

## The origins of the Federal Reserve

The Federal Reserve was established with the Federal Reserve Act on 23 December 1913 signed into law by President Wilson. The Federal Reserve Act was passed by the Senate a few days earlier with a narrow margin and represented the culmination of a long and strenuous process that had its roots back in the first years after the independence of the United States from Britain.

The establishment of a central authority that would be responsible for directing the economic affairs and policies of the new state was a hugely controversial topic because it touched the very principles upon which the United States were founded.

In the paragraphs that follow we will try to present the lengthy and difficult process that eventually led to the creation of one of the cornerstones of fiscal and economic policy with a huge impact on the fiscal and monetary policy in the United States and beyond.

### The first attempt to create a central bank

The creation of a central bank that would manage the fiscal policies of the United States was first advocated by Alexander Hamilton, Secretary of Treasury during George Washington's presidency from 1789 to 1795. Alexander Hamilton advocated the creation of a central bank to manage the nation's finances and credit.

Hamilton faced significant opposition to his plans from within George Washington's government. The Secretary of State Thomas Jefferson believed that since the Constitution of 1789 did not authorize Congress to create a central bank, the government did not possess the authority necessary to constitutionally create a central bank.

Alexander Hamilton claimed that the creation of a central bank was nothing more than the creation of an instrument necessary to manage the fiscal and monetary affairs of the new state. Therefore, claimed Hamilton, the Constitution did provide the government with the authority necessary to create a central bank under the clause that stipulated that the government possessed all powers "necessary and proper" to carry out its specifically enumerated responsibilities. Since the government had so many fiscal and monetary responsibilities, the creation of a central bank would be nothing more than the constitutional exercise of these responsibilities, argued Hamilton.

The political dispute that followed ended in Hamilton's favor with the creation of the first Bank of the United States in 1791.

The bank had the following main characteristics.

The bank was created with a charter or mandate of twenty years.

It had a capital of \$10 million. The government provided \$2 million and the rest came from various private individuals.

The new bank was headquartered in Philadelphia but was a national institution with branches in most of the major cities of the United States.

The bank performed the basic banking functions of issuing bank notes, taking deposits, making loans and purchasing securities.

The bank had twenty-five directors, five of which were appointed by the government. The remainder was appointed by the private investors in the bank.

The bank quickly established itself as one of the most important institutions in the new state and was successful in fulfilling its intended role.

When the charter of the bank ended in 1811, James Madison, the president at that period, favored the extension of the bank's charter on grounds of its practical usefulness and submitted the matter to a vote with the Congress.

Congress voted against extending the charter of the bank by a single vote.

The result of the bank's demise was chaos and confusion in the economy that were further accentuated by the turmoil that followed the war of 1812 with Britain.

## **The reasons behind the demise of the first central bank**

The controversy surrounding the creation of the first central bank after independence reflects the political climate of the period and the dilemmas that dominated the newly created state.

The root of the failure of the first central bank seems to be the distrust that a significant portion of the political elite of the United States had towards a strong central government. A central bank is a powerful symbol and an even more powerful tool at the hands of a government that seeks to impose its authority. More importantly, many felt that a central bank did not fit within the decentralized structure of the new state.

This notion of distrust started to slowly dissipate after the creation of the first central bank but it remained an ever powerful influence in the political scene of the time.

The distrust for a strong central government was strongly present within the common people of the time. We should not forget that the population of the United States in this period was largely rural and away from the cities. The farmers and merchants who formed the backbone of the population of the United States treasured their independence and mistrusted any attempt to impose any central authority that violated their jealously guarded rights.

This feeling was particularly strong in the South and West of the United States and this is where the principal source of opposition to any attempt to create a central bank lay.

## **The second bank**

The necessity for a central bank became evident and acceptable to many after the chaos that followed the demise of the first central bank in 1811 and the war of 1812 with Britain.

James Madison introduced a bill in Congress for the creation of a new central bank in his final year as president, in 1816.

This time Madison managed to ensure the support of Henry Clay, the Speaker of the House. Clay had resisted attempts to extend the charter of the first central bank in 1811.

The second bank was like the first in most aspects. It also received a charter of twenty years.

The main difference lay in the fact that the capital of the new bank was \$35 million.

The second bank quickly became one of the most dominant factors in the economy of the United States and acquired a significant amount of economic and political power.

The success of the second bank was such that a significant part of the political establishment of the time came to view it as a threat to democracy.

Of course, the underlying distrust against the central bank as we described it in the previous paragraph continued to exist.

All these factors did not help the public acceptance of the second bank.

When Andrew Jackson became president in 1829, the bank had seven more years to run. Jackson's opposition to the bank was deep and pronounced. He considered "such a concentration of power in the hands of a few men irresponsible to the people."

Despite the president's opposition to the bank, Jackson's opponent in the 1832 presidential election Henry Clay managed to push a bill through Congress to re-charter the bank. As was expected, Jackson vetoed the bill.

