



# THE TWELVE FEDERAL RESERVE BANKS: GOVERNANCE AND ACCOUNTABILITY IN THE 21ST CENTURY

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## SUMMARY

Chronicling the politics that led to the creation of the twelve Reserve Banks and the pursuant legal and political consequences, this paper argues that the Federal Reserve's quasi-private Reserve Banks are, at best, opaque and unaccountable, and, at worst, unconstitutional.

Following the Panic of 1907, one of the most destructive in the nation's history, Republicans and Democrats offered competing proposals to overhaul the nation's monetary system. Republicans wanted a single central bank, whereas Democrats wanted multiple independent reserve banks across the country that could tailor policy to local conditions. In both plans, private bankers would determine central bank leadership. As a compromise, President Woodrow Wilson proposed the creation of 8 – 12 reserve banks run by appointees of private bankers, but supervised by a single central board of Presidential appointees. Wilson's vision formed the basis of the Federal Reserve Act of 1913, the Fed's founding statute. The Wilsonian structure resulted in turf battles between the private Reserve Banks and the public Board in Washington, which led to policy uncertainty that contributed to the Great Depression. In response to this uncertainty, Congress, at the insistence of President Roosevelt, revoked Wilson's vision and centralized authority in the Board of Governors in Washington. But while the Depression-era legislation removed the 12 quasi-private Reserve Banks' autonomy, it did not eliminate them.

This structure, which persists today, presents problems for both constitutional law and public policy. The President and Congress play no role in choosing who leads the Reserve Banks, and the President must rely on an indirect process if he wants to remove Reserve Bank presidents, a feature which violates constitutional principles of separation of powers. In addition, because Reserve Bank presidents have close ties to the banks they regulate, they are less likely to police bad behavior.

One possible solution is to give the Fed's Board of Governors the power to appoint and remove Reserve Bank Presidents at will. This structural change would make our nation's central banking system more answerable to the democratic process and, in turn, improve the Fed's policymaking.

*This paper is derived from the author's book, The Power and Independence of the Federal Reserve, forthcoming from Princeton University Press. The author thanks Anat Admati, Sarah Binder, Alan Blinder, Sarah Carroll, Nikki Conti-Brown, Harold James, Simon Johnson, John Morley, Sean Vanatta, Art Wilmarth, and Julian Zelizer for helpful feedback.*

## INTRODUCTION

*With such an organization [as the Federal Reserve System] it is almost impossible to place definite responsibility anywhere. The layman is completely bewildered by all the officers, banks and boards. Even the outside experts know only the legal forms.*

—Laughlin Currie, in a letter to Marriner Eccles, 1934

*A slight acquaintance with American constitutional theory and practice demonstrates that, constitutionally, the Federal Reserve is a pretty queer duck.*

—Rep. Wright Patman (D-TX), 1966

It's been an exhausting 7 years to be a central banker. It began in the summer of 2007 and extended through the shotgun marriage between JPMorgan Chase and Bear Stearns, the concomitant resurrection of unusual lending authority, the ongoing implementation of unconventional monetary policy, and so much else in between. To paraphrase Thomas Paine, these have been the times that try central bankers' souls, that test the resolve of the summer hawk or the sunshine dove (Paine, 1776 and 2014).

But these central banking times have been trying not only, perhaps not even especially, for central bankers, but also for the public they serve. This heterogeneous public—including longstanding Fed watchers and those who have only recently realized that the United States has a central bank, those who love the Fed, and those who hate it—has not always, or indeed not even very often, been fully comfortable with these decisions. The emergency lending—the “bailouts,” in the popular if misleading parlance—that began with Bear Stearns and accelerated through the alphabet soup of Fed and Treasury programs gave birth to the populist-libertarian revival of 2010. And the monetary policy response, especially in unconventional monetary policy, has only exacerbated these tensions. The views of once and future presidential hopeful Rick Perry are emblematic of the feelings of many in the American polity: quantitative easing was “printing more money to play politics,” and was, by Perry's lights, “almost treacherous, or treasonous” (Zeleny and Calmes, 2011). In the United States, the Fed and its chair were among the most admired of agencies and officials in government at the time of, for example, Alan Greenspan's retirement in 2006; just a few years later, they were among the lowest (Conti-Brown, 2015b).

As a consequence, there has been no shortage of discussions—during the crisis and unceasingly since—about how to reform the Fed. Most of these discussions, though, have been on reforming the Fed's functions. That is, changing the way it lends money in an emergency, how it determines which financial institutions are systemically important, how it accounts for its spending and decisions, how it determines its models of the economy, and how it makes monetary policy. The answer to the question: “What *does* the Fed do, and what *should* it do?” is no doubt essential to our understanding of what lessons for central banking we are to take from the recent crisis.

Less discussed, however, is the Fed's structure, raising the question, “*Who* is the Fed?” Public and scholarly attention on the Fed usually focuses on a monolithic *it*, or on the personal *she* or *he*. In fact, the standard grammatical practice—followed in this paper—is to refer to the Federal Reserve (or just “the

Fed”) as a proper noun. The Fed raised interest rates; the Fed bailed out AIG; the Fed issued new banking regulations; the Fed fired a bank examiner for challenging Goldman Sachs. But this linguistic practice is an institutional, and even grammatical, error. The term “Federal Reserve” is not a noun, but a compound adjective. There are Federal Reserve Banks, Federal Reserve Notes, a Federal Reserve Board, and, taken together, a Federal Reserve System, all created by the Federal Reserve Act of 1913 (1913 Act). But there is no “Federal Reserve” by itself.<sup>1</sup> This vocabulary failure belies a harder problem for thinking about the Federal Reserve System—even though we rarely refer to it as such, to paraphrase Kenneth Shepsle, the Fed is a “they,” not an “it” (Shepsle, 1992).

This is not a pedantic grammatical point. Understanding the Fed’s complex ecosystem and the institutional actors within the Federal Reserve System is essential to understanding the space within which the Fed makes policy. It also speaks to the very independence that some distrust and others hold very dear. This complexity also illustrates a problem not just of public understanding—though it is certainly that—but also one of governance. When the public is faced with a monolith, all debates about Fed actions—no matter where they occur within the system, and no matter what those actions may be—easily spiral into debates. Such debates involve the first principles about the gold standard, the Coinage Clause of the U.S. Constitution, and the pure democratic virtues of Thomas Jefferson over the venal tyrannies of Alexander Hamilton.

*The Power and Independence of the Federal Reserve* takes up the largely descriptive task of laying out the governance, independence, and structure of the Federal Reserve System, especially as that structure has evolved over time (Conti-Brown, 2015b). It relates it to the conception of central bank independence that grew out of a historical moment in the 1980s and 1990s. But this paper examines one aspect of the largely normative issue of central bank design: not what the Fed is, but what it should be. In particular, this is a question of the *federal* in the Federal Reserve, looking at the curious decisions of institutional design to place some authority in a government agency in Washington, DC, and other authority dispersed unevenly in mostly private regional Federal Reserve Banks. It is a question of whether or not this failed experiment in quasi-federalism and central banks (and without question, it was a failure) should inform our discussions of structural reform today.

By the way I’ve framed the questions, one can anticipate my argument. Briefly, I make the following argument. The answer to the ostensibly basic question—who or what is the Fed?—is in fact a very complicated and often neglected issue of governance, accountability, and independence that gets to the pith of what makes the Fed so powerful and controversial. The problem is not only that most people (even Fed watchers) do not fully understand the Fed’s complex governance structure. The problem is that the structure we have inherited through historical contingencies and institutional evolution is simply not up to the task we have placed before it.

In its place, I recommend extending public accountability not, as some would prefer, by increasing the length and complexity of the statutory instructions we give our central bankers, but by changing the way the public participates in selecting them. More specifically, I offer a few solutions to the problem of

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<sup>1</sup> To highlight this point, in the original debates during, and for many years following, the passage of the Federal Reserve Act of 1913, the only word capitalized was frequently “Federal.” it was the “Federal reserve board” and the “Federal reserve banks” (Glass, 1927).

current appointment opacity at the Reserve Banks, whether to make them presidential appointments (a perennial reform proposal, and one in part pending before the Congress) or, preferably, by making them fully subservient to the Fed's Board of Governors.

Part I of this paper looks at the curious history of the Reserve Banks and argues that their inclusion in the system reflects a political compromise that seemed like a stroke of Wilsonian genius in 1913, but quickly proved a failure that was almost completely repudiated during the New Deal. Part II moves from history to policy to look at the consequences of the neo-federalist Federal Reserve System, focusing on the problems for policy and constitutional law that this model of central banking presents. Part III offers solutions, including making the Reserve Bank presidents appointed and removable at will by the Board of Governors, effectively rendering them senior staff of the Federal Reserve System.

## I. A (FAILED) EXPERIMENT IN FEDERALISM: THE FIRST FEDERAL RESERVE SYSTEM, 1913–1935

*In other words, the [Federal Reserve Act] is modeled upon our Federal political system. It establishes a group of independent but affiliated and sympathetic sovereignties, working on their own responsibility in local affairs, but united in National affairs by a superior body which is conducted from the National point of view. The regional banks are the states and the Federal Reserve Board is the Congress.*

—Carter Glass, 1913

*The system of 12 Federal Reserve banks . . . has always existed for the benefit of the commercial and investment banks that created the system, that own the banks and that control their boards of directors. To think that these banks exist for any other reason than to serve their Wall Street masters is complete folly.*

—William Cohan, 2014

The basic governance problem with the Federal Reserve System is that it is an early 20th century solution for a 19th century problem that is no longer relevant in the 21st century. The idea of spreading authority within a national banking system was a novelty of the Woodrow Wilson administration. At the time, many celebrated it as an overwhelming achievement. In time it was regarded as an overwhelming failure, mostly repudiated by scholars, the Roosevelt administration, and most important of all, the U.S. Congress.

And yet, the mythos of a federalist central bank—a central bank whose authority is divided among core and peripheral governments—remains. The consequence is bad for accountability, bad for Fed independence, bad for bank regulation, and anyway, is probably unconstitutional (Glass, 1927).

