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# Federal Reserve Structure and Economic Ideas

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**Federal Reserve Structure and Economic Ideas**

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**Abstract**

This essay was written in memory of Marvin Goodfriend for a Federal Reserve Bank of Richmond book called *Essays in Honor of Marvin Goodfriend: Economist and Central Banker*. We discuss his Carnegie-Rochester conference paper titled "The Role of a Regional Bank in a System of Central Banks." In that paper, Marvin argued that the Federal Reserve's decentralized structure allowed for competing ideas about monetary and banking policy to develop with the central bank. In our essay, we describe how Marvin demonstrated this argument during his long career at the Federal Reserve Bank of Richmond. We also describe the institutional developments that led to this competition, including reforms that Chairman William McChesney Martin made to the operation of the Federal Open Market Committee in the 1950s and the introduction of monetary policy ideas such as monetarism and rational expectations by the Reserve Banks.

Keywords: Federal Reserve structure, monetary policy, governance, Marvin Goodfriend
JEL Codes: B0, E58, G28, H1

Marvin Goodfriend's essay "The Role of a Regional Bank in a System of Central Banks" was written for the November 1998 Carnegie-Rochester conference series on public policy. [2] The title of the conference was "Issues Regarding European Monetary Integration," which

[1] This essay was prepared for a Federal Reserve Bank of Richmond (FRBR) project called "Marvin Goodfriend: Economist and Central Banker" and will be published in a May 2022 FRBR book titled *Essays in Honor of Marvin Goodfriend: Economist and Central Banker*. We would like to thank the editors of the book, Bob King and Alex Wolman, for helpful comments. The views expressed in this essay are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or the Federal Reserve System.
[2] See Goodfriend (1999a). Marvin's essay was also reprinted in the Federal Reserve Bank of Richmond's annual report in 1999 (Goodfriend, 1999b).

focused on the European monetary union experiment that was just underway at the time.[3] Marvin's essay was about the institutional design of European monetary institutions. His strategy was to describe the partially decentralized structure of the Federal Reserve System, laying out the respective roles of the headquarters in Washington and the regional Reserve Banks, and then to use the American experience to provide lessons for the newly formed European system. The analogy was apt due to the strikingly parallel structure of the nascent European monetary institutions with a headquarters institution — the European Central Bank in Frankfurt — and numerous regional institutions in the form of the preexisting national central banks.

While ostensibly about the design of the European monetary system, the essay is also a statement of Marvin's views about the proper role of a central bank and a defense of the federal structure of the Federal Reserve System. The decentralized structure of the Federal Reserve periodically comes under attack from various interests that want a centralized, less federal system. Marvin's essay provides an important antidote to these attacks by laying out the many advantages of the federal system.

In the essay, Marvin stated his philosophy of how a central bank should operate:

> "The overarching principle is that a central bank should provide the necessary monetary and financial stability in a way that leaves the maximum freedom of action to private markets. In keeping with this principle, monetary policy is implemented by direct means, with an interest rate policy instrument rather than with direct credit controls. In the banking sphere every effort is made to minimize as far as possible the regulatory burden associated with financial oversight."[4]

[3] The conference agenda is available at https://www.sciencedirect.com/journal/carnegie-rochester-conference-series-on-public-policy/vol/51/suppl/C.

[4] Goodfriend (1999a), p. 51.

He also stated what he believed a central bank needed to operate in this way: independence, credibility, and an ability to learn about economic ideas and markets. Furthermore, for the United States, he argued that the Reserve Banks played an important role in meeting these needs. He discussed how the Fed's decentralized structure enhanced credibility and supported independence because "… the diffusion of power makes it more difficult for outside pressures to be brought to bear on a central bank."[5] He also believed that the regional structure helped gather and disseminate information to the various regions of the United States and helped with bank supervision. Finally, he argued that "… a system of regional banks led by the center institution harnesses competitive forces to encourage innovative thinking within the central bank."[6]

In this essay, we discuss Marvin's last point. The other benefits of the Reserve Banks, while important, are already well known. However, the idea that the decentralized structure encourages innovative thinking is less appreciated, but it is, we think, one of the System's biggest strengths. In his essay, Marvin planted the seed for this idea.[7]

Furthermore, when it comes to innovative thinking, there is no better person to be honoring than Marvin. As we both know from personal experience, and many others know as well, Marvin was full of ideas. He thought for himself, followed economic logic to its conclusions, and was willing to advocate for his ideas even if they challenged central bank orthodoxy.

