Diversity Now

As it celebrates its 100th birthday, the Federal Reserve needs some reexamining.

By Charles Calomiris

The Fed is celebrating its100th birthday. The celebration has been muted, sometimes even somber, and for good reason: the Fed has achieved both of its central objectives—price stability and financial stability—in only about one-quarter of its years of operation. There is one Fed leader, however, whose record receives universal accolades. In a Fed cartoon prepared for high school students, Paul Volcker is lovingly portrayed as a superhero wearing a red cape.

Few would object to that characterization. Over the one-hundred-year history of Fed monetary policy, Volcker's combination of integrity, judgment, and courage stand alone. Integrity, because, prior to his appointment, he leveled with President Carter about his intention to attack inflation aggressively. Judgment, because he rejected the model-driven advice of some top Fed economists who adhered to "Phillips-curve"-based projections. Volcker recognized that only a draconian policy change would be sufficient to establish Fed credibility in lowering inflation. Courage, because he stayed the course despite sustained high unemployment and vilification.

If the Fed were to face a similar challenge again—and the risks associated with its balance sheet's size and structure make that a real possibility—would someone emerge with the same combination of virtues? Sadly, the answer is perhaps not. People like Volcker—who took macroeconomic

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modeling with the appropriately large grain of salt, whose spine was stiffened by years in the trenches of global banking, and who deeply understood the psychology of financial markets—are unlikely to end up as leaders of today's Fed.

Why wouldn't a Volcker emerge, if needed? After all, popular aversion to high inflation explains why Jimmy Carter appointed Volcker in the first place, and why Ronald Reagan provided continuing political cover for fighting inflation. The parallel experience in the United Kingdom—which suffered even higher inflation before the rise of Margaret Thatcher—offers additional evidence of the populist appeal of inflation fighting. Even in autocracies, unpopular inflation can produce major social change; in Brazil, the perennial high-inflation autocracy of the last century, hyper-inflation was a major contributor to fundamental reform in 1988–1994.

All true, but also too glib. The great inflation fighters of the 1980s and 1990s—Volcker, Reagan, Thatcher, and Brazil's Cardoso—were extraordinary leaders; not all countries enjoyed similar leadership (Argentina and Zimbabwe are obvious examples). Furthermore, Paul Volcker became chairman after prior experience as the president of the New York Fed. He was selected from a pool of people with demonstrated knowledge of the Fed and the financial system. Today, the comparable pool of people with Fed leadership experience doesn't contain anyone like him, although there are a governor and two presidents with some business experience.

That fact would not have pleased the Fed's founders. The structure of the System, as originally conceived, was designed to ensure a healthy diversity of experience among its leaders. Fed leadership was supposed to combine those with experience in banking with political appointees. Academics were absent from leadership positions, as they were not selected as political appointees until much later—Arthur Burns was the first academic to serve as chair. A system of twelve Federal Reserve Banks was intended to ensure Fed leaders would be guided by diverse regional banking perspectives. Even at the Board, banking professionals sometimes dominated (for example, Marriner Eccles was a Utah banker, and Paul Volcker worked at Chase when he wasn't at the Treasury or the Fed).

Some Fed leaders I have spoken with tell me that non-academics are typically quite mediocre as Fed presidents or governors, as they often lack understanding of key economic issues. That may be true, but every governor or president doesn't have to understand statistics deeply to be able to contribute. Sometimes the most important contribution is to question things that economists as a group accept too easily. Belief in the current macroeconomic modeling fad has been a perennial problem at the Fed, and there is no better antidote than having people on hand to scoff a bit at economists' certainties, especially if their own experiences provide credible alternative perspectives about how markets behave.

Part of the decline in the Fed's commitment to diversity reflects changes in the banking industry. The rise of nationwide branch banking in the 1990s caused important local and regional banks to largely disappear, which has changed the profiles of Federal Reserve

Man of Rare Courage

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—C. Calomiris

Paul Volcker

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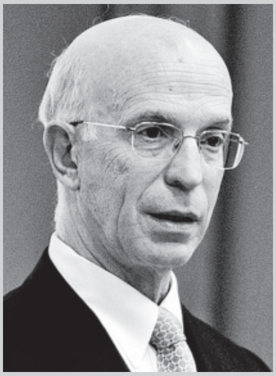

Alan Blinder

Laurence Meyer

Inside Grumblings

Former Vice Chairman Alan Blinder has frequently complained about the limitations placed on his ability to communicate with Fed staff, and also complained about the "real reluctance to advance alternative points of view" at the Fed. Former Governor Laurence Meyer said that he was "frustrated by the disproportionate power the Chairman wielded over the FOMC," and said that dissents were viewed as disruptive to the process of monetary policymaking.