Before we can understand why this is so we must understand more about the story of the Fed and its first two foundings, in 1913 and 1935. The conventional retelling of the Fed's founding in 1913 begins with the financial panic of 1907, one of the most destructive in the nation's history. In that retelling, the panic was an accelerating financial bloodletting that the U.S. government could do nothing to staunch. It was only after the intervention of J. Pierpont Morgan—that towering figure of Anglo-American finance in the

late 19th and early 20th centuries—that the panic finally subsided. According to his associates at the time, Morgan was “the man of the hour” whose pronouncements (bland and obvious in retrospect) assumed talismanic significance: “If people will keep their money in the banks everything will be all right.”<sup>2</sup>

After the 1907 financial panic, private bankers and government officials decided that an all-eyes-turn-to-Morgan approach to financial crises could not continue to be the basis of U.S. banking policy. Or so the story goes. After a secret meeting on Jekyll Island of bankers and their political sponsors in Congress—a meeting complete with disguises and code names and Omertà-like oaths of secrecy—the Federal Reserve System was hatched, finally signed into law by President Woodrow Wilson as the Federal Reserve Act of 1913.<sup>3</sup>

This, again, is the conventional retelling.<sup>4</sup> Many elements are true: There really was an extraordinary global financial panic of 1907, J. P. Morgan did have a role in arresting the spread of contagion, a secret meeting of bankers and politicians did take place in Jekyll Island, and the Federal Reserve Act of 1913 did follow these events chronologically. But from the perspective of the structure the Federal Reserve System would take—especially its federalist governance—the story tells us almost nothing. The primary problem with this retelling is that it links, almost ineluctably, the Panic of 1907 and the Federal Reserve Act of 1913. For understanding Fed governance, this uncritical link is a mistake. The Panic of 1907 occurred in, well, 1907; the Federal Reserve Act of 1913 in, unsurprisingly, 1913. The six years in between were extraordinarily important for the fate of the Federal Reserve System, including as they did two congressional elections in which both houses changed political hands, from the Republicans—at the time the bankers’ primary supporters in Congress—to Democrats (the House changed in 1910, the Senate in 1912).<sup>5</sup>

More important still was the presidential election of 1912—a four-way race between incumbent Republican President William Howard Taft, erstwhile Republican former President Theodore Roosevelt, Socialist Eugene Debs, and Democratic New Jersey Governor Woodrow Wilson. The election was one of the most significant presidential contests in American history, and continues to capture the popular imagination today (Goodwin, 2014). Although historians have debated how much policy daylight stood

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<sup>2</sup> Herbert Satterlee—Morgan’s son-in-law, business associate, and attendant to the events of that fateful fall—was the chronicler of the Morgan mythos (Satterlee, 1939).

<sup>3</sup> The Jekyll Island meeting gets a lot of attention; far more than it should. It is mysterious, intriguing, and proof positive that politicians and bankers form a secret cabal. But the details of getting to the island are more interesting than the influence that their plan—as distinct from the many plans that existed prior to the meeting—had on the Federal Reserve Act. For more on Jekyll Island and its place in the Fed’s history, see Wiebe (1966), Kolko (1963), Broz (1997). For entertainment but not information, see Griffin (1998)

<sup>4</sup> “Mr. JP Morgan was able to coordinate a private sector rescue of the U.S. financial system in 1907, but only because relative to the capacity of the private entities involved in the rescue its size was still manageable. The crisis raised sufficient concerns about the reliability of private sector bailouts to provide the political impetus for a new central bank, the Federal Reserve, established in 1913” (Pistor, 2013). “Though the duration of the crisis was relatively brief, the repercussions proved far-reaching, resulting in the formal establishment of a powerful central bank in the United States through the Federal Reserve System” (Bruner and Carr, 2007).

<sup>5</sup> See Party Divisions of the House of Representatives, 1789–present, available at <http://history.house.gov/Institution/Party-Divisions/Party-Divisions>.



between the three primary candidates<sup>6</sup>, the perception then and today was that the aspirations of each candidate represented distinct approaches to the role of government in society.<sup>7</sup> In the words of one historian, the 1912 election “verged on political philosophy” (Cooper, 1983, pg.141).

That political philosophical moment in American history intervened between the Panic and the Act in ways that were essential to the ultimate shape the Fed system took, including relating to the critical questions of who would govern that system. While conspiracy theorists hit their target in noting the existence and significance of the Jekyll Island meeting—the leading popular account of the conspiracists is called *The Creature from Jekyll Island*, the exposé that seeks to “set off into the dark forest to do battle with the evil dragon” (Griffin 1998)—the reality is that the “creature” established in that meeting and sponsored by the Republicans in 1910 bore little relationship, from a governance standpoint, to the Federal Reserve System ultimately embraced by Woodrow Wilson as his greatest domestic accomplishment and signed into law on December 23, 1913 (Berg, 2013).

On the most basic level, the elections mattered because of partisan control. The first proposals following the Panic of 1907 were entirely Republican; the final bill was largely Democratic.<sup>8</sup> Senator Nelson Aldrich was the Republican leading the monetary reform efforts. In 1908, Congress passed the Aldrich-Vreeland Act, which created the National Monetary Commission, with Aldrich at the head. The commission imagined a structure very different from the system the Federal Reserve Act eventually created. The resulting National Reserve Association (NRA) (Friedman and Schwartz, 1963), was to be governed by a mix of public and private appointments, but dramatically weighted toward the private. For example, the board of the NRA was to have 46 directors, 42 of whom—including the governor and his two deputies—were to be appointed directly and indirectly by the banks, not by the government (Kemmerer, 1922, pg. 64). Most important of all, it was a centralized system, located in New York City with the private bankers, not in Washington, DC, with the politicians.

But from a governance perspective, the Republican NRA approach failed to carry the day. The emphasis here is on the Fed’s governance. There has been a spirited, if somewhat intramural, debate about who could claim paternity of the Federal Reserve System with respect to the new system’s functions. A cottage industry of dueling memoirs arose in the two decades following the Federal Reserve Act of 1913, each claiming a decisive role in including this or that language in the statute. This “exegetical problem,” to quote the somewhat dismissive view of one historian (Kolko, 1963, pg. 222), is an important one that still captures the attention of historians of the Fed.<sup>9</sup> But it tells us very little about the extraordinary

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<sup>6</sup> Smith (1999, pp. 410–11) views the candidates on a right-center-left Progressive spectrum, whereas Kolko (1963) views them clumping fairly narrowly as conservatives.

<sup>7</sup> The hostility of feelings among the various factions of the 1912 election are displayed well in Goodwin (2014), Morris (2010), and Berg (2013).

<sup>8</sup> The vote in the House of Representatives was 298 to 60; only two Democrats voted against the bill, whereas 35 Republicans voted in favor. In the Senate, the vote was 43 to 25 (with 27 not voting). The Democrats were unanimous in favor, and all but three Republicans voted against. Clifford (1965, pg. 40) has the details.

<sup>9</sup> The historians of the Fed’s founding—from Sanders (1999) to Livingston (1989) to Wiebe (1966) to Kolko (1962)—essentially ignore the main functional contribution of the Federal Reserve Act: its facilitation of the rise of the United States as an international financial center. Lawrence Broz (1997) offers the most thorough and compelling account to this end. He carefully reviews each section of the Act, engaging in an important scholarly effort. Broz’s argument is essentially that the banking system, as it existed prior to the passage of the Federal

changes to the Fed's governance that occurred in the 11th hour of the Federal Reserve Act's debate and passage. After the election of 1912—which capped a change of the partisan guard in the House, Senate, and White House—the Democrats made the cause of monetary reform their own. The key consequence of this political transformation was what might be called the Wilsonian Compromise of 1913, despite Rep. Carter Glass's (D-VA) protestations of family ownership of the 1913 Act.<sup>10</sup>

The tension Wilson confronted between the two poles—public and private, accountable to the political process and independent from it—is essential to understanding the nature of Fed independence, then and now. Paul Warburg's ideas set the stage in the early 1900s for much of the debate preceding the enactment of the Federal Reserve Act. A German-American private banker in the old-school European banking tradition, he feared public influence over what he viewed as an inherently private function. More colorfully, Republican opponents to the Democratic structure were fierce; in the recollection of Secretary of the Treasury William McAdoo, they thought it “populistic, socialistic, half-baked, destructive, infantile, badly conceived, and unworkable” (McAdoo, 1931, pg. 213). McAdoo may not be an altogether reliable narrator here, especially after the fact. But there is no question that, from the tumult of the election of 1912 up until the passage of the 1913 Act, opponents thought the departure from the Republican plan an unmitigated disaster.<sup>11</sup>

The structure the Fed took—a public board centralized in Washington, DC, with 12 essentially private, decentralized central banks—was Wilson's innovation. Until Wilson supervised the bringing together of the various pro- and anti-central banking factions, this hybrid institution did not exist on paper or in thought. The result was the mostly supervisory, leanly staffed Federal Reserve Board, based in Washington, DC. The board would include Secretary of the Treasury as the *ex officio* chairman of the system, with the Comptroller of the Currency—until then, the exclusive federal banking regulator—also

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Reserve Act, created serious domestic barriers to the internationalization of the U.S. financial system. The arguments in favor of farmers, or the class consciousness of bankers, or the domestic longing for order, or the triumph of conservatism, miss what the statute was actually about. According to Broz, the Federal Reserve Act responded directly to those concerns by (1) reiterating the nation's commitment to the Gold Standard, a commitment that was extraordinarily controversial less than a generation before the Act's passage, (2) adding liquidity to the secondary markets for financing international trade, and (3) creating a mechanism whereby reserves could be shifted within the system to those institutions most in need of those reserves in a panic. We mentioned how the Federal Reserve Act created a market for international bankers' acceptances; the Act also made it possible for other parties to buy those acceptances after they have already been drawn. Doing so not only made the rancher in South Dakota more likely to accept the order from the tanner in Manchester, but also made the banker who would finance the entire deal more likely to be in Chicago than in London. If there was a thriving secondary market in the United States for such acceptances, then there would be no need for the financing of a dollar-denominated transaction to occur anywhere other than a dollar-denominated economy.

<sup>10</sup> The term Wilsonian Compromise comes from Wiebe (1966, pg. 221), and refers to Wilson's general legislative program, where he forced—through will and reason and the exercise of political power—otherwise hostile groups to bargain one with another to reach conclusion. In this, Wiebe concludes, “[n]either Wilson, his advisers, nor the leaders in Congress could pretend that this remarkable balance followed a master plan.” It was in the “dextrous management” of the initial legislative projects that Wilson's skills were on display. The dysfunction of the institutional design, in the case of the Federal Reserve at least, didn't manifest itself until after Wilson was out of office.