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[5] Goodfriend (1999a), p. 52.
[6] Goodfriend (1999a), p. 53.
[7] See also Wheelock (2000).

Marvin's intellectual contributions to central banking and monetary economics are well known, and many of them are described in companion essays in this volume. What we want to emphasize is how the semi-independence of the regional Reserve Banks allowed a creative thinker like Marvin to flourish and led to a transformation in thinking about policy both in the System and among central banks more generally. The key elements provided by a Reserve Bank were direct exposure to policy problems, via a Reserve Bank's role on the Federal Open Market Committee (FOMC) and in the banking and payment systems, and enough independence from headquarters so that ideas that challenged an existing orthodoxy could be developed, explored, and supported over time.

The most striking example of this institutional dynamic among Marvin's work is his 1986 *Journal of Monetary Economics* paper in which he derived from economic principles the costs and benefits of FOMC transparency.[8] While transparency is now taken for granted, it was not at the time. The prevailing central bank view was that secrecy was valuable for central banking, and, consistent with that view, the reaction from the Board in Washington to this publication was strong disapproval. However, since he was at the Richmond Fed, which supported him, his career in the Federal Reserve was not slowed down and he was able to flourish. The subsequent change in views by the Federal Reserve and the central banking community on transparency is a testament to the value of Marvin's insights and a prominent example of how an idea can develop from a Reserve Bank, gestate, and later lead to good reforms for the institution.

[8] See the essay by Lars Svensson in this volume.

It was no accident that during his time at the Richmond Fed, that bank developed a reputation for being independent within the System and its presidents dissented on numerous FOMC votes. Indeed, a creative economist like Marvin would probably have contributed far less to monetary policy if he had worked at a highly centralized institution. At a monolithic central bank, Marvin might not have even thought of proposing these ideas because they would likely have been stopped before seeing the light of the day.

While it is not unusual for an institution to have internal debate, it is unusual for an institution to allow some of that debate to appear in public. For this reason, we think there is some value to describing how the System evolved to the point where competing ideas could coexist and flourish.[9] The Richmond Fed was one of the early innovators in this evolution.

The Federal Reserve was designed as a decentralized institution in 1913, with 12 privately chartered Reserve Banks and a Federal Reserve Board in Washington, DC, that had limited oversight. The structure was explicitly designed to distribute power throughout the country. However, as with many other federal institutions, power was centralized by the Roosevelt administration during the Great Depression. The Banking Act of 1935 moved monetary policy primarily to the Board of Governors by creating the FOMC and increased the oversight of the Reserve Banks. However, Congress retained a role for the Reserve Banks by giving them, on a rotating basis, five of the 12 votes on the FOMC. Furthermore, it left the Reserve Banks' corporate structure with its unique quasi-public governance relatively untouched.[10]

[9] The subsequent analysis is based on Bordo and Prescott (2019).
[10] See Bordo and Prescott (2019) for details on Reserve Bank governance.

For the next 15 to 20 years, the Reserve Banks, other than New York, played a relatively minor role in monetary policy. This was partly because the Federal Reserve had become subservient to the Treasury in the 1930s under Secretary Henry Morgenthau and Chairman Marriner Eccles, who believed in fiscal dominance, and partly because, during World War II, the Fed accommodated Treasury's war expenditures by setting a low interest rate peg.[11] The subservience ended with the Treasury-Fed Accord of 1951, which gave the Federal Reserve monetary policy independence and made William McChesney Martin the Chairman of the FOMC.[12]

While the accord reasserted the Federal Reserve's independence, the role of Reserve Banks (other than New York) in setting monetary policy remained relatively minor. The FOMC met infrequently, and most decisions were made by an executive committee consisting of the Chairman, the New York Fed president, and a few other members. For a variety of reasons, including a battle for control over monetary policy with the New York Fed, Chairman Martin instituted reforms to the FOMC in the mid-1950s in which the executive committee was eliminated and decisions were made by the entire FOMC. This change in operating procedures gave the presidents of the other 11 Reserve Banks a more prominent role in monetary policy. Previously, their responsibilities focused on providing banking services and supervising banks in their regions.[13]

The other development at this time was external. Starting in the late 1950s, and even more so in the 1960s, the economics profession was becoming increasingly professionalized.

