**Federal Reserve Bank Governance**
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The governance structure of the Federal Reserve Banks has been the subject of public discussion lately.[1] I'd like to provide some background on why the Fed is structured the way it is and the important purposes that structure serves – particularly to the monetary policymaking process that is core to the Fed's existence.[2]

## How Our Structure Came to Be

To understand the Fed's structure, it is essential to understand the Fed's purpose.

The Fed's founders sought to address what they called "the currency problem." This referred to the inability of the economy's supply of notes and bank reserves – what today would be called the money supply – to expand and contract with the needs of commerce. A number of features of the pre-Fed monetary system contributed to the problem: Currency was issued by national banks and was required to be backed by U.S. Treasury securities, making note issuance costly and slow. And widespread branching restrictions resulted in thousands of small, undiversified banks throughout the country, which meant that a substantial portion of banks' reserves were held as interbank deposits. Overall, the financial system was vulnerable to shocks and unable to quickly move reserves to where they were needed, resulting in interest rate spikes that hampered economic activity on a frequent basis.[3] Clearinghouses – bank-owned cooperatives that settled payments in larger cities – played an important role in how periodic crises were resolved. They could not legally issue currency, but they issued certificates that were circulated by their members as an (imperfect) substitute currency when the demand for currency surged.[4]

The Fed was created to "furnish an elastic currency," so that the supply of monetary assets would vary with the needs of economy. Reserve Banks, in turn, were modeled after clearinghouses. The operation of clearinghouses, however, was limited to the cities. The idea of the founders was to mimic and improve upon this model to serve broader public interests. They sought to create a system of institutions with *universal eligibility* for membership, so all banks would have access to clearinghouse services. The new institutions would have the ability to issue currency and would accept bank deposits to prevent reserves from "pyramiding" in large cities.[5]

A key debate at the founding of the Federal Reserve was how such a system should be governed.[6] A primary concern of the founders was the extent to which the economic characteristics of large money centers and the rest of the country diverged. The initial legislative proposal was the Aldrich Plan, which provided for an elastic currency issued by a single National Reserve Association. That plan was rejected out of concern about excessive Wall Street influence at the expense of diverse regional interests. Proposals for a government-controlled central bank were viewed as risky for fear that the federal government would use control of the money supply to resort to inflationary deficit financing. At the same time, a measure of public sector oversight was viewed as essential, consistent with Progressive Era thinking. So the Act included a federal authority – the Federal Reserve Board, today called the Board of Governors – to oversee regional Reserve Banks' operations and policies, and whose leaders were politically appointed.[7]

Thus, the final Federal Reserve Act reflected a balance of competing considerations: a federated set of institutions to provide for representation of a diverse range of geographic and commercial interests, with a hybrid public-private governance structure to provide for public oversight but contain potential misuse of monetary authority.

The governance of the individual Reserve Banks was also designed to be a blend of public and private elements. Like clearinghouses before them, Reserve Banks are capitalized by their members through the purchase of stock rather than capitalized by the government.[8] Reserve Bank stock is unlike traditional corporate stock, however, in that it comes with no voting rights and is not transferrable. Each Reserve Bank is governed by a nine-member board of directors that is partly public, with three members appointed by the Board of Governors, and partly private, with six members elected by member banks. By statute, six of the nine directors represent the public, not banks. The Reserve Banks' CEOs – originally called governors and today called presidents – are appointed by the boards but require the approval of the Board of Governors.