<sup>11</sup> Carter Glass's final speech on the House floor, following the reconciliation of the House and Senate bills, goes into some detail on these critiques from bankers of the day (Glass, 1913). Aldrich, who had retired from the Senate in 1911, before the debates over the 1913 Act began in earnest, hated the final result (Wicker, 2005).

serving on the board. In addition to these two political appointees, the board consisted of five Presidential appointees, each serving a 10-year term.<sup>12</sup>

The rest of the system consisted of “not less than eight nor more than twelve” Reserve Banks—although the initial legislation didn’t set the definitive number.<sup>13</sup> These Reserve Banks would each have a “governor” and a nine-person board of directors. They would be the essentially private features of the system.

This Wilsonian System would not, in theory at least, be dominated by one faction or the other. Rather than a *National Reserve Association*, it would be a *Federal Reserve System*. The emphasis, at least to some of these early legislative framers, was on the *Federal* in the Federal Reserve System. That balance was at the core of Glass’s conception of the new system:

In the United States, with its immense area, numerous natural divisions, still more numerous competing divisions, and abundant outlets to foreign countries, there is no argument, either of banking theory or of expediency, which dictates the creation of a single central banking institution, no matter how skillfully managed, how carefully controlled, or how patriotically conducted (H.R. 7837, 1913).

Glass wasn’t alone in this federalist emphasis. E.W. Kemmerer, an early observer of the creation of the Fed, called the arrangement of “twelve central banks with comparatively few branches instead of one central bank with many branches” the “most striking fact” about the system (Kemmerer, 1922, pg. 64). Glass shared the view of the Reserve System as a series of central banks; indeed, he was a steadfast defender of the Reserve Banks any time the board sought to assert itself in the power struggles that arose.<sup>14</sup> Wilson agreed: “We have purposely scattered the regional reserve banks and shall be intensely disappointed if they do not exercise a very large measure of independence” (New York Times, 1913).

Wilson would not have been “intensely disappointed,” but his representatives on the Federal Reserve Board were. As Allan Meltzer notes, tensions “between the Board and the reserve banks began before the System opened for business” (Meltzer, 2003, pg. 75). Because the statute—in the tradition of many great legal compromises (Rakove, 1997)—expressly left room for divergent interpretation for competing factions, the legislative authors of the Federal Reserve Act left undefined a number of key terms, and largely unspecified the power relationship between and among the Federal Reserve Board and the Reserve Banks (Clifford, 1965, pp. 103–09). In the two places where the Fed exercised the most power—the proactive purchase of securities in the open market and the reactive discounting of securities brought to the doors of the Reserve Banks—rivalries arose immediately, both between the board and the banks and among the banks themselves. In the post-World War I period, these rivalries were resolved, in favor

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<sup>12</sup> See House Report on Glass Bill (reprinted in Glass, 1927). Note that in the Glass Bill that passed the House of Representatives, the Secretary of Agriculture would also be an ex officio member, with each member of the Board serving 6 years.

<sup>13</sup> The House version would have set the floor at 12, and put no limit on the final number (Glass, 1927).

<sup>14</sup> After the Federal Reserve Board took a stronger hand in setting discount rates in 1927, Glass sought to clamp down on their authority (Kettl, 1988, pg. 32). For more about how these kinds of disputes between the Reserve Banks and the original Federal Reserve Board came about, see Meltzer (2003, pp. 62–75) and Clifford (1965, pp. 66–67).

of the Federal Reserve Bank of New York, and especially its worldly chief executive, Governor Benjamin Strong.

According to his biographer in an assessment that subsequent research hasn't contradicted<sup>15</sup>, Strong was “one of the world's most influential leaders in the fields of money and finance.” From the founding of the Federal Reserve System until his death in 1928, “his was the greatest influence on American monetary and banking policies; he had no close competitor” (Chandler, 1958, pg. 3).

Strong was ostensibly deeply committed to the public spirit of his work. In the top drawer of his desk he always kept a note to himself (written “to the governor of this bank”) to “never forget that it was created to serve the employer and the working man, the producer and the consumer, the importer and the exporter, the creditor and the debtor; all in the interest of the country as a whole” (Chandler, 1958, pg. 1). But not everyone agreed that his policies matched his aims. Herbert Hoover's memoirs, for example, are filled with Fed-directed rancor for causing the Great Depression. “This orgy [of speculation] was not a consequence of my administrative policies,” he writes. “In the main it was the result of the Federal Reserve Board's pre-1928 enormous inflation of credit at the request of European bankers which, as this narrative shows, I persistently tried to stop, but I was overruled.”<sup>16</sup> Hoover's critique of the Fed was, in fact, a critique of the quasi-private Federal Reserve Bank of New York.<sup>17</sup>

The point here is not to rehash the details of how the Fed contributed to—or created—the Great Depression.<sup>18</sup> For our purposes—to understand internal Fed governance and the evolution of a federalist central bank—the point is to emphasize that the ambiguities of the Federal Reserve Act made the exercise of Fed power a shared and contested function. With Benjamin Strong's death, that contest for power left a chaotic vacuum that the Wilsonian federalist compromise not only didn't avoid, but in fact caused.

## THE FED'S SECOND FOUNDING: MARRINER ECCLES AND THE BANKING ACT OF 1935

Such was the state of things when Franklin Roosevelt's team of New Deal experimenters arrived on the economic scene. Roosevelt was clear that experimentation was his philosophy. During the campaign, he argued that “[t]he country needs and, unless I mistake its temper, the country demands, bold persistent experimentation. It is common sense to take a method and try it: if it fails, admit it frankly and try another. But above all, try something.”<sup>19</sup> Roosevelt lacked a consistent theory of regulatory response; the pride of place following his 1932 election was for fast reaction, not necessarily legal or institutional coherence. As historian Richard Hofstadter put it, the New Deal was characterized as a “chaos of experimentation” (Hofstadter, 1960, pg. 304).

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<sup>15</sup> For more on this tumultuous period, see Ahamed (2009), Eichengreen (1992), Friedman and Schwartz (1963), and Meltzer (2003).

<sup>16</sup> Hoover further complained that the Fed (under Benjamin Strong) turned American optimism into “the stock-exchange Mississippi Bubble” (Hoover, 1952, vi and pg. 5). History has agreed with Hoover's conclusion, but not his reasoning.

<sup>17</sup> Hoover makes this connection explicit, see Hoover (1952, pg. 7).

<sup>18</sup> It's an important topic, of course. Ben Bernanke, then writing as a scholar, wrote that “[t]o understand the Great Depression is the Holy Grail of macroeconomics” (Bernanke, 2004). And it remains a hot-button issue for scholars and public commentators. Compare Shales (2008) with Eichengreen (2015).

<sup>19</sup> Address at Oglethorpe University in Atlanta, GA, May 22, 1932.

Despite the Fed's centrality to the banking system, institutional reform of the Fed was not high on the list of priorities. There were some adjustments that came in the first round of economic legislation. In the Glass-Steagall Act of 1933—more famous for the institution of federal deposit insurance and the famed separation of commercial and banking institutions—Congress created the Federal Open Market Committee (FOMC) as the central body that would make proactive decisions about the purchase of market securities, including government securities. Importantly, though, the federalist system was reinforced in the first New Deal. The FOMC created in the first 100 days consisted of the 12 Reserve Bank presidents and was meant to add a more formal structure on coordination that excluded the “governmental” Federal Reserve Board.

Nibbling around the edges of the Wilsonian federalist central bank might have remained the order of the day had it not been for Marriner Eccles, perhaps the most intriguing figure in Federal Reserve history. Eccles's father was a Scottish immigrant, a Mormon convert, a bigamist (Marriner's mother was his father's second wife), and, in time, one of the wealthiest men in the state of Utah. Eccles thrived in his father's business and expanded the business into mining, timber, and especially banking. He was a millionaire in his own right by the age of 22.

Eccles rose to national prominence because of his astonishing success as a banker during the height of the banking crises of the Great Depression. With bank failure rates reaching unprecedented heights, Eccles's banks survived, largely due to his own savvy ability to maintain credibility and confidence. While there were other successful bankers, what made Eccles noteworthy was that he was also something of a radical. For example, at the 1932 Utah State Bankers Convention, he laid out his theory of the Depression and its cure in plain language. “Our depression was not brought about as a result of extravagance,” he said. “It was not brought about as a result of high taxation. We did not consume as a nation more than we produced. We consumed far less than we produced. The difficulty is that we were not sufficiently extravagant as a nation.” There was a simple reason for this:

The theory of hard work and thrift as a means of pulling us out of the depression is unsound economically. True hard work means more production, but thrift and economy mean less consumption. Now reconcile those two forces, will you?

Eccles had a solution, too: “There is only one agency in my opinion that can turn the cycle upward and that is the government” (Eccles, 1951 pp. 83–84). In 2015, we'd call arguments like these Keynesian. In 1932, it was 4 years before John Maynard Keynes published his *General Theory of Employment, Interest, and Money*.<sup>20</sup> If Eccles was a radical, he was also something of a visionary. His auditors weren't as impressed, by the way. “Poor Eccles,” a president of a Western railroad is to have said. “He must have had so terrible a time with his banks that he is losing his mind” (Eccles, 1952, pg. 84).

After a chance meeting with Rex Tugwell, one of FDR's “brain trusters,” Eccles—clothed in the fortuitous garb of a Western banker—came into the Roosevelt Administration, initially as a special assistant to the Secretary of the Treasury. Eventually, Eccles was considered for the position of “governor” of the Federal Reserve Board. The chairmanship belonged to FDR's then Secretary of the

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<sup>20</sup> Keynes had circulated these ideas prior to the *General Theory*, as early as 1929, but Eccles claims never to have heard them. And besides, Keynes was not the first to espouse these views (Laidler, 1999).

Treasury, Henry Morgenthau Jr. (To give a sense of how the governor position was then perceived, the post became vacant when Eugene Black resigned to take the position of governor of the Federal Reserve Bank of Atlanta (Eccles, 1952, pg. 84).

