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POLICY BRIEF

Governance and Diversity at the Federal Reserve

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The purpose of good governance is good outcomes. From that perspective, the recent surge in inflation and the Federal Reserve System's delayed response in 2021 and early 2022 must be central to any discussion of the future of Fed governance. Several Fed leaders have since expressed regret regarding the delay, and a strong case can be made that the Fed's decision to hold off responding was a significant error given what they knew at the time. For example, in a 2023 Brookings Institution conference paper, authors Gauti Eggertsson and Don Kohn argue that earlier recognition by the Fed of the seriousness of the inflation surge and earlier response to the surge likely would have dampened demand sooner, lessened the increase in inflation, and enabled a more gradual tightening of policy.[1]

Many factors have been cited as contributing to the Fed's disappointing performance—such as the effects of the revised framework document adopted in August 2020, the strong forward guidance provided in September 2020, and the overestimation of labor market slack in 2021. Could the recent evolution of Fed governance practices also have contributed to the Fed's poor performance? I would argue that this possibility is worth serious consideration. In particular, I would point to the change in the role of the Board of Governors of the Federal Reserve System in the search for Federal Reserve Bank presidents, the seemingly shifting norms around public dissension by Federal Open Market Committee (FOMC) participants, and the nature of the Board's entanglement in the legislative response to the COVID-19 pandemic.

EVOLVING GOVERNANCE AT THE FEDERAL RESERVE

In the final paragraph of their report, Eggertsson and Kohn note that despite challenges facing Fed policy making in 2021 and 2022, "no FOMC voters dissented between September 2020 and June 2022, raising questions about whether Committee discussions and decisions were being sufficiently challenged by diverse viewpoints."[2] Not only were formal dissenting votes largely absent during a period of widely divergent views among economists outside of the Fed, but also few FOMC members expressed differing views in their public speeches and interviews. That there was so little public display of divergent views from Committee participants is striking.

The paucity of evidence of diverse views within the FOMC in recent years continues a longer-run trend. Dissents by members of the Board of Governors virtually disappeared in the late 1990s.[3] Although dissents by Reserve Bank presidents also fell after the 1990s, such dissents became frequent again during and after the 2007–2009 recession, which might have been expected given the Fed's innovative and controversial credit market interventions at that time. But since then, the frequency of per-meeting dissents has been declining. Compared with the years 2010 through 2014, the number of dissents per meeting from 2015 to 2019 was 45 percent lower and has been 88 percent lower since 2020. I think it's fair to say that public expressions of alternative policy perspectives by Committee participants have also declined since 2010.

I have two conjectures about what might explain the decline in the apparent diversity of views. Both have to do with the Fed's governance practices, broadly construed, and both deserve careful reconsideration by the Fed's leadership in the wake of this episode. My first conjecture is that a change in the Board of Governors' role in the Reserve Bank presidential search process since 2010 has resulted in a change in the profile of Reserve Bank presidents and a reduction in diverse views around the table.

Reserve Bank presidents are appointed by nonbanker directors of their respective Reserve Banks "with the approval of the Board of Governors."[4] In the 2000s, the Board would play a relatively hands-off role until the end of the search process, after the Reserve Bank had settled on its desired candidate. The governor serving as chair of the Bank Affairs Committee (a group of governors responsible for overseeing Reserve Bank operations) would generally be the point of contact with the Reserve Bank's board. The head of the Reserve Bank search committee, typically the board chair, would check in periodically by phone and provide progress reports. After the Reserve Bank had decided on a presidential candidate, the Board of Governors would be informed, allowing it to weigh in before the candidate's name was formally voted on by the Reserve Bank and submitted to the Board for approval. On occasion, the Board would let the Reserve Bank know that its chosen candidate would likely be rejected and would advise the Reserve Bank to reconsider its choice. In some cases, the Reserve Bank would follow the Board's recommendation and select another candidate, but in other cases, a confrontation would ensue between the Board of Governors and the Reserve Bank. However, the Board's involvement during the actual search process, before the Reserve Bank's initial candidate decision, was generally fairly limited.