**Why is This Structure Still Relevant Today?**

The structure and governance of the Federal Reserve is still effective today because the considerations the founders wrestled with are all still relevant. While the nature of our economy and financial markets have changed in many ways since the founding of the Federal Reserve, the federated structure still ensures that a diversity of perspectives on monetary policy and economic conditions are brought to the table. Each Reserve Bank president, supported by an independent staff of economists, conducts his or her own analysis. In addition, the presence of geographically dispersed, independently chartered institutions has promoted broad regional engagement across the country, deepening the Fed's understanding of the diverse economic challenges facing American communities.[9]

There is evidence that Reserve Bank presidents are more willing than governors to challenge conventional views and that this has benefited policymaking. First, presidents have been more likely than governors to dissent on Federal Open Market Committee (FOMC) decisions, especially since the Great Moderation.[10]

Second, there are historical episodes in which the scope for diverse views served monetary policy well. In the 1960s and 1970s, Reserve Banks led the charge within the Fed on the idea that monetary policy was primarily responsible for inflation. The St. Louis Fed was an early proponent of monetarist views, which for a time earned it a reputation as a "maverick" bank but later became widely adopted. The Minneapolis Fed showed similar early leadership by questioning the idea that there was a stable trade-off between inflation and unemployment. These were more than academic debates; within the Fed, they directly supported the eventual development and acceptance of policies under Paul Volcker and Alan Greenspan that brought high and unpredictable inflation to an end. And in several key instances, Reserve Banks have continued to show intellectual leadership on topics that initially went against the grain of mainstream thinking but later became broadly accepted.[11]

To be sure, our country's understanding of diversity has expanded since 1913.[12] And it is in keeping with the spirit of our founding that the Federal Reserve has taken the importance of diversity seriously as we have sought to ensure broad representation of views in the formulation of monetary policy, including those associated with disadvantaged communities. I believe our record in this regard, like that of many other organizations, shows a combination of substantial progress and areas where more can be done.

**Governance and Monetary Policy Independence**

In addition to bringing diverse viewpoints to bear, the Fed's public-private structure helps our policymaking focus on its longer-term objectives. Monetary policy can stimulate economic activity in the short run, but these effects are generally temporary; over time, monetary policy mainly affects inflation. At times there is a temptation to provide excessive economic stimulus in the short run and leave the inflationary costs, which often are evident only later, for future policymakers to deal with. For central banks, this implies that meeting-to-meeting monetary policy decisions need to be insulated from short-term political pressures driven by electoral considerations.

This is not just a theoretical argument: Across the history of central banks around the world, when monetary policy has been subject to high-frequency political winds, the results have not been good.[13] And our own history shows that the temptation of short-sighted monetary policies is a bipartisan vulnerability, just as the Fed's founders feared. In the 1960s and 1970s, for example, the Fed came under pressure from the Johnson and Nixon administrations to pursue accommodative policies, setting off a cycle of so-called "go-stop" policy, in which rising inflation would ultimately force the Fed to raise rates abruptly, causing a recession.[14]

The lesson from these episodes is clear: Monetary policy independence is essential to achieving good economic outcomes. Undue political influence can and did happen even under our current structure, and as a country we should be wary of changes to Fed governance that could make such breaches easier. Nations around the world came to similar conclusions in the 1980s and 1990s – after long, hard struggles to tame inflation – that central banks delivered better results when insulated from short-run political pressures. Most accordingly structured their monetary policy decision-making processes to include independence.

Independence has its limits, however. Independence with regard to short-term choices of monetary policy instrument settings – that is, policy interest rates – must be paired with strong accountability for the economic results of policymaking over time. The economics literature has contrasted "instrument independence," which we have, with "goal independence," which we do not[15]: Congress sets the Fed's monetary policy objectives, and the FOMC chooses a succession of instrument settings in pursuit of them.

Accountability rests on the Fed's transparent communications, which help Congress and the public evaluate the Fed's performance against its mandate. The chair delivers a Monetary Policy Report to Congress twice per year and testifies semiannually, and all Fed leaders give occasional testimonies, speeches and interviews. The FOMC also provides considerable real-time information on its policy decisions: interest rate settings and voting records are immediately available the day of the meeting; the chair holds a press conference after every other FOMC meeting; the Fed's balance sheet is published weekly; the forecasts of FOMC members are published four times per year; and meeting minutes are released three weeks after each meeting (with full transcripts released after five years).