Eccles essentially refused the offer. In response to inquiries of his availability, he responded that he “would not touch the position of governor [of the Federal Reserve Board] with a ten-foot pole unless fundamental changes were made in the Federal Reserve System” (Hyman, 1976, pg. 155). He was invited to propose his view of what those changes should be, and he and an assistant prepared a three-page blueprint of what amounted to a radical refounding of the Federal Reserve that eliminated the federalist compromise. He narrowed his sights on the Reserve Banks: “Although the Board is nominally the supreme monetary authority in this country,” he wrote in a memo to Roosevelt, “it is generally conceded that in the past it has not played an effective role, and that the system has been generally dominated by the Governors of the Federal Reserve Banks.”<sup>21</sup> As an “unfortunate result,” he continued, “banker interest, as represented by the individual Reserve Bank Governors, has prevailed over the public interest, as represented by the Board.”<sup>22</sup> Eccles’s position was striking: Eccles was himself a banker whose views were represented by the Federal Reserve Bank of San Francisco, and yet he sought the banks’ exclusion from national policy.

Roosevelt was sold. He committed the presidency to the passage of Eccles’s bill, and Eccles accepted the governorship so that he could more effectively lead the legislation through Congress from inside the Fed. The *New York Evening Post* summarized the point perfectly: “Marriner S. Eccles is a unique figure in American Finance—a banker whose views on monetary policy are even more liberal than those already embraced by the New Deal” (Hyman, 1976 pg. 161).

But Eccles wasn’t simply taking aim at private influence over banking policy; he was taking aim at the power vacuum that the Federal Reserve Act created. His right-hand man in this was Lauchlin Currie, a Canadian-born economist Eccles met when they both served at the Treasury. When Eccles moved to the Fed, he took with him Currie, whose academic work in economics had been critical of the economic theory behind the Reserve Banks’ policies under Benjamin Strong. Currie was an active memo writer, and leaves us with a record of his thinking on each major issue debated during the 1935 Act’s drafting, debate, and passage.<sup>23</sup>

Currie placed the question not of private versus public control, but of *plausible* control. He described the problem in a 1934 memo to Eccles: “Decentralized control is almost a contradiction in terms. The more decentralization the less possibility there is of control.” The problem was that “[e]ven though the Federal Reserve Act provided for a very limited degree of centralized control, the system itself by virtue of

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<sup>21</sup> Memo from Eccles to Roosevelt, November 3, 1934, OF 90, box 2, Franklin D. Roosevelt Library

<sup>22</sup> *Ibid.*

<sup>23</sup> There is reason to suspect that Eccles shared Currie’s views on these issues: Currie and Eccles were, in fact, the authors of the memorandum that first proposed the Fed’s overhaul, and they engaged in a flurry of correspondence during the months prior to the bill’s enactment. These memos are included in the Eccles Papers, housed in hard copy at the University of Utah, but almost fully digitized by the Federal Reserve Bank of St. Louis, through their Federal Reserve Archival System for Economic Research. This extraordinary collection of primary documents tempts me to rethink my commitment to reshape Fed governance in a way that would disfavor the collectors of this comprehensive, easily-accessible national treasure.

necessity was forced to develop a more centralized control of open market operations.” The ad hoc institutional development was simply corralling into a room “fourteen bodies composed of 128 men who either initiate policy or chair in varying degrees in the responsibility for policy.” These Reserve Banks, their governors and boards, and the uncertain authority of the Federal Reserve Board, created “such an organization it is almost impossible to place definite responsibility anywhere. The layman is completely bewildered by all the officers, banks, and boards.” Currie glumly concluded that “[s]uch a system of checks and balances is calculated to encourage irresponsibility, conflict, friction, and political maneuvering” such that “anybody who secures a predominating influence must concentrate on handling men rather than thinking about policies” (Currie Memo to Eccles, April 1, 1935).

In light of these problems, in Eccles’s (and Currie’s) view, the structure had to change, and radically. Their timing was impeccable: the New Deal experimenters were embarking on a legislative frenzy known as the Second New Deal. In a single legislative session, Congress passed five major pieces of legislation, including (1) the Social Security Act, (2) the Wagner Act (which reshaped American labor law), (3) the Public Utilities Act, (4) the Banking Act, and (5) the Revenue Act—a controversial tax bill known by critics and defenders alike as the “Soak the Rich” bill.<sup>24</sup>

Eccles’s Banking Act of 1935 was the “least controversial” of the five (Kennedy, 2001, pg. 274). Least controversial, perhaps, but in some sense also one of the most consequential. The Act created a system that represented a dramatic departure from every other experiment in central bank design in U.S. history. It also abolished the Federal Reserve Board created in 1913 and replaced it with the Board of Governors of the Federal Reserve System. (The term “Federal Reserve Board” remains in wide if anachronistic use to refer to the Board of Governors.) It also demoted the heads of the Federal Reserve Banks, who would no longer carry the name “governor.” That title would be reserved for the members of the Board of Governors. At the Reserve Banks, the head would be the “president.”

As a consolation to Carter Glass—that jealous guardian of the Federal Reserve System, its original sponsor in the House, chairman under Woodrow Wilson, and now caretaker as the senior Senator from Virginia—the Reserve Banks weren’t eliminated entirely, despite Eccles’s preference for that abolition. They also became a minority presence on the newly reformed FOMC, which consisted of the seven-member strong Board of Governors, plus five Reserve Bank presidents on a rotating basis.<sup>25</sup> But the legal ambiguity regarding the relationship between the political appointees and the regional Reserve Banks was resolved: the Reserve Banks lost their autonomy. Wilson may have been “intensely disappointed” with the result had he lived to see it, but the chaotic uncertainty that the Wilsonian system left behind had been—with a stroke of Eccles’s pen—abolished.

The Reserve Banks weren’t the only ones shown the door by the Banking Act of 1935. The act also booted the Secretary of the Treasury and the Comptroller of the Currency, the other ex officio member of both the board and the President’s administration, from the newly created Board of Governors. The Board of Governors became a separate entity from the administration not only in law, but also in personnel.

As historian David Kennedy has written, after the 1935 Act, “the Fed now had more of the trappings of a

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<sup>24</sup> For more on the Second New Deal, see Kennedy (2001) and Katznelson (2014).

<sup>25</sup> The permanent presence of the president of the Federal Reserve Bank of New York didn’t get added until 1942.

true central bank than any American institutions had wielded since the demise of the Bank of the United States in Andrew Jackson's day" (Kennedy, 2001, pg. 274). I would go further: the Fed's Board of Governors consisted exclusively of Presidential appointments; the Second Bank of the United States had 25 directors, only 5 of whom were presidential appointments.<sup>26</sup> The post-1935 Federal Reserve System had the trappings not only of a "true central bank," in Kennedy's term, but was the first to launch what economic historian Charles Goodhart has called central banking's evolution. The Fed didn't join the fold of central banks at last in 1935; Eccles and FDR had created a new institution altogether.

Almost. To invoke the applied philosopher Omar Little from season 1 of *The Wire*, "If you come at the king, you'd best not miss." Eccles had hoped to dethrone the Reserve Banks from the policy business entirely; the compromise to allow them to participate as minority players on the reconstituted Federal Open Market Committee has allowed them to continue to exercise extraordinary control over the nation's financial system. Moving from the past to the present we must now inquire: What, exactly, are the Federal Reserve Banks, and what is their purpose in light of the failure of the quasi-federalist system that created them?

## II. THE POLICY AND CONSTITUTIONAL PROBLEMS OF THE FEDERAL RESERVE BANKS

Even before the 1935 Act, the Federal Reserve Banks have eluded easy definition, in large part because they began their lives as private corporations roughly dedicated to a public function, and have since become more and more like public regulatory institutions. This process began with the Banking Act of 1935 and has continued throughout the last 80 years due to significant nonlegal institutional change.

It is that tension between their public functions and their private governance that presents problems for both constitutional law and public policy. To put it bluntly: the Federal Reserve System as currently organized is unconstitutional under a straightforward application of the recent U.S. Supreme Court precedent. And even if it were constitutional, the governance problems at the Reserve Banks present at least the appearance of and at most the reality of deep conflicts of interest in the enforcement of federal banking laws.

To understand that tension we need to know more about the legal status of the Reserve Banks even after their demotion via the Banking Act of 1935. The Reserve Banks remain private corporations chartered under federal law. They have stockholders: the private banks that join the Federal Reserve System must buy stock in the Reserve Banks and receive a dividend set by statute (set at 6%). Those stockholders also elect two-thirds of the Reserve Bank's directors. Each board is divided into three classes (12 U.S.C. § 341). Class A directors are stockholder bankers selected by the stockholder banks (12 U.S.C. § 341). Class B directors are nonbankers selected by the stockholder banks. And Class C directors are nonbankers selected by the Fed's Board of Governors in Washington, DC. The directors voted as a whole to select the

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<sup>26</sup> "And be it further enacted, that for the management of the affairs of the said corporation, there shall be twenty-five directors, five of whom, being stockholders, shall be annually appointed by the President of the United States, by and with the advice and consent of the Senate" (3 Stat. 266, 269, An Act to Incorporate the Bank of the United States, April 10, 1816).

Reserve Bank president until 2010, but since Dodd-Frank only Class B and C directors take that vote, which is in turn subject to approval by the Board of Governors. The Board of Directors, under the Federal Reserve Act, is required to “perform the duties usually appertaining to the office of directors of banking associations and all such duties as are prescribed by law” (12 U.S.C. § 301).

But this talk of “corporations” and “stockholders” and “dividends” is misleading. Beyond the election of the directors (and the directors’ selection of the Reserve Bank president), the stockholders don’t look at all like private stockholders. There are limits on how much Reserve Bank stock they can purchase and prohibitions on the sale of that stock (12 U.S.C. § 287). And if the Reserve Banks are ever liquidated as federal bank corporations, the surplus goes to the U.S. government, not to the banks (12 U.S.C. § 290). In these senses, the Reserve Banks remain creatures of statute, much like the Federal Reserve System itself. But the form of ownership is important. It is from this corporate structure that we hear the frequently repeated assertion that the Federal Reserve is “owned” by private bankers (Griffin, 1998). This isn’t true of the Board of Governors, and it only is marginally true of the Reserve Banks.

But interestingly, if they are not quite private corporations, neither are they government agencies. When asked whether the Reserve Banks were government agencies in a congressional questionnaire by Congressman Wright Patman (a perennial scourge of the Federal Reserve System during his 50 years of service in the House of Representatives), the newly appointed Fed Chair William McChesney Martin wouldn’t answer directly. Instead, he responded with a verbose and legalistic description of them as “corporate instrumentalities of the Federal Government created by Congress for the performance of governmental functions.”<sup>27</sup> The Reserve Bank presidents, in a joint statement in response to the same question, said that they were “government instrumentalities,” not government “agencies,” meaning that they were “partially part of the private economy and are part of the functioning of the Government (although not technically a part of the Government).” This ambiguity allowed the banks to let the “public interest” be “dominant in their policies,” even as they maintained their private independence.

