street."
  - 1951: Fed gets new Chair, William McChesney Martin
    - Martin would tell you, in all sincerity, that "We have a 'Federal Reserve System' and I'm trying to make it into a system."… He wanted to make the presidents count…. [He] wanted his presidents to be actively engaged in thinking about monetary policy. " – Dewey Daane, Fed staffer and then governor
    - 1955: Changed governance rules to eliminate the executive committee and to further provide that all presidents could participate in every meeting of the FOMC

Looking Ahead

- We are in a period of disruption. It will likely take years to establish a new equilibrium.
- Even if the Supreme Court creates a "Fed exception" when it does away with other independent agencies, it is far from clear that Fed independence will be sustainable as a legal or normative matter
- The Twelve Federal Reserve Banks were pivotal in Fed's path to striking balance between independence and accountability. Could be key going forward:
  - Efficacy - Goodfriend, Bordo & Prescott
  - Legitimacy – regionalism
  - Constitutionality – most akin to First and Second Banks of the United States; may facilitate congressional oversight