My understanding is that, in recent years, the Board has been much more involved in the early stages of presidential searches. There are regular calls between the search committee head and the chair of the Bank Affairs Committee, lists of prospects are shared with and vetted by the Board early on, and names of prospective candidates are suggested to the Reserve Bank. In essence, the Board's role appears to have shifted from final-stage review and approval, as suggested by the language of the Federal Reserve Act, to co-management of the presidential search process.[5] This more extensive early involvement enables the Board to more directly shape the selection process and steer the Reserve Bank's choice toward candidates that the Board favors. My conjecture, based on observations described earlier about the decline in dissents and public expressions of divergent views, is that the Board has used its more active involvement in presidential searches to steer Reserve Banks toward candidates with a greater affinity for the Board's policy views and a disinclination to publicly diverge from those views. In fact, achieving that result may have been the Board's motivation for more active involvement in presidential searches.

One indicator that aligns with this conjecture is the noticeable shift that has occurred in the composition of the presidents. In 2009, just over half of the presidents had records of multiple academic journal publications in monetary economics and macroeconomics. All but two of such presidents had retired or stepped down by late 2021, and no new presidents with such characteristics have been named since the appointment of John Williams in 2011.[6] Such an active research background in disciplines closely related to monetary policy plausibly provides an FOMC participant with more confidence in coming to divergent assessments of policy issues and with a greater willingness to question the majority's view in public. Moreover, a background in the theoretical grounding of macroeconomic analysis is especially useful at sharp turning points, when empirics alone are less helpful and theoretical reasoning can play a critical role.

I am not asserting that an academic research career in monetary economics is a prerequisite for arriving at divergent assessments about monetary policy and voting or speaking out accordingly. There are certainly many counterexamples; Esther George and Tom Hoenig, both former presidents of the Federal Reserve Bank of Kansas City, would be prominent among them, along with Tom Melzer of the Federal Reserve Bank of St. Louis. I am just highlighting a readily observable factor that might relate to a Reserve Bank president's propensity to dissent. More subjective and less readily observed factors are undoubtedly relevant as well. For example, presidents may differ in their approach to using their Reserve Bank's research department, which often serves as a source of independent thinking. And presidents may have different philosophies about the role of dissent at the FOMC. My conjecture is that, on an array of dimensions, a noticeable shift in the composition of the presidents has taken place over the past decade or so as a result of the deeper preappointment role the Board now plays in presidential selections.

EVOLVING COMMUNICATION NORMS

My second conjecture is that there has been a shift in Committee norms regarding FOMC participants publicly airing divergent views. Under former Fed chairman Alan Greenspan, the sharing of independent views, especially about the monetary policy outlook, was rare. As chair, Greenspan served as virtually the sole conduit for what FOMC messaging took place.

Former Fed chairman Ben Bernanke, in contrast, promoted transparency and open communication. Under Bernanke, Reserve Bank presidents enjoyed more latitude to articulate their own framework and views. Over time, this openness led to greater expression of individual policy views by FOMC participants both inside and outside FOMC meetings. I would argue that, consistent with Bernanke's expectations, this greater openness aided public understanding of the Fed and its mission. The firestorm of criticism that arose in the wake of the Fed's interventions during and after the 2007–2009 financial crisis, however, made divergent views politically inconvenient for the Board, because they allowed critical members of Congress and the public to cite the alternative views of Fed policymakers.

Some important elements of Bernanke's "glasnost" remain, such as postmeeting press conferences and the quarterly Summary of Economic Projections. But in the past few years, the Fed appears to be returning to a less open approach to public communications. At times, the FOMC seems to be behaving more like a corporate board, keeping dissenting views internal and hewing to the "house view" externally. This norm contrasts with that of deliberative public policy bodies, such as the US Securities and Exchange Commission and the board of the Federal Deposit Insurance Corporation, whose members feel accountable for articulating their views to the public. One can see why the corporate model would be attractive to Board leadership, given the intense scrutiny of the Fed since 2008. The chair gets tighter control over messaging to Congress and is forced to answer questions about alternative views within the Fed less often, thus making external political relations easier to manage.