This public-private ambiguity has been the source of extraordinary controversy over the course of the Fed’s history. The participation of the Reserve Banks in the operation of governmental policies was the main cause of Wright Patman’s lifelong antipathy for the Federal Reserve System. It has motivated similar congressional obsessions from Congressmen Henry Gonzalez (D-Texas, 1961–1999) and Ron Paul (R-Texas, 1979–1985, 1997–2013).

The Reserve Banks’ very existence owes itself to the failed Wilsonian experiment in federalist power sharing. In time, the Federal Reserve System looked like the Holy Roman Empire: neither Federal, nor Reserve, nor a System.<sup>28</sup> The power of institutional inertia has kept the Reserve Banks in the mix. If there are no costs to their ongoing survival, then perhaps our inquiry ends here, of interest only to historians. After all, we are surrounded by vestigial institutions, from the pomp and circumstance of medieval graduation rituals to a foreign minister who still goes by the title of “Secretary of State.”

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<sup>27</sup> These responses were to questions submitted by the Subcommittee on General Credit Control and Debt Management, Joint Committee on the Economic Report, 82d Cong., 2d Sess. (Feb. 1952), pp. 242–248.

<sup>28</sup> The role of excess reserves, essentially negligible for decades, became resurgent again after the crisis (Wallach, 2014).

But there are serious problems with the ongoing participation of the Reserve Banks on both the policy and constitutional levels. Let's take a recent example very much in the news and on the minds of members of Congress: alleged failures of supervision at the Federal Reserve Bank of New York.

In the wake of the financial crisis of 2007–2009 (by some measures the largest financial crisis in world history) William Dudley, president of the Federal Reserve Bank of New York, faced the reality that the New York Fed had not been up to the challenge of supervising the world's largest banks. This was his institution's responsibility, and he wanted to know why they had failed. So he hired David Beim, a former banker and professor of finance at Columbia University, to do an exhaustive, unlimited access review of the New York Fed and its operations. In return, the report would be secret.<sup>29</sup>

Eventually made public, the report disclosed a “culture that is too risk-averse to respond quickly and flexibly to new challenges” (Beim, McCurdy, et al., 2009, pg. 2), and bank supervisors who deferred to the banks they regulated in virtually every aspect of bank supervision, from developing and relying on internal risk management systems to deferring to banks' reactions to potential problem spots. The stated modus operandi of many bank supervisors was to avoid confrontation with the banks. This seemed a sure-fire way for the New York Fed to render itself irrelevant at best, and complicit in fueling future crises at worst.

In reaction to the Beim report, and following its recommendation, the New York Fed hired a new crop of bank examiners, including Carmen Segara. And true to expectations, Segara was vocal when she spotted failures to comply with federal law at Goldman Sachs, the bank where she was stationed as an examiner. In particular, she concluded that Goldman Sachs had failed to have a firm-wide conflict-of-interest policy to manage situations in which the firms' bankers would advise clients on decisions where those bankers had other interests—advising the purchase of a company where the banker owned stock, for example.

In some ways, the lack of a firm-wide conflict-of-interest policy is astonishing: such conflicts have been at the heart of a series of Wall Street scandals throughout the 20th century, from the Great Crash of 1929 to the accounting scandals following the collapse of Enron in the early 2000s.<sup>30</sup> And yet, this is what Segara discovered and reported to her superiors at the New York Fed.

But, with a few exceptions, Segara's superiors didn't share her enthusiasm for pushing Goldman to change its practices, and they pushed back, hard. Because Segara was worried about all that she saw, and in case she needed to support her version of events in the future, she started to secretly record her conversations at the Fed and at Goldman Sachs. She ended up with 46 hours of recorded conversations, which ended when Segara was fired. She worked at the New York Fed for a total of 7 months.

As the news of Segara's tapes, her accusations, and the New York Fed's banking culture leaked to the press, deeply researched reports appeared in ProPublica, and a major feature was aired on the public radio program *This American Life*. Reactions were divided roughly along two lines. Defenders of the Fed have said that Segara's claims are inaccurate, overblown, or not reflective of the regulators' usual practices, etc

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<sup>29</sup> This account is taken from the exhaustive reporting at ProPublica (Bernstein, 2013a, 2013b, and 2014).

<sup>30</sup> For a description of these conflicts preceding the Great Crash, see Perino (2010, pg. 136) for particularly moving examples of what happens when these kinds of interests conflict.

(Federal Reserve Bank of New York, 2014). Critics of the Fed have said that this is what the New York Fed does—it has always been captured by the banks it regulates, and this proximity is baked into the Fed’s DNA (Cohan, 2014).

Dudley and the Federal Reserve Bank of New York have vehemently denied Segara’s characterization of both her own firing and the nature of the transaction she found so dubious. But in the aftermath of the Segara revelations, Dudley has also articulated his conception of his role as a bank regulator. Under skeptical questioning from Senator Elizabeth Warren, Dudley disputed the idea that the Fed, as banking regulator, should be a heavy enforcer of the banking laws. “It is not like a cop on the beat,” he said. “It is more like a fire warden” (Dealbook, 2014).

There is good reason to support Dudley in this conception of a bank-supervision-only mode for the Reserve Banks. The New York Fed served exactly this purpose during the financial crisis, as it had done before in previous crises. But there also is evidence that the New York Fed’s views of good bank supervisory practices don’t match those in Congress. Time and time again, the New York Fed has sought to ignore problematic behavior or affirmatively lobby against proposals for change. When the Fed’s Board of Governors and the Federal Deposit Insurance Corporation sought to finalize the rules limiting how much debt the world’s largest banks could carry—probably the most important regulatory change to follow the financial crisis—Dudley was by his own admission the courier of the banks’ arguments that such regulation (almost uniformly praised by economists on the left and right) would somehow limit the Fed’s ability to conduct monetary policy. While Dudley’s argument failed to carry the day, it did succeed in delaying the implementation of the rule by several months (Eavis, 2014). He has said that he merely meant to convey industry concerns, a curious point since industry insiders have been anything but silent on their opposition to these rules.

Consider, too, former New York Fed President and Secretary of the Treasury Timothy Geithner’s own admissions about the New York Fed’s failure to police the mortgage-backed securities markets at the heart of the financial crisis. “Ned Gramlich, a Fed governor in Washington, was already leading a process to examine excesses and abuses in the mortgage business serving lower-income Americans,” Geithner wrote in his memoir. “I was impressed by Gramlich’s work, and those issues seemed to be getting a fair amount of attention from the Fed in Washington. I didn’t want us to be like kid soccer players, all swarming around the ball. I wanted us to focus on the systemic vulnerabilities that were getting less attention—starting with our own banks, but looking outside them as well.” Like many New York Fed leaders before him, Geithner wasn’t as interested in policing Wall Street’s bad behavior; he was more interested in resolving its collective action problems.

But every town needs both a fire department and a police force. Perhaps there is an argument to be made that they shouldn’t be in the same building. But the civil enforcement of the banking laws is currently at the feet of the Federal Reserve Banks. Under their current governance system, they appear, in a word, “captured.” At the very least, “the optics of the institution’s governance,” as Geithner put it elsewhere, “are awful” (Geithner, 2014, pg. 88). The New York Fed’s proximity to the banks it regulates gives it the appearance of closeness that might prevent the kind of engagement needed to police bad behavior. The New York Fed has insisted that there is no such coziness, but the data suggests otherwise. (The banks’ CEOs are on the Reserve Bank’s board, and the bankers—through their representatives—assist in the supervision of the bank’s leadership.) The relationships between and among the CEOs and the New York

Fed's board, including those Class C directors not selected by the bankers, are many.<sup>31</sup> And while there are significant problems of measuring exactly what we mean by “capture” (Carpenter, 2013, pp. 3–4), there can be no doubt that the ties between the New York Fed and the banks it regulates make it a regulator unlike any other.

That uniqueness comes with benefits: the coordination function is an impressive one. There is almost no doubt that Geithner's work simplifying the clearing of derivatives contracts in the years leading up to the financial crisis dampened the consequences of that crisis. But it is not clear that private actors are incapable of providing that function themselves. It may simply be that, after so much use of the New York Fed's conference room, they may have come to rely on it.

The existence of a federalist central banking system served the purpose in 1913 of reassuring warring factions in a core dispute about American identity that neither the government nor the bankers would wield undue power to accomplish undue mischief. But as a federalist and institutional designer, Woodrow Wilson was no James Madison. Once the justification of ambiguous power sharing was removed, what defense of the quasi-private exercise of federal policy could there be?

The most obvious defense raised by economists is that the existence of nonpolitical appointees on the FOMC is itself an enhancement of the Fed's independence, and therefore a greater brake on a politicians' (or politicians' appointees) inflationary biases.<sup>32</sup> A growing empirical literature verifies that the Reserve Bank presidents tend to be more likely to dissent from a dovish consensus than political appointees (Thornton and Wheelock, 2014).

There are three problems with this hawkish defense of the Reserve Banks in their current form based in history, practice, and the availability of other alternatives. First, the leading theoretical text that seeks to give credit to the Fed's “founders” doesn't reflect the stunningly different monetary policymaking context that existed at the various legislative moments in 1913, 1933, and 1935. Faust (1996), for example, citing Kettl, ably summarizes some of the political considerations that motivated the coalitions behind the Federal Reserve System. But even these conclusions are vulnerable. As Broz (1997) thoroughly demonstrates, most of the attention in the pre-1913 political moment was on the international orientation that the Fed would take, facilitating the expansion of U.S. commerce in foreign markets. The structural decisions highlighted in Part I of this paper came in a Wilsonian attempt to declare victory for all.

The historical point is finer than that. As I have explored elsewhere (Conti-Brown, 2015a), the monetary policy context that existed under a gold standard and real-bills regime meant that the band of decision making we normally contemplate for central bankers—hawks and doves and owls and such—was simply not the relevant consideration.

This argument about history is fascinating for historians, but is distinct from the policy question of central bank design. Whether the mix of private and public appointees on the FOMC reflected the wisdom of

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<sup>31</sup> For specific work on the capture at the Fed, see Kwak (2013) and Acemoglu and Johnson (2012), which measure the value to firms affiliated either through the New York Fed or through common nonprofit board memberships with New York Fed President and Treasury Secretary designee Tim Geithner.