The Fed's public-private structure plays an important role in supporting monetary policy independence. The Fed has independent control of its balance sheet in terms of deciding which assets to buy and accept as collateral (within certain constraints provided by the Federal Reserve Act) and when to buy them. We also are self-funded and excluded from the federal appropriations process. In this regard, Reserve Bank capital, contributed by member banks, serves as an additional pillar of policy (instrument) independence by conveying a sense of self-sufficiency to market participants. And while the Fed's operations are audited extensively, monetary policy has a limited exclusion from federal audit by the Government Accountability Office. All of these measures serve to limit high-frequency interference that might diminish instrument independence.

The public elements of the Fed's hybrid structure provide balance and accountability. Governors are appointed by the U.S. president and confirmed by Senate. The Board, in turn, selects three directors for every Reserve Bank board, including the chair, and also must approve the selection of Reserve Bank presidents. And when the Board is fully staffed, Board members outnumber presidents on the FOMC.

**Bankers on Boards of Directors**

The presence of bankers on Reserve Bank boards has attracted attention of late. It is said to represent a conflict of interest since Reserve Bank staff supervise banks. But strict rules limit bankers' roles. No director is involved in, nor provided information about, the supervisory decisions or outcomes for specific institutions, and federal criminal statutes against conflicts of interest apply to directors, including those banning them from participating in decisions in which they knowingly have a financial interest. Directors representing banks are not allowed to participate in the process of selecting new Reserve Bank presidents, and the Board of Governors has final approval over such selections. Directors, and indeed Reserve Banks, have no formal role in crafting banking regulations; this is the authority of the Board of Governors. In short, bankers have no avenue through which they can influence supervisory matters.

Moreover, best practice for any board is to seek members with expertise relevant to the organization's activities. Indeed, this is why it makes sense for members to serve on the boards of joint venture associations, such as clearinghouses. Payments processing remains core to Reserve Banks' business: Fed systems move $4.5 trillion in payments every single day. Thus, the original rationale for having bankers serve on Reserve Bank boards is still valid. Buttressed with the Board of Governors, the Reserve Bank boards have direct oversight responsibility for operations on which bankers arguably are experts. In addition, bankers have broad contact with consumers and businesses in their footprints, which makes their reports on economic conditions particularly useful.

More broadly, Reserve Bank boards have always been structured to represent diverse views, and their diversity has increased over time. For example, though it was natural to have bankers on boards, the original Federal Reserve Act mandated that a majority of directors represent the public. The Act also required the representation of varied commercial interests, which was expanded in 1977 to include "due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor and consumers." Over time, boards have come to include a much broader representation of professions, races and genders.[16]

Meanwhile, the role of boards in monetary policy has decreased. Before 1935, the boards essentially set monetary policy for their districts; they had far more control than even the Board of Governors. This reversed with the Banking Act of 1935, and now the role of Reserve Bank boards in monetary policy is strictly advisory: Directors provide crucial insight on local economic conditions, but their recommendation on discount rates is nonbinding.

In other corporate settings, potential conflicts of interest are viewed as manageable, and I believe they are well managed in the Fed's case. To be sure, however, the Fed could do a better job of educating the public about its safeguards.

**Conclusion**

I stated at the outset that the proper governance structure of the Fed ought to be driven by a deep understanding of the Fed's purpose.

Many aspects of the Fed and our financial system have changed since the Fed's founding, and some claim that the Federal Reserve's governance structure is a historical anachronism. Nevertheless, our core function – providing stable monetary conditions to facilitate economic activity – remains unchanged. And the continued relevance of the trade-offs taken into account by the authors of the Federal Reserve Act argues for the continued utility of the finely balanced arrangements they crafted.

Thank you.

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[1] See, for example, Jordan Haedtler, Andrew Levin, and Valerie Wilson, "Making the Federal Reserve Fully Public," Economic Policy Institute, August 22, 2016; and Narayana Kocherlakota, "The Decentralized Central Bank: A Review Essay on 'The Power and Independence of the Federal Reserve,'" August 29, 2016, Journal of Economic Literature, forthcoming, included within Narayana Kocherlakota, "Four Ways to Reform the Fed," Bloomberg View, August 30, 2016.