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Banks' boards. The increasing rigor of Fed modeling at FOMC meetings (despite the inaccuracy of that modeling, especially in the years leading up to the subprime crisis) has fostered a culture that makes it quite difficult for non-academics to challenge the assumptions of the chair's preferred econometric model, however misspecified it may be. Even someone like Alan Greenspan, a trained economist who worked outside of academia and who resisted placing too much weight on forecasts from the Fed's macroeconomic models, is missing in the ranks of Fed leadership today.

PROMOTING DIVERSITY

The new academic-dominated culture within the Federal Reserve System will be hard to reverse. Not only has monetary policy understanding become a matter of extreme technical pretension, but the establishment view of regulatory policy has become enormously complex technically (consider the measures of risk in the Basel requirements, the mechanics of stress testing, the structure of liquidity requirements, the enforcement of the Volcker Rule, and Dodd-Frank's Title II intervention rules), and the Fed's role as a regulator has expanded exponentially over the past two decades. The regulatory reaction to the subprime crisis, in particular, has pushed the Fed toward greater centralization of power in the Board of Governors, and the vilification of bankers after the crisis has produced a near monopoly of leadership by academics. Finally, Fed salaries are a bit lower than academic compensation but are a real hardship for someone whose alternative is Wall Street pay.

Is it possible to construct new rules for Fed leadership that will enhance diversity and make it more likely that someone with Volcker's unique combination of personal virtues will be available if the moment calls for it? Serious Fed reformers, like Rep. Kevin Brady (R-TX), should be sponsoring a thorough discussion of that question. Here are some ideas to get the ball rolling.

Congress could require, for example, that at least two of the seven Fed governors be people with significant financial markets experience. Having at least two people on the Board with backgrounds like those of, for example, Peter Fisher and Kevin Warsh would create a critical mass of market-savvy opinion. To further build diverse thinking at the Board, the power of the chair should be limited. Governors almost never dissent at FOMC meetings, partly because they are completely beholden to the chair, who controls the budget and the staff of the Board. Governors have no staff of their own. All staff work for the chair, and their access to Fed Board staff is dependent on the willingness of the chair to permit governors to interact with staff economists. Former Vice Chairman Alan Blinder has frequently complained about the limitations placed on his ability to communicate with Fed staff, and also complained about

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the "real reluctance to advance alternative points of view" at the Fed. Former Governor Laurence Meyer said that he was "frustrated by the disproportionate power the Chairman wielded over the FOMC," and said that dissents were viewed as disruptive to the process of monetary policymaking. To ensure that governors have access to necessary information and can act independently in their voting, governors should each have at least a few staff members under their direct control, and who are not beholden to the chair, which would enable them to develop independent views.

Perhaps these reforms would help to solve another problem—the short tenure of most governors. Governors are appointed for twelve-year terms, but most leave after only a couple years. Before governors become fully educated to the intricacies and challenges of monetary policy, they are on their way back to the universities whence they came (to avoid losing their chaired professorships). Another reform that Congress should consider is asking all governors to resign their other positions, including university professorships, as a condition for appointment as a governor, and also ask them to pledge that they expect to stay on as governors for at least half of their appointed terms.

Changing FOMC voting rules so that all Federal Reserve Bank presidents vote at every meeting would promote diversity by giving more power and voice to the research staffs of the reserve banks. Current rules of rotation are designed to give greater weight to the Board, which effectively means that the research staff are controlled by the Fed chair.

The twelve Federal Reserve Banks should also be freed from the budgetary control of the Fed chair, who limits the size and scope of their research activities. For example, the Federal Reserve System could establish a committee comprised of representatives of all the Federal Reserve Banks and the Board of Governors, and perhaps even some outsiders, to consider the budgets of each bank and each governor's staff.

It would further promote diversity of thinking if Federal Reserve Banks were prohibited from appointing Reserve Bank presidents from within. When Federal Reserve Banks' boards were comprised of regional banking and business leaders, boards had a direct stake in Fed decision making and presidents were selected from a broad pool of outsiders. Now, almost all Fed presidents are former Bank research economists (usually research directors). Although formal searches are always undertaken, it is hard to attract qualified outsiders to participate in that process when they know that the internal candidate has the inside track, based on his or her relationship with the Board, and even if they do participate, risk-averse Boards often prefer the devil they know to the one they don't. This has added to the inbred monoculture of the Fed system that promotes excessive faith in macroeconomic fads, such as the current "DSGE" model (a model in which, unbelievably, the financial sector is either completely absent, or tacked on as an afterthought).