<sup>32</sup> The anchor theoretical paper here is Faust (1996).

some reified “founders” or an accident of historical contingency isn’t as interesting a policy question as whether that mix actually serves an anti-inflationary purpose. But this is where the empirical literature on FOMC hawkishness runs up against the hard realities of FOMC culture. Unlike other committees tasked with deciding extraordinarily contentious questions of federal policy—the U.S. Supreme Court comes to mind—the FOMC functions almost exclusively by consensus. There are simply too few dissenting votes to give us much confidence in the hawk versus dove tendencies of the Reserve Bank versus Board members of the FOMC. For example, Thornton and Wheelock (2014) estimate on average one dissent per meeting between 1948 and 2014, with only six in the period between 2005 and 2008. Some scholars have begun to employ, very profitably, content analysis on the FOMC transcripts to get a better sense of inflationary preferences that don’t terminate in dissent (Schonhardt-Bailey, 2013). But even here, the culture of consensus tells us less about how Reserve Banks shape the outcome of monetary policy decisions. This seems to be little more than an assertion that it should be obvious that banker-appointed representatives will favor tighter money than would political appointees. The logic here is often repeated, but is a fragile one.

Finally, there is the availability of other alternatives. If the concern is that changes to the appointment structure of the Reserve Bank presidents, or even their removal from the FOMC, would make the Fed more inflationary in its monetary policy decision making, then there are a wealth of other options available to anchor the Fed to a predefined inflationary path. Taylor Rules, inflation targeting, consequences for failure to meet targets, and any number of other alternatives would be superior to the wing-and-a-prayer method of hoping (most) of the Reserve Bank presidents will (always) be more hawkish on the FOMC in a way that will effect policy outcomes.

### **THE RESERVE BANKS AND EXECUTIVE CONTROL OF FEDERAL POLICY: THE FED’S CONSTITUTIONAL PROBLEM**

The problems of the Reserve Banks continued participation in national policy also presents a question of constitutional law. In short, the U.S. Supreme Court has concluded that Congress can create some kinds of “independent” agencies, but doesn’t have carte blanche in institutional design. Under a straight-forward reading of the Court’s most recent decision on this front, the Reserve Banks—at least in their participation on the FOMC—are probably unconstitutional.

In administrative law—the law governing the internal and external relationships among and between government agencies and other parts of the government and private actors—“agency independence” means something very specific. It is a “legal term of art in public law, referring to agencies headed by officials that the President may not remove without cause. Such agencies are, by definition, independent agencies; all other agencies are not” (Gersen, 2010, pp. 347–48). Thus, “agency independence” in administrative law is not concerned with independence in the sense that we have been using it—that is, the shape of the space within which an agency operates—but only whether the President can summarily fire the person in charge of the agency.<sup>33</sup>

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<sup>33</sup> Of course, one legal feature is not enough to tell us much about the operational independence of an agency, including, and perhaps especially, the Federal Reserve. Because of this narrowness, there is near scholarly unanimity

To understand more, we need to unpack the legal doctrine a little more thoroughly.<sup>34</sup> Over the course of about 80 years, courts have developed a set of rules that guide how and whether Congress can make it hard for the President to fire government employees. Most relevant to presidential control of the Federal Reserve, the Supreme Court held in 1935 that Congress can create agencies to “perform . . . specified duties as a legislative or as a judicial aid”—that is, independent commissions like the Federal Trade Commission—and, to enhance the independence of those kinds of agencies, Congress can limit the President’s ability to fire members of those commissions (*Humphrey’s Executor v. United States*, 1935, pp. 627-28). Decades later, the Court extended that kind of protection to lower-level executive appointees like independent counsel (*Morrison v. Olson*, 1988), but not if the chief of a department and the lower-level appointee are both protected by for-cause removability protection (*Free Enterprise Fund et al. v. Public Company Accounting Oversight Board et al.*, 2010). That is, the Constitution—as interpreted by the Supreme Court—forbids Congress from making the President reach through more than one level of “for-cause” removability protection. In other words, Congress can insulate an officer from (1) getting fired for any or no reason, or (2) getting fired—again, unless for good cause—by another principal officer, so long as that officer is herself subject to direct Presidential supervision. No nesting of such protections is allowed. That is, Congress cannot insulate both an officer and her superior officer from firing at will.

### *Removability and the FOMC*<sup>35</sup>

It is the presence of the Reserve Banks on the FOMC that creates constitutional problems, both with respect to their appointment on the one hand and removability on the other.<sup>36</sup> The Reserve Bank president, in her rotating capacity as a member of the FOMC, is exercising the power of the federal government. While the Board of Governors certainly supervises the Reserve Banks in other respects, as provided by statute (for example, 12 U.S.C. § 301), as members of the FOMC, Reserve Bank presidents’ votes count the same as those of their would-be superiors, the President-appointed, Senate-confirmed board governors.<sup>37</sup>

First, the President does not appoint, and the Senate does not confirm, the Banks’ presidents. (Note that while the statute does not require that the Reserve Bank representative be the president, the president is in practice almost always the Bank’s representative on the FOMC. See 12 U.S.C. § 263[a]). As discussed above, the Reserve Bank presidents are appointed by two-thirds of the bank’s directors, subject to approval of the Board of Governors. The President never

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that the removability focus is something of a fetish. For a review of the legal scholarship literature, see Conti-Brown (2015a).

<sup>34</sup> A mountain of detail is missing here. For more, see Huq (2013); Barkow (2010); and Vermeule (2013).

<sup>35</sup> Similar arguments are made in this essay: Conti-Brown (2013). For more on this topic, see Zaring (2015)

<sup>36</sup> More detail on these constitutional questions can be found in Conti-Brown (2015a).

<sup>37</sup> There does remain the question of whether monetary policy is, in fact, federal policy of the kind that will trigger Appointments Clause concerns. The answer is unquestionably “yes.” The very foundation of the Federal Reserve System presupposed the inability of private systems such as the clearinghouse model in place prior to the Federal Reserve System, to manage financial crises in a sustainable way. Some governmental structure was necessary. If that was true in the monetary conditions of the early 20th century, it would be beyond dispute in the vastly more complicated, and vastly larger, monetary context of the early 21st century.

formally indicates any preference for their appointment to their posts at the Reserve Banks, and their role within the FOMC is determined by statute (12 U.S.C. § 263[a]).

Second, the President has no authority to remove members of the FOMC qua members of the FOMC, just as he has no power to appoint members of that committee. He appoints, and the Senate confirms, the seven members of the Board of Governors, who are statutorily members of the FOMC. We already know that board members are removable “for cause” only (12 U.S.C. § 242). But the Reserve Bank presidents are removable at the pleasure of the Reserve Bank directors. Removal of all of those directors is possible by the Board of Governors, but only after “the cause of such removal” is “forthwith communicated in writing by the Board of Governors of the Federal Reserve System to the removed officer or director and to said bank.” While there is some ambiguity as to whether “the cause” of such removal is equivalent to “for cause” removal, the inclusion of the term “cause” may be sufficient to trigger that presumption.

In other words, there is something of a Russian doll problem of precisely the type prohibited by the Supreme Court. If the U.S. President wants to remove, for example, the president of the Federal Reserve Bank of New York from her role on the FOMC, he must:

1. Ask the governors to fire the New York Fed president, instructing them that he will deem their failure to comply with the request as “cause” for their own termination. The President must send this message not to the chair alone, but to all seven governors.
2. The governors would have to turn to the New York Fed’s directors and say that they will be removed if they fail to fire the Reserve Bank president, as the President requested, and that such cause for firing the Reserve Bank president would be “forthwith communicated by writing,” as required by statute.
3. The New York Fed’s directors—all three classes, not just the ones that appointed the Reserve Bank president in the first place—would then have to fire the Reserve Bank president, who is removable at the pleasure of the board. In other words, the bankers’ representatives would have to agree that the Reserve Bank president’s failure to honor the U.S. President’s policies—not their own—was sufficient for the Reserve Bank president’s removal.

It is precisely this kind of nested removability problem that the Supreme Court has determined violates constitutional principles of separation of powers. In *Free Enterprise Fund v. PCAOB*, the Court addressed a structure that Congress created to combat the excesses that led to the accounting scandals at Enron, WorldCom, and the like. Congress created the Public Company Accounting Oversight Board (PCAOB) as an independent agency within the independent Securities and Exchange Commission (130 S. Ct. 3138, 2010). To protect the PCAOB’s

independence, Congress protected the board members from arbitrary removal by the SEC, which was in turn protected from arbitrary removal by the President.<sup>38</sup>

The Supreme Court ruled that this double layer of removability was unconstitutional. Writing for the five-justice majority, Chief Justice John Roberts held “that such multilevel protection from removal is contrary to Article II’s vesting of the executive power in the President.” He continued: “The President cannot ‘take Care that the Laws be faithfully executed’ if he cannot oversee the faithfulness of the officers who execute them” (130 S. Ct. 3138, 3147, 2010). One layer of removability protection passed constitutional muster; two did not.

Restating the holding in *Free Enterprise Fund*—that Congress cannot create an agency that is insulated by two levels of removal protection—reveals the constitutional defect of the FOMC. The President cannot remove bank president members of the FOMC without reaching through two explicit for-cause removal restrictions, on top of a third layer of at-will removability: from the U.S. President, to the Board of Governors (layer 1), to the Reserve Bank board of directors (layer 2), to the Reserve Bank president (layer 3). Granted, the relationships among the three layers in the FOMC and the two in the SEC-PCAOB are different—the bank presidents and the governors are colleagues on the FOMC, rather than separate, ostensibly hierarchical entities. But these differences don’t matter constitutionally. If the Reserve Bank presidents are “principal officers” in their capacity as members of the FOMC (as defined by the U.S. Constitution and the Supreme Court), then they, too, must be subject to the constitutional requirements of the Constitution’s Appointments Clause. In either case, as currently designed, the Federal Reserve is unconstitutional. The separation between the U.S. President and the Reserve Bank presidents on the FOMC is simply too great.<sup>39</sup>

It is a conceivable constitutional defense of the FOMC structure that the board of governors—each member of which is in possession of a presidential commission and a Senate confirmation—constitutes a numerical majority of the FOMC. On that argument, so long as the majority holds, the requirements of public vetting and confirmation are satisfied. The Reserve Banks aren’t creating federal policy because they are outnumbered by those Presidential appointments who are.