[11] Meltzer (2002).
[12] For more information about the accord, see Hetzel and Leach (2001a and 2001b) and Meltzer (2009).
[13] Business Week (1956).

Keynesian ideas about macroeconomic policy were developing in academia, young Ph.D.s were bringing these ideas into the Federal Reserve, and the FOMC was using more formal analysis. Furthermore, the Council of Economic Advisers under the economist Walter Heller was pushing to appoint Keynesian economists to the Board of Governors.[14] The result was an increased role for economists in leadership positions throughout the Federal Reserve.[15]

This change in the internal and external environments created the conditions that encouraged a Reserve Bank to innovate on monetary policy. The first innovator was President D.C. Johns of the St. Louis Fed. Johns felt that the Board was ignoring him and the other presidents, so in 1958, he hired Homer Jones, who had taught Milton Friedman, and soon that Bank became closely tied to monetarist ideas on monetary policy.[16] The Bank served as a conduit for the monetarist ideas of prominent economists such as Karl Brunner, Milton Friedman, Allan Meltzer, and Anna Schwartz, but it also made important monetarist contributions such as Andersen and Jordan's (1968) paper on monetary versus fiscal policy. A sequence of presidents and the leadership of the research department provided enough organizational continuity that the St. Louis Bank was able to support monetarist ideas through at least the 1990s. A progression like this could exist only with enough separation from Washington to develop and maintain independent ideas.

The next innovator was the Minneapolis Fed, which, starting in the 1970s, became closely associated with and contributed to the rational expectations and dynamic stochastic general equilibrium revolution in macroeconomics. Even more so than St. Louis, Minneapolis

[14] Bremner (2004).
[15] Whittlesey (1963).
[16] See Melzer (1989). Following D.C. Johns, President Daryl Francis, who served from 1966 to 1976, championed monetarist ideas at FOMC meetings.

was actively involved in the development of academic ideas, particularly rational expectations. Much of this work was done jointly and in partnership with the University of Minnesota, which was only about two miles away from the Bank. There are three especially notable examples. Tom Sargent and Neil Wallace worked on rational expectations while professors at the University of Minnesota and consultants with the Minneapolis Fed.[17] Ed Prescott's real business cycle methodology (developed with Finn Kydland) led to important changes in macroeconomic methods, and their identification of time-consistency problems with optimal macroeconomic policy led to a renewed emphasis on monetary policy credibility and the role that institutional structure plays in providing that credibility.[18] Chris Sims developed path-breaking time series methods.[19]

The monetarist ideas associated with St. Louis and the rational expectations ideas associated with Minneapolis gained increased attention in the 1970s due to the high inflation and other failures of the Keynesian ideas of the time. It was during this period of intellectual and economic ferment that Marvin was hired by the Richmond Fed in 1978. The late 1970s were a particularly auspicious time for an energetic and creative economist like Marvin to start at the Fed. Inflation was over 8 percent in 1978 and would reach 14 percent in 1980. Paul Volcker would become Chairman in 1979, and the FOMC would then start to dramatically raise the fed funds rate. The Monetary Control Act of 1980 would change the Federal Reserve's role in the payment system, and the increasing number of thrift and bank failures would highlight the importance of bank regulation, deposit insurance, and Federal Reserve lending facilities. It

[17] See, for example, Sargent and Wallace (1975, 1981).
[18] Kydland and Prescott (1977, 1982). Alesina and Summer (1993) showed that independent central banks did a better job of controlling inflation.
[19] Sims (1980).

was an exciting time intellectually to work on money and banking research, and it was an exciting time to do policy, and Marvin excelled at both.