[2] These remarks reflect my own views and not those of my colleagues in the Fed System. I am grateful to Renee Haltom and John Weinberg for their assistance in preparing these remarks.

[3] Charles W. Calomiris and Stephen H. Haber, Fragile by Design: The Political Origins of Banking Crises and Scarce Credit, Princeton, N.J.: Princeton University Press, 2014.

[4] For more on this history, see Jeffrey M. Lacker, "A Look Back at the History of the Federal Reserve," Speech at Christopher Newport University, Newport News, Va., August 29, 2013. Also see: Milton Friedman and Anna Jacobson Schwartz. A Monetary History of the United States: 1867–1960, Princeton: Princeton University Press, 1963; Gary Gorton and Donald Mullineaux, "The Joint Production of Confidence: Endogenous Regulation and Nineteenth Century Commercial-Bank Clearinghouses," Journal of Money, Credit and Banking, November 1987, vol. 19, no. 4, pp. 457-468; Allan H. Meltzer, A History of the Federal Reserve, Vol. 1, Chicago: University of Chicago Press, 2003; Richard Timberlake, "The Central Banking Role of Clearinghouse Associations," Journal of Money, Credit and Banking, February 1984, vol. 16, no. 1, pp. 1-15.

[5] For background on the objectives of the Fed's founders, see Roger Lowenstein, America's Bank: The Epic Struggle to Create the Federal Reserve, New York: Penguin Press, 2015; Eugene White, The Regulation and Reform of the American Banking System, 1900-1929, Princeton: Princeton University Press, 1983; and Elmus Wicker, The Great Debate on Banking Reform: Nelson Aldrich and the Origins of the Fed, Columbus: Ohio State University Press, 2005.

[6] For detail on these debates, see especially Wicker (2005), and George Selgin, "New York's Bank: The National Monetary Commission and the Founding of the Fed," Cato Institute Policy Analysis No. 793, June 21, 2016.

[7] See Wicker (2005), and Helen Fessenden and Gary Richardson, "The Cost of Fed Membership," Federal Reserve Bank of Richmond Economic Brief No. 16-02, February 2016.

[8] Fessenden and Richardson (February 2016).

[9] Marvin Goodfriend, "The Role of a Regional Bank in a System of Central Banks," Federal Reserve Bank of Richmond Economic Quarterly, Winter 2000, vol. 86, no. 1, pp. 7-25; and Kocherlakota (2016).

[10] Daniel L. Thornton and David C. Wheelock, "Making Sense of Dissents: A History of FOMC Dissents," Federal Reserve Bank of St. Louis Review, Third Quarter 2014, vol. 96, no. 3, pp. 213-228.

[11] Michael Bordo, "Some Historical Reflections on the Governance of the Federal Reserve," in Central Bank Governance & Oversight Reform, edited by John H. Cochrane and John B. Taylor, Stanford, Calif.: Hoover Institution Press, 2016. Earlier working paper version available here.

[12] Helen Fessenden and Gary Richardson, "Whom Do the Federal Reserve Bank Boards Serve?" Federal Reserve Bank of Richmond Economic Brief No. 16-08, August 2016.

[13] Alberto Alesina and Andrea Stella, "The Politics of Monetary Policy," in Handbook of Monetary Economics, Vol. 3, edited by Benjamin M. Friedman and Michael Woodford, Netherlands: Elsevier, 2010, pp.1001-1054.

[14] For more on the political pressures that jeopardized the Fed's independence in the 1960s and 1970s, see Robert P. Bremner, Chairman of the Fed: William McChesney Martin Jr., and the Creation of the Modern American Financial System, New Haven: Yale University Press, 2004; Robert Hetzel, The Monetary Policy of the Federal Reserve: A History, Cambridge: Cambridge University Press, 2008, Chapter 12; and Allan H. Meltzer, A History of the Federal Reserve, Vol. 2, Book 1, Chicago: University of Chicago Press, 2009, Chapter 4.

[15] Alesina and Stella (2010).

[16] Fessenden and Richardson (August 2016).