This is not a compelling argument. As a formal matter, if the authority exercised is federal, and the officer exercising the authority is a principal one, the inquiry should be over. The presence of public actors exercising constitutional power doesn’t erase the unconstitutionality of private actors exercising the

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<sup>38</sup> Ironically, the SEC commissioners were only “independent” in this sense because the Supreme Court assumed they were so (130 S. Ct. at 3148-49). See Vermeule (2013) for a discussion of this convention of independence in administrative law.

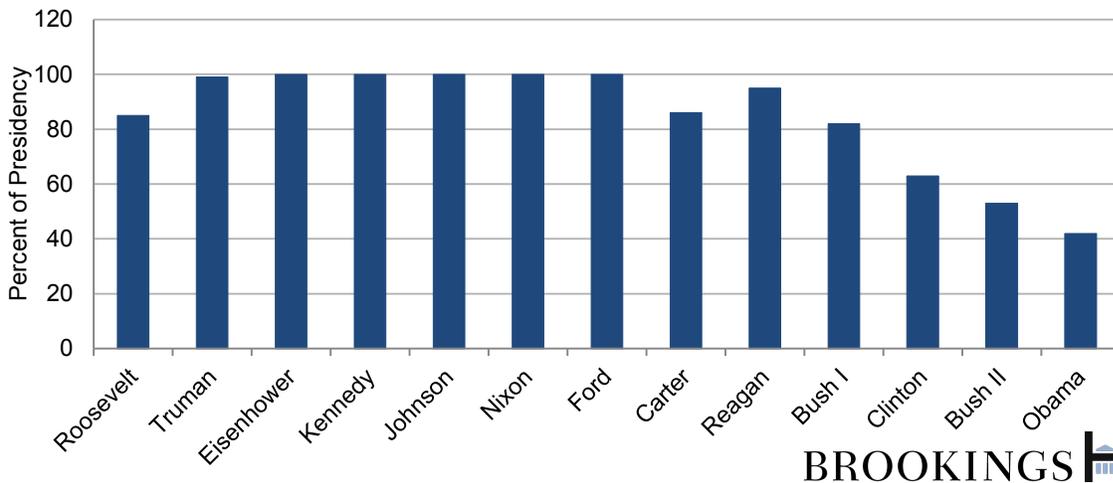
<sup>39</sup> Interestingly, there is little chance this unconstitutional structure will be challenged in court, because of doctrines of justiciability created precisely to prevent this question from being adjudicated. The issues of the Fed’s constitutional structure were litigated extensively in the 1980s, but never reached the merits stage. For more, see Conti-Brown (2015a).



equivalent power. But it may be more promising, functionally: if the purpose of a constitutional limit on private exercise of federal power is public accountability, then a governor majority on the FOMC should be sufficient to keep that private power in check.

But it does raise this question: How often have the governors enjoyed a majority? Figure 1 shows the historical trend.<sup>40</sup> After the newly created Board of Governors slowly displaced the abolished Federal Reserve Board during the last 10 years of the Roosevelt administration, the governors enjoyed a majority nearly 100% of the time, from 1945 until 1977. The majority fell to parity, and never lower, for just 16 days in 32 years. In the Carter administration, things started to slide. Carter’s appointees (and their predecessors) on the board held an FOMC majority about 85% of the time, but that majority was back up above 90% during the 8 years of the Reagan administration. The slow descent began after that, culminating in the Obama administration’s abysmal record at 42%. That is, private bankers effectively held a majority on the FOMC 58% of the time. The Obama administration holds another ignominious record touching on the constitutional debility of the FOMC: it is the first administration to take the governors to a four-to-five minority, as opposed to parity, which it has done three times (Board of Governors of the Federal Reserve System, 2015).

Figure 1: Governors' Majority on the FOMC



The governors’ majority is not stable on the FOMC. This reality—especially given the expectation of continued vacancies in the end of an administration<sup>41</sup>—represents a sea change over two generations. It also means that any defense the seven-to-five public majority on the FOMC has enjoyed is no defense at all.

This romp through the constitutional law of the Reserve Bank presidents’ appointment and removal may seem like a side show to our inquiry into the nature of the Fed’s independence, accountability, and governance, but it is in fact central to understanding where the Reserve Banks reside within government

<sup>40</sup> Author first introduced these ideas in Conti-Brown (2014a)

<sup>41</sup> For a thorough exploration of vacancies in administrative agencies, see O’Connell (2009).

and how the law protects that status. It is the fascinating story of an unconstitutional statutory structure that raises the potential of policy mischief.

It also raises this question: If the Reserve Banks are bad for policy and bad for constitutional law, why haven't they already been abolished? In a word, politics. Even though the Fed's popularity (usually expressed through the person of the Fed Chair) has plummeted since the financial crisis began, the Reserve Banks represent a buffer between the political forces that would reshape the Fed most completely.<sup>42</sup> This is political protection not only for the Reserve Banks themselves, but also represents a significant source of the Fed's general political protection from members of Congress.

The political power of the Reserve Banks comes from the structure of their own, individual governance. Recall the three-class structure of each Reserve Bank board. A similar structure exists for the 24 branches of the 12 Reserve Banks. Four board members are appointed by the Reserve Banks (through their own boards of directors), while three are appointed by the Board of Governors in Washington, DC (again, in informal consultation with the Reserve Bank and its leadership).

In each case, the directors are leaders in their community. They are the presidents of banks and universities, CEOs of major corporations and nonprofits, union leaders, and museum presidents. In the event that the Fed is threatened, or, indeed, that the Federal Reserve Banks are threatened, there stands a ready-made, broadly distributed constituency of Fed defenders ready to engage their Senators in defense of the system.

This is not speculative. The Reserve Banks have used this political power to great effect. The case in point is in the recent lead-up to Dodd-Frank. Senator Dodd sought to remove bank supervision from the purview of the system for the majority of banks, and included that provision in the version of the bill reported out of committee. The Board of Governors was indifferent to the continuing regulation of the smaller banks. But in time, the Reserve Banks made their presence felt. The final version of the bill, while it limited some of the Fed's authority to make emergency lending decisions, left the supervisory bailiwicks of the Reserve Banks intact while it massively expanded the authority of the Board of Governors. The amendment that restored that supervision, sponsored by Texas Republican Kay Bailey Hutchison and Minnesota Democrat Amy Klobuchar, passed 91 to 8, just barely less popular than an amendment that eliminated what Republicans had characterized as a permanent bailout fund (Kaiser, 2013, pg. 304).<sup>43</sup>

The Reserve Banks, as a matter of politics, are almost certainly here to stay. And they influence the practice of systemwide independence in important ways. They make the practice of bank supervision and the enforcement of bank regulation—delegated as those are to the Reserve Banks by the Board of Governors—a process largely removed from the public eye. They are a layer of protection against public attempts to wrest control of financial regulation from private interests. From a policy perspective, that

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<sup>42</sup> See Conti-Brown (2015b) for discussions of the public's approval rating of the Fed (in 2009, it was the second worst of federal agencies measured; the IRS took the cake). In 2005, the Fed's approval rating was overwhelmingly high.

<sup>43</sup> See Irwin (2013, pp. 192–197) for the full account of the Reserve Banks' lobbying effort, including via the deployment of the member banks. See also Kaiser (2013, pg. 306).

proximity can be useful in some cases, destabilizing in others. But from a governance perspective—from the perspective of the structure of Federal Reserve independence—the net effect of the Reserve Banks’ place in the Federal Reserve System is a scrambling of lines of accountability. The Reserve Banks’ role in shaping the space within which the Fed makes policy makes the Fed increasingly illegible to the outside public.

### CONCLUSION: THE FALSE PROMISE OF A FEDERALIST RESERVE

We think of the Reserve Banks as an addition to the Federal Reserve Act of 1913 created to thread the needle between governmental and private control. This isn’t correct, chronologically. The Reserve Banks were always with us; it was the Federal Reserve Board that was added in the 11th hour. At the time, the dominant conception of central banking was the private function: the Federal Reserve Board was the new creature, not the Reserve Banks.

But they were intended to devolve control away from New York City and from Washington, DC. Their existence is what made the Reserve System *federal* (rather than the originally proposed *national*). But the federal aspect was misleading, even from the beginning. The banks’ very locations reflected not a federal union between state and national governments, but political compromises concerning an America that no longer exists. Leave to the side the 50 state governments served by 12 Reserve Banks: a new Reserve System with 12 banks created in 2013 would certainly include New York, Chicago, and San Francisco; would probably include Philadelphia, Boston, and Atlanta; might include Minneapolis, Dallas, and St. Louis; and would probably not include Cleveland, Kansas City, and Richmond (Binder and Spindel, 2013).

Whatever the federalist intentions of the first framers of the Federal Reserve System, Congress and central banking practice have largely left that vision behind. Time and experience left behind this private model. Central banks evolved and became primarily public-facing institutions (Goodhart, 1988). The ambiguously public-private Reserve Banks have remained—for better and worse—largely based on their political connections, not their functional utility.

## III. REFORMING THE RESERVE BANKS

In the summer of 2013, the uncertainty around Barack Obama’s second appointment to the Fed Chair (after he reappointed Ben Bernanke in 2010) generated an unusually large amount of political chatter. This chatter was, to great extent, personality driven: forces organized in opposition to the appointment of Lawrence Summers—former Treasury Secretary, President of Harvard, widely respected economist, and close economic adviser to President Obama. There was no question as to Summers’s qualifications as an economist, but Summers had made personal enemies and alienated constituencies, which then rallied to defeat his candidacy in favor of Janet Yellen, another eminently qualified candidate who had served three times on the FOMC.

Some found this personality frenzy, which started to look more like a Supreme Court confirmation than a routine technocratic appointment, distasteful. *Washington Post* columnist George Will wrote that “the campaigning by several *constituencies* for and against what supposedly were the two leading *candidates*—Larry Summers and Janet Yellen—to replace Bernanke as chairman of the Federal Reserve”

meant that the Federal Reserve “can no longer be considered separated from politics” (Will, 2013). And Glenn Hubbard, a former economic adviser to President George W. Bush and himself once a leading candidate for the Fed Chair, thought the political attention to Obama’s decision something of a disgrace: “In place of this serious discussion, the White House has allowed, if not orchestrated, a circus campaign of personality” (Hubbard, 2013).

