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Good article

Note

Chairman Kevin Warsh should appreciate the benefits of the central bank's federalist structure.

A Key to Fed Independence: Its 12 Regional Banks

By Kathryn Judge And Mickey D. Levy

Besides achieving the Federal Reserve's dual mandate of 2% inflation and maximum employment, an important matter for Kevin Warsh's tenure as chairman is how he will support the central bank's independence and enhance its accountability. He can further both aims by supporting the vital role played by the 12 regional Federal Reserve banks.

The Reserve Banks help make the Federal Reserve system both more independent of the president and more accountable to Congress and the public at a time of diminished credibility of central government institutions. The banks—which stretch from San Francisco to Boston—bring diverse views to the table in Washington. At the last meeting of the Federal Open Market Committee, three Reserve Bank presidents dissented from the easing bias in the FOMC's statement, emphasizing the risk that high inflation may linger. The Reserve Banks have a history of innovative research, including ideas likely to challenge the prevailing wisdom promoted by the staff of the Fed's Board of Governors. They contribute to the Fed's understanding of the economy and are conduits to the households and businesses in their districts.

Yet the important roles played by the Federal Reserve Banks are often played down and constrained within the Fed. There are signs that in recent years the board has exerted increasing control over the Reserve Banks' choices of new presidents, purposely trying to strengthen the Fed's consensus view.

The Fed's federalist structure, with a dozen regional central banks, resolved a conundrum that had haunted America since its founding. The nation's first two central banks—the First and Second Bank of the United States—closed when their 20-year charters expired, because of the public's aversion to concentrated power. More-frequent financial crises and recessions resulted. When Congress created the Federal Reserve System in 1913, lawmakers sought to diffuse power across 12 Federal Reserve district banks that were public-private hybrids with local boards consisting of local bankers, industrialists and community leaders.

Franklin D. Roosevelt's vision of expanded executive authority that could better control the Fed's policies involved a 1935 initiative that would have meaningfully diminished the autonomy and authority of the Reserve Banks, putting more power in the hands of the Board of Governors. Sen. Carter Glass (D., Va.) pushed back. At the congressional hearings on the president's proposed Fed reforms, Glass lined up an array of witnesses to counter the reforms. Those witnesses recognized—long before empirical evidence emerged that highlighted the political realities—that giving the president control over the central bank would tend to be inflationary. This has meaningful parallels to President Trump's threats on the Fed's independence today.

Give-and-take on FDR's centralizing proposals culminated with the Banking Act of 1935, which created the modern structure of the Fed. A powerful seven-member Board of Governors would oversee the Reserve Banks and have sole responsibility for regulatory matters. Monetary policy would be set by the newly created Federal Open Market Committee, which included all Fed governors and five of the 12 Reserve Bank presidents. This design makes the Federal Reserve system unique among federal agencies.

Earlier Fed chairmen have worked to further Fed independence and accountability by bolstering the role of the Federal Reserve Banks. William McChesney Martin, who helped solidify Fed independence, stipulated in the mid-1950s that all 12 Reserve Bank presidents attend and participate in every FOMC meeting regardless of their voting rotation.

The Fed is arguably the most important economic policymaking body in the world. When it makes mistakes, the costs are felt nationally and reverberate internationally. The FOMC's distinct design, with a central Board of Governors in

Washington and the feet-on-the-ground Reserve Banks, leans against groupthink that can lead to errors. The Reserve Bank presidents bring distinctive views, informed by their close ties with businesses and households in their districts.

Regional presidents dissent more frequently from FOMC policy decisions than governors. They make public their views on the economy, inflation and monetary policy. This is particularly important during times of heightened uncertainty. The Reserve Banks provide important information to Congress, financial markets and the public about the risks the Fed faces and the trade-offs among its choices.

Mr. Warsh's years of Fed experience should help him appreciate the importance of protecting the autonomy of the Reserve Banks. At his confirmation hearing, he embraced the idea of "messier meetings" in which policymakers "can have a good family fight." Reserve Bank presidents have a history of speaking out rather than passively going along with decisions they find troubling. Following the 2008 financial crisis, several Reserve Bank presidents expressed concern that the Fed's large balance sheet and holdings of mortgage-backed securities reflected "mission creep" that could ultimately jeopardize the Fed's independence. These concerns resonate with Mr. Warsh.

The Reserve Banks are far from perfect, and their public-private nature would create a democracy deficit if they had too much power. But their function is quite different when viewed as part of an interdependent Federal Reserve system. Mr. Warsh must seek a balance that supports a constructive role of the Reserve Banks in the Fed's federalist system. Just as FDR and now Mr. Trump have sought greater control over how the Fed conducts monetary policy, the Fed's distinct regional design that counterbalances the central bank's inside-the-Beltway board is vital to the institution's independence and accountability.

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