But there is an important tradeoff that the Fed would do well to recognize. The presumption underlying deliberative policy bodies is that the quality of decision-making is strengthened when diverse perspectives are voiced and given serious consideration. This concept is, of course, a key rationale behind the movement to enhance diversity and inclusion in organizations; the idea is that greater ethnic and racial diversity expands the diversity of intellectual perspectives brought to bear on collective decision-making. And the value of diverse perspectives was a strong driving force behind the federated structure that was adopted at the origin of the Federal Reserve System, whose founders saw the geographic diversity provided by 12 dispersed Reserve Banks as adding a vital intellectual breadth to the Fed's deliberations. This feature survived the amendments made to the Federal Reserve System by the Banking Act of 1935, which established the FOMC and increased the power of the Board of Governors. Moreover, an organizational norm of tolerating public articulation of alternative views can enhance the incentive of other participants, including the chair, to take alternative views seriously when expressed internally, since external expression of those views may spark public queries.

EVOLVING RELATIONSHIP WITH CONGRESS

An additional governance factor may also have contributed to recent policy errors. One striking feature of the Fed's responses to the financial crisis of 2007–2009 and the COVID-19 pandemic was the large-scale interventions in credit markets. Before 2007, Fed lending rarely exceeded a few billion dollars. But during the financial crisis of 2007–2009 and the COVID-19 pandemic, it expanded dramatically and was extended well beyond the traditional scope of banking system counterparties. Although such interventions are sometimes described as "monetary policy tools," they went well beyond what was necessary for monetary policy alone.

Decades ago, the late Marvin Goodfriend and Robert King pointed out the distinction between monetary policy and credit policy, noting that control of the Fed's monetary liabilities with open market purchases and sales of US Treasury securities should be sufficient for managing monetary conditions and stabilizing inflation.[7] When the Fed extends credit to the private sector—either inside or outside the banking system—it is engaging directly in fiscal policy, because the same effect on the monetary liabilities of the Fed can be achieved with open market purchases of Treasuries. By lending rather than buying Treasuries, the Fed is, in essence, selling a Treasury to the public and using the proceeds to extend a loan. If that is not fiscal policy, it is hard to see what is. Goodfriend argued that a corollary of the Fed's monetary policy independence is that the Fed should use its balance sheet only for monetary policy purposes, thereby avoiding involvement in the fiscal, distributional, and thus political decisions inherent in credit market interventions.[8]

The Fed was drawn into credit allocation in the mid-1960s under pressure from Congress when dysfunctional banking regulations meant that Fed tightening caused outsized credit crunches.[9] The resulting backlash from sectors sensitive to interest rates led to political pressure on the Fed to intervene to aid housing markets. Fending off congressional attacks arguably sapped the Fed's political capital and weakened its resolve to fight inflation in the late 1960s and early 1970s. That experience undoubtedly contributed to the Fed's traditional taboo on commenting on fiscal policy. When Greenspan testified in favor of tax cuts in 2001, he was careful to say that he was doing so only in his capacity as a private citizen, wanting to distance his views from those of the Fed as an institution.

Related political dynamics may have been at play during the most recent inflation surge. The Fed became deeply entangled in fiscal policy deliberations and credit program design, including arguments about municipal security purchases, the Paycheck Protection Program, and the Main Street lending facility.[10] It was only a short step from there to Fed Chair Jerome Powell's urging Speaker of the House Nancy Pelosi to "think big" on fiscal policy, a subject on which his predecessors rarely had the temerity to advise the legislative branch. That advice was taken too far in the relief measures enacted in spring 2021, which arguably provided the central impulse to that year's inflation surge. The Fed maintained an accommodative monetary policy stance well into the following year, responding slowly to the resulting surge of inflation despite warnings from several prominent economists.

Could the current inflationary episode be a realization of Marvin Goodfriend's fear that credit-related political entanglements would sap the Fed's political capital and impede the Fed's pursuit of monetary stability? Did the Fed's contribution to the design of COVID-19 fiscal stimulus measures make the Fed hesitant to counteract the stimulus by tightening monetary policy promptly in 2021? At this point, only Fed insiders know how strong an influence these political entanglements were, compared with the effects of the revised framework document, the strong forward guidance, and the overestimation of labor market slack.

As they reflect on the inflation surge of 2021–2022 and on the Fed's response, Fed insiders would do well to appraise whether deep involvement in fiscal policy compromised the Fed's monetary policy stance. They also would do well to consider, as Eggertsson and Kohn suggest, "whether Committee discussions and decisions were being sufficiently challenged by diverse viewpoints."[11] The recent evolution of governance practices that I noted may have played a role in reducing the diversity of viewpoints that were given serious internal consideration in 2021–2022. Whatever other objectives those practices may have achieved, they may have contributed to notably disappointing monetary policy outcomes.