But Will and Hubbard are wrong. Whether one was part of Team Summers or Team Yellen, the attention to the Fed Chair brought a tremendous amount of insight and political attention to the placement of the personalities who lead the Fed and its many sometimes conflicting missions. Indeed, because law can be so slippery, the selection of personnel is the best hope for ensuring appropriate political participation. For those who despise political gridlock and mock the uselessness of U.S. democratic institutions, the sight of a public vetting of political appointees may be distasteful. But for those who accept the idea that the very opacity of the Reserve Banks, their very connections to the private banks they regulate, represents a threat to the Fed and its independence, then the proposal to change their appointment structure—including by introducing more, not less, public participation in their selection—will be very appealing.

These issues of determining the appropriate role for nonelected officials to participate in the political life of a society are some of the perennial questions of government theorists. Once we accept that there is a role to play for government in implementing policies that redound to the social good—a sometimes contested proposition, but one that enjoys relatively widespread support—we must answer two additional questions: (1) How will those governmental agents be selected?, and (2) Will their policies reflect that “social good,” or some other set of values?

This is the fundamental question for the Reserve Banks’ continued participation in the formulation of the nation’s banking and monetary policies. As explained in this paper, the Reserve Banks—especially the Federal Reserve Bank of New York—have the potential to make policy and constitutional trouble. Reforming the Reserve Banks by revisiting the question of the appointment of their leaders should be the top priority of any politician who wants the system to conform to constitutional requirements and to allow meaningful democratic accountability.

The constitutional and policy problems with the Reserve Banks are in the nature of their appointment and restrictions on their removal. There are four alternatives for resolving this problem: (1) render the Reserve Bank presidents removable by the board, satisfying the constitutional requirement as articulated by the U.S. Supreme Court, but still appoint them largely by private bankers; (2) make the U.S. President responsible for appointing the Reserve Bank presidents; (3) make only the president of the Federal Reserve Bank of New York a Presidential appointment, or most convincing, (4) make the Board of Governors responsible for *both* appointing *and* removing the Reserve Bank presidents. Let’s take each in turn.

First is the fix apparently favored by the Supreme Court. This refers to the Court’s conclusion in *Free Enterprise Fund* that the Constitution permits restrictions on the President’s ability to fire subordinates only one level down. The removability restrictions at the board level are permissible, but not at the level of the Reserve Banks. The solution is to excise from the statute any language that would prevent the

Board of Governors from firing the Reserve Bank presidents at will.

If the FOMC removability issue were ever litigated to conclusion, the result might be the same.<sup>44</sup> The members of the FOMC not appointed by the President would be rendered removable at will by the Board of Governors, just as the governors supervise the Reserve Banks in every other aspect of the Fed's wide regulatory berth. And, also following *Free Enterprise Fund*, that removability would immediately render them Appointments Clause-approved inferior officers (*Free Enterprise Fund v. PCAOB*, 2010).

Some defenders of the present configuration may say that such a change would have a chilling effect on the FOMC conversations or votes. Would Jeffrey Lacker or Richard Fischer or Thomas Hoenig dissent, as they have done, if the board could remove them for any reason at all?<sup>45</sup> It's impossible to speak with certainty to the counterfactual, but the public outcry that would result from the exercise of that legal authority is likely all the protection that people like Lacker, Fischer, and Hoenig would need. This is perhaps the greatest problem with the focus on removability as the watchword of independence: formal protection against removal isn't necessary to make a removal decision controversial. President George W. Bush and Attorney General Alberto Gonzalez suffered after firing nine U.S. attorneys (who had no tenure protection), as did President Richard Nixon and Solicitor General Robert Bork, after they terminated the at-will service of Special Watergate Prosecutor Archibald Cox. The summary firing of at-will employees of the executive led to the ouster of an Attorney General and, in part, the resignation of a President.

While the *Free Enterprise Fund* fix might satisfy the court's requirements, it is not a very satisfying result in terms of democratic governance. The focus on personnel is not on their removability, but on their appointment. And the basic problem of appointment at the Reserve Banks is the dramatically disproportionate influence that regulated banks have on the people who become their overseers. From the perspective of democratic accountability, banker influence at the appointment threshold is the real issue.

The second alternative is the perennial proposal to vest the appointment of the Reserve Bank presidents in the U.S. President, with the Senate confirming those appointments. This would resolve absolutely the constitutional issues of appointment and removal. And the statute could be clarified to demonstrate a hierarchy in nonmonetary policy, placing the Reserve Banks under the supervision of the board. But this would also allow the Reserve Banks to remain on the FOMC as equals to the governors. Given the diversity of their views, this seems a promising reform.

Of course, the recent trend toward failing to fill the appointments on the Board of Governors may suggest that the fate would be the same for the newly installed Presidential appointments at the Reserve Banks, as discussed above. This possibility also points toward rendering the Reserve Banks fully accountable to the Board of Governors. At the same time, it is not likely that we would see the same vacancy rates at the Reserve Banks as we have at the Board of Governors, for two reasons. First, filibuster reform made it much harder for the minority party to block presidential nominees. And second, the vastly expanded Senate franchise at the Federal Reserve might make Reserve Bank presidents look more like ambassadors

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<sup>44</sup> See, for example, *Intercollegiate Broadcasting System, Inc. v. Copyright Royalty Board*, (684 F.3d 1332, 1334, DC Cir., 2012), which found a similar institutional defect and followed the *Free Enterprise Fund* court in judicially reconstructing the relevant statute.

<sup>45</sup> For an explanation and defense of these dissents, see Hoenig (2011).



or U.S. attorneys, positions that don't usually attract the same kinds of partisan political attention we associate with Senate gridlock. Even so, this concern is enough to weigh against a policy proposal in favor of rendering the Reserve Banks presidential appointments.

There's another reason why making the heads of the 12 Reserve Bank Presidential appointments seems a misplaced policy. It would almost be sentimental. If all members of the FOMC become Presidential appointments, the value of a 19-person committee must come from something other than the process of their appointment (the strongest justification under the current arrangement). If the problems that inhere to the other proposed alternatives are enough to defeat those proposals—that is, to subject the Reserve Bank presidents to board removal, or board appointment and removal—it may be appropriate to entertain the idea that motivated Marriner Eccles back in 1935: removing the Reserve Banks entirely from the world of making policy. The Reserve Banks could continue to exist as branch offices of the Federal Reserve in the 12 cities where they are located, but they would not participate on the FOMC. And, consistent with Carter Glass's original conception, the Fed could then expand its presence even more evenly to other cities, even removing regional banks from places where they no longer serve a useful purpose. That way, we could revisit some of the decisions about the design of the system that were curious even in 1914 when they were decided: Do we really need two Fed branches in Missouri, and only one west of Dallas?

Third, Senator Jack Reed (D-RI) has proposed making only the president of the Federal Reserve Bank of New York subject to Presidential appointment and Senate confirmation. While the Federal Reserve Bank of New York and its president are by far the most important players in the system from both banking and monetary policy perspectives, this may not be the best approach. There are three reasons to be skeptical. First, it does nothing to the constitutional defect. It's all fine and good to have the vice chairman of the FOMC (by tradition, the New York Fed president) subject to Presidential appointment, but what of the others? Second, there are worrisome implications for strategic behavior by banks seeking more sympathetic regulatory treatment by changing their seat of incorporation out of New York and into another district. This wouldn't mean many jobs would leave New York, or that New York would cease to become a global capital. It would just mean that banks would comply with the legal requirements to move their identity to a more sympathetic Federal Reserve District where they could have a say in selecting their regulatory overseer. And finally, despite its centrality, New York isn't the only banking center interest in the United States. Wells Fargo and Bank of America are each banking juggernauts. Is it really reasonable to say that their regulators don't need to be subject to Presidential appointment? For these reasons, an "all or nothing" approach is best: approach. Either make the full slate of Reserve Banks fully subordinate to the Board of Governors, or make them all equals by way of Presidential appointment.

And finally, there is the best proposal: Vest the appointment and removal of the Reserve Bank presidents in the Board of Governors.<sup>46</sup> Here, the constitutional problem is resolved: there would no longer be multiple layers of removal protection, nor a complicated asymmetry in the appointment and removal

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<sup>46</sup> The Federal Reserve Act does give the Board of Governors approval over the appointment of the Reserve Banks. While there are anecdotal reports about the frequency with which the board exercises this veto, this still needs to be confirmed systematically. "The president shall be the chief executive officer of the bank and shall be appointed by the Class B and Class C directors of the bank, with the approval of the Board of Governors of the Federal Reserve System, for a term of 5 years" (12 U.S.C. § 341).

dynamic. In that sense, the change would complete the revolution in central banking design that Marriner Eccles began 80 years ago.

This solution does present something of a quandary. If the Board of Governors fully appointed, and could remove at will, the Reserve Bank presidents, what would be the point of the 19-person FOMC at all? Wouldn't this just make the Federal Reserve Bank president a member of the Fed's senior staff? And why give them votes on the nation's monetary policy?

The answer to these questions seems obvious. Making the Reserve Bank presidents fully subject to board appointment and removal would also mean the abolition of the FOMC and the consolidation of all the Fed's legal authority at that board. As mentioned earlier, even for those who favor the mixed committee system as a check on inflation, there are sharper ways to accomplish this task. It's unclear what we gain by having such an unwieldy committee.

One argument in favor of retaining the current committee size is that each Reserve Bank president comes equipped to FOMC meetings, at least in part, with research conducted independent of the board's own staff assessments. But this feature of the Fed's dispersed research function is preservable, if it is indeed desirable. That is, governors can gain better access to staff assessments, rather than consume only the options the chair has shaped with the staff ahead of FOMC meetings. In other words, getting diversity of research views presented at the FOMC is not tied to the existence of a 19-person committee.

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It appears that the worst of the financial crisis may be behind us. Maybe. The world of international central banking continues to test our very conceptions of the governance, independence, and accountability of these peculiar institutions. There will almost certainly come a time when we will once again need the Fed to make unpopular decisions for the sake of the global financial system. Whatever value the Reserve Banks offer—and it is not nothing—the costs of the opacity of the system, the conspiracy theories they inspire, and the real challenges they offer to our constitutional order make their continued existence, in present form, a challenge. In this way, the Reserve Banks may be like the gallbladder of the American financial system. They serve a useful purpose, albeit not an essential one. But they can threaten the entire system in the wrong circumstances. Reconfiguring their appointment process has been a perennial proposal. It remains a very good one.

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