The environment in Richmond when Marvin arrived was not that of a modern research department with an emphasis on academic publications, but it was moving in that direction. The intellectual interest was there. The president at the time was Bob Black, who was trained as an economist and had become sympathetic to monetarist thinking. His colleagues in the department included Al Broaddus, who led the macroeconomists and later became research director and then president; Bob Hetzel, who was a student of Milton Friedman's and a monetarist; and Tom Humphrey, who, with his background in the history of economic thought, was resurrecting intellectual interest in the Fed's role as lender of last resort by studying lessons from Henry Thornton and Walter Bagehot. When Marvin joined, the spark was lit for the department to take off.

With the support of an ambitious institution and amid the exciting intellectual debates at the time, Marvin thrived. Anyone who worked with him will remember his excitement when discussing economic ideas, or monetary policy operating procedures, or just about any other topic associated with the Fed. In these discussions, he consistently linked research and monetary policy.[20] Relative to St. Louis and Minneapolis, Richmond's innovation was to closely integrate research and the policy process. During Marvin's tenure at Richmond, this integration was best represented by his collaboration with Al Broaddus, who was president from 1993 to 2004. As Mark Gertler mentions in his essay in this volume, at the time Marvin may have been

[20] While Marvin is most associated with monetary policy, he also wrote on banking and payments policy (Goodfriend and Hargraves, 1983, and Goodfriend, 1990).

unique within the System in both actively doing research while also serving as the senior monetary policy advisor. [21]

The value of the St. Louis, Minneapolis, and Richmond models has been recognized within the System. Today, virtually every Reserve Bank has a thriving research department and to varying degrees policy and research complement each other in the way that Marvin exemplified.[22] Some Reserve Banks partner with local universities, and all of them interact with academics. There is a regular flow of ideas within the Fed and with the outside, and research results are actively part of FOMC discussions. For example, at a 2005 FOMC meeting, then-San Francisco Fed President Janet Yellen stated:

> "A considerable body of research—most conducted within the Federal Reserve System—has examined the possibility that the last recession and recovery were characterized by unusually large structural shifts, resulting in an exceptional degree of mismatch in the labor market. If an unusually small fraction of the currently unemployed are qualified for existing or emerging job vacancies, the true degree of slack in the labor market is overstated by measured unemployment. In effect, the NAIRU has risen. This possibility motivates one of the alternative simulations in the Greenbook. At the AEA [American Economic Association] meetings in Philadelphia last month, I chaired a session in which four teams of Fed economists subjected this structural-shifts hypothesis to close scrutiny. I emerged from this session a skeptic. I see this recent research as casting considerable doubt on the hypothesis that the jobless recovery was a period of pronounced economic restructuring."[23]

As we said earlier, Marvin took some controversial stands. In his case, we can see the important role of the Fed's structure in supporting debate and differing views. His work on

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[21] We don't want to give the impression that other Reserve Banks didn't develop ideas during this period as well. For example, in the late 1980s, Chicago became associated with deposit insurance reform and Cleveland became associated with inflation targeting. For more details and other examples, see Bordo and Prescott (2019).

[22] Marvin's innovations were also recognized internationally. For example, the European Central Bank asked him to undertake a review of their research activities (Goodfriend, König, and Repullo, 2004).

[23] FOMC Meeting Transcript, February 1-2, 2005, p. 87. https://www.federalreserve.gov/monetarypolicy/files/FOMC20050202meeting.pdf.

transparency challenged the orthodox view at the Board at the time, and his work would likely not have been published if he had worked in a more centralized institution. However, due to the Reserve Banks' structure, each with its own president and board of directors, the Richmond Bank was able to support him and keep him there, which was to the long-term benefit of the Richmond Fed and the System as a whole.

What is striking in rereading Marvin's essay is that his ideas are not just abstract arguments weighing the pros and cons of the System's structure. Instead, they are based on what he observed and experienced during his career. Those of us who were fortunate to have been able to talk over these and so many other topics with him, we deeply miss him.

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