ABOUT THE AUTHOR

Jeffrey M. Lacker served more than 12 years as president and CEO of the Federal Reserve Bank of Richmond, from August 2004 to April 2017. Currently, he is a senior affiliated scholar at the Mercatus Center at George Mason University. He also serves as a member of the Shadow Open Market Committee and is a fellow at the Global Interdependence Center's College of Central Bankers. From August 2018 to May 2022, Lacker was a Distinguished Professor in the Department of Economics at the Virginia Commonwealth University School of Business. Prior to being named president of the Richmond Fed, he served as senior vice president and director of research. He was an assistant professor of economics at the Krannert School of Management at Purdue University from 1984 to 1989 before joining the Richmond Fed in 1989 as an economist. He has published research in monetary economics, banking and financial intermediation, financial contracts, and payment economics. Lacker received a doctorate in economics from the University of Wisconsin in 1984 and a bachelor's degree in economics from Franklin & Marshall College in 1977.

NOTES

1. Gauti B. Eggertsson and Donald Kohn, "The Inflation Surge of the 2020s: The Role of Monetary Policy" (Working Paper 87, Hutchins Center on Fiscal and Monetary Policy at Brookings, August 2023), 3.
2. Eggertsson and Kohn, 35. Actually, Jim Bullard, then president of the Federal Reserve Bank of St. Louis and a voting member of the FOMC, dissented on March 16, 2022, the first meeting at which the FOMC raised interest rates following the COVID-19 pandemic, preferring to raise the target for the federal funds rate by 50 basis points rather than 25.
3. Daniel L. Thornton and David C. Wheelock, "Making Sense of Dissents: A History of FOMC Dissents," *Federal Reserve Bank of St. Louis Review* 96, no. 3 (2014). There have been just two dissents by governors since 1995 and just four since 1990, whereas there were 63 dissents by governors from 1980 to 1989.
4. Specifically, they are to be appointed by the Class B and Class C directors. Class B directors are nonbankers elected by the member banks, and Class C directors are appointed by the Board of Governors.
5. Christopher Condon, "Fed Documents Show Powell's Hand in Richmond President Search," *Bloomberg*, July 16, 2018. Records obtained by Bloomberg News under a Freedom of Information Act request "show that in 2017 then–Fed Governor Jerome Powell kept up a running discussion by phone and email with officials at the Richmond Fed" during their 10-month search for a president, including sharing names of potential candidates and providing feedback on names compiled by the Richmond Board and its search firm.
6. Williams began serving as president of the Federal Reserve Bank of San Francisco in March 2011 and then began serving as president of the Federal Reserve Bank of New York in June 2018.
7. Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy, and Central Banking," *Federal Reserve Bank of Richmond Economic Review*, June 1988, 3–22. The same point was made by Anna J. Schwartz, "Real and Pseudo-financial Crises," in *Financial Crises and the World Banking System*, ed. Forrest Capie and Geoffrey E. Wood (London: Palgrave Macmillan UK, 1986), 11–40.
8. Marvin Goodfriend, "Why We Need an 'Accord' for Federal Reserve Credit Policy: A Note," *Journal of Money, Credit and Banking* 26, no. 3 (August 1994): 572–80. A similar point regarding Federal Reserve involvement in foreign exchange operations was made by J. Alfred Broaddus and Marvin Goodfriend, "Foreign Exchange Operations and the Federal Reserve," *Federal Reserve Bank of Richmond Economic Quarterly* 82, no. 1 (1996): 1–19.
9. Jeffrey M. Lacker, "Racing through Red Lines: Jeanna Smialek: *Limitless: The Federal Reserve Takes on a New Age of Crisis*," *Business Economics*, September 12, 2023. For an account of how the Fed was drawn into credit allocation in the 1960s see Renee Haltom and Robert Sharp, "The First Time the Fed Bought GSE Debt" (Economic Brief EB14-04, Federal Reserve Bank of Richmond, April 2014).
10. Jeanna Smialek, *Limitless: The Federal Reserve Takes on a New Age of Crisis* (New York: Alfred A. Knopf, 2023).
11. Eggertsson and Kohn, 35.