Diversity, of course, is not a panacea. It will not prevent all wrong-headed thinking. The Fed's adherence to its now infamous "free reserves targeting" policy from the 1920s through the 1960s occurred despite great diversity of experience among its leaders.

PROMOTING INDEPENDENCE

Furthermore, not all Fed errors were errors of thinking. Some of the Fed's worst errors were the result of political interference. As Allan Meltzer's three-volume *A History of the Federal Reserve* points out, Fed failures often have reflected political pressures on the Fed to accommodate deficits, or to focus on short-term unemployment goals (with an eye to upcoming elections) at the expense of long-term inflation and unemployment goals. An important safeguard against monetary policy errors, therefore, is to promote greater independence of the Fed.

The most obvious improvement would be to repeal the "dual mandate" imposed on the Fed in the 1970s and replace it with a single price-stability mandate, as Paul Volcker, among many others, has publicly championed. The call for a single price-stability mandate is often misunderstood as reflecting a callous lack of interest in

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unemployment, but the opposite is the case. Economic studies have shown that in the long run there is no tradeoff between price stability and maximum employment; the best way to minimize unemployment in the long run is to pursue a policy that keeps inflation low and stable. A clearly stated goal of low and stable inflation also offers everyone the opportunity to measure the Fed's achievements, which ensures the accountability that is essential in a democracy. And a single price-stability mandate would insulate Fed officials from the ire of Congressional critics who use the dual mandate to criticize the Fed for not doing more to reduce short-term unemployment, which can undermine the Fed's commitment to long-term price stability. The Fed's risky QE3 program of purchasing mortgage-backed securities and long-term Treasury bonds in an effort to demonstrate its commitment to reducing unemployment is the latest example of how myopic political pressures can distort monetary policy.

Just as important, the Fed should be removed from its role as a financial regulator. Regulatory power is a lightning rod for politicization which has sometimes placed the Fed at the center of highly contentious power struggles, often with disastrous consequences for both the economy and the Fed's independence. There are many examples, but the most obvious one has been the Federal Reserve Board's role as the arbitrator of bank mergers in the last three decades. The Fed was given that role precisely because it could be counted upon to go along with ill-conceived government policy, which designed the merger approval process to be a source of rent creation for merging mega banks in the 1990s, so that those rents could be shared between merging banks and community activist groups, which were given power by legislation to influence the merger approval process. Fears of Congressional reprisals against the Fed in the realm of monetary policy clearly were part of the explanation for the Fed's willing participation in this farce. As Stephen Haber and I show in our new book, *Fragile By Design: The Political Origins of Banking Crises and Scarce Credit,* Fed bank merger hearings were mainly focused on the testimony of activist groups about whether the merging banks were "good citizens," a trait that was measured by the amount of loans and grants the merging banks had contractually promised to give the activists as the *quid pro quo* for their testimony. Those contractual promises exceeded $850 billion from 1992 to 2006. The Fed's role in overseeing these unseemly political bargains not only lessened the Fed as an institution, it also helped to precipitate the risky mortgage lending that was at the heart of the recent subprime crisis.

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Removing the Fed from its regulatory role would not in any way prevent the Fed from examining banks and pursuing all the related supervisory functions that are necessary to a central bank's lending function. Examination powers and some limited continued shared supervisory authority should be preserved. But there is no reason for the central bank to determine merger policy, whether banks should be permitted to act as real estate brokers, or other matters unrelated to central banking. And allocating that decision making to the Fed does positive harm by putting the Fed in the line of fire with respect to highly charged political battles, which often results in inferior regulatory decisions and jeopardizes independent monetary policy.

AVOIDING DISTRACTIONS

As we begin the second century of Fed history, we should take advantage of the record of success and failure during the first century to strengthen the Fed as an institution. We also should avoid utopian fantasies. Calls to "end the Fed" and restore the gold standard distract from the discussion of deep, constructive reforms that is needed. Few people acquainted with the history of the gold standard (including its contribution to the deflationary shocks of the 1930s) would advocate its restoration on economic grounds. And those who understand the political history of the past two centuries recognize that democracies are less willing today to sacrifice short-term domestic objectives for long-term international agreements than they were in the nineteenth century, which makes adherence to fixed exchange rates a practical impossibility. We should focus instead on ways to improve thinking at the Fed by promoting more diversity of experience, as well as ways to improve Fed independence and accountability so that the Fed acts in accordance with that improved thinking. ◆