Henry Clay and his supporter's expected to gain the public's support and ran an extensive campaign against Jackson on this issue but their move backfired. Andrew Jackson won the presidential elections and the second bank charter was not extended when it expired in 1836.

Many of the people who supported the second bank appear to have chosen sides against Jackson, confirming in this manner the suspicions of a large part of the public in the United States that the bank was indeed dangerous to the young democracy.

The fact that the central bank through its representatives took part in the political game was a serious miscalculation that brought the end of the second bank.

## **The aftermath of the second bank's demise**

The demise of the second bank in 1836 was a catalyst for developments that would define the banking landscape for the next decades.

The banking system reverted back to development along local lines. The backbone of the banking system was a large number of local, state-chartered banks that functioned without federal supervision.

The picture that resulted was as fragmented as the banks involved. In some areas of the country, the banking system functioned in well-organized manner, with planning and restraint. In some other areas however, the banking system was highly unstable and unpredictable.

Many historians claim that this situation presented an obstacle to the development of the United States. The fact that, despite its problems, the system functioned, and provided the fact that the United States continued to develop rapidly during this period, one would have to wonder whether such views are really founded.

## **The National Banking Act of 1863**

The National Banking Act of 1863 and its major amendments in 1864 and 1865 aimed to provide the banking system in the United States with stability.

The main provisions of this act were the following.

Nationally chartered banks were created. Only such banks had the right to issue bank notes. Bank notes issued had to be backed by holdings of government securities.

The act also introduced capital requirements for banks in order to increase the stability of the many, notoriously volatile local banks.

The act also introduced for the first time the control of banks by a federal institution, the Office of the Comptroller.

The National Banking Act of 1863 is certainly not what one could consider a step in the development of a central bank.

Banking remained essentially a private business that developed largely without federal control.

The banking system in the United States however, remained relatively unstable and suffered from structural problems such as an inelastic and immobile currency. The National Banking Act era, as the period came to be known, is now notorious for the endemic financial crisis that were happening with regularity.

## **Reform in the 20th century**

During the last decades of the 19th century, the United States economy developed at a rapid pace. The country rapidly changed from a rural, agricultural economy to an industrial giant with a complex and demanding economy.

The events that led to the creation of the Federal Reserve were probably triggered by the financial crisis of 1907. This financial crisis is also known as the Banker's Panic. The financial crisis started in New York and spread quickly throughout the United States, leading to the closure of banks and businesses.

The magnitude of the crisis was such that the government was forced to intervene by earmarking federal funds to support banks and other institutions under threat from depositors simultaneously withdrawing their deposits.

As a response to the panic of 1907, the Aldrich-Vreeland Act was passed on 30 May 1908 that authorized the issuance of emergency currency during a financial crisis. The act also established the National Monetary Commission that was to study the situation and to provide ideas on how to operate a central bank.

The National Monetary Commission issued a number of reports and studies that became the basis for the Federal Reserve Act.

## **The Federal Reserve Act**

We can safely state that the way to introducing the Federal Reserve Act was paved by the National Monetary Commission created in 1908.

The National Monetary Commission worked with method and efficiency and on 12 January 1912 submitted a report in fifty-nine sections that included draft legislation for far-reaching reforms in the US banking sector and currency laws.

The report called for the creation of fifteen regional central banks, to be called National Reserve Associations that would be coordinated and controlled by a national board of commercial bankers.

These associations would ensure that there were enough money reserves to create an elastic currency supply, they would provide member banks with loans when required and they would be the fiscal agents for the US government.

There was an immediate and powerful public reaction to the proposals.

The main bone of contention was the fact that the proposed legislation gave control of the new system to a number of powerful commercial bankers.

Many in the US political elite feared that the new central system would become a tool for the rich and powerful bankers of the Eastern United States.

The Pujo Committee was formed to examine whether certain rich bankers used their financial power to secure control over a number of industries. The committee worked from May 1912 to January 1913 and examined a number of prominent financiers such as JP Morgan and George Baker.

The Democratic Party won the elections of 1912 and the political scene in which the proposals for a central bank developed changed substantially.

The Democrats were against the plans and proposals of the National Monetary Commission. They called however for a general revision of the banking and currency laws in force in the United States during that period.

The House and Senate Banking and Currency committees convened under their chairmen, Carter Glass and Robert Latham Owen, and re-drafted the proposals of the National Monetary Commission. They worked meticulously and efficiently and based their work on many sources, including the work of the National Monetary Commission.

The result was a proposal in thirty sections that called for the creation of a central banking system that was based on a mixture of public and private entities.

The result was that twelve regional Federal Reserve Banks were created, each as a specific separate entity with its own board of directors, branches and district limits. These regional Reserve Banks were controlled by a Federal Reserve Board made up of officials appointed by the President. The Federal Reserve Board was renamed to Board of Governors of the Federal Reserve System in 1935. In a unique and unusual move for the time, the Secretary of the Treasury and the Comptroller of the Currency were removed from the board.

This is one of the developments that gave a good degree of independence to the Federal Reserve.

The Federal Reserve Act also created a Federal Advisory Committee and a single currency for the United States as we know it today.