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Financial Crises, Reform, and Central Banking: Establishing the Federal Reserve

"The Federal Reserve, consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system."
—Former Federal Reserve Chairman Alan Greenspan, October 20, 1987

Financial crises and recessions have often provided the impetus for significant financial reform. For example, the recent economic crisis led to the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the 1987 savings and loan crisis to the Financial Institutions Reform, Recovery and Enforcement Act of 1989. Perhaps the most noteworthy financial reform of the past century, though, was the formation of the Federal Reserve System in 1913. To stabilize the financial system after decades of disorganized banking practices and crises, President Woodrow Wilson signed the Federal Reserve Act to establish the Federal Reserve as the nation's central bank.[1]

Early efforts to reform the financial system were limited to the First and Second Banks of the United States (1791-1811 and 1816-36, respectively).[2] Both institutions were short-lived because of public misgivings about concentrated economic power. A period of laissez-faire (or free-market) banking followed, rife with flawed banking practices and instability. In 1863 and 1865, Congress enacted the National Banking Acts to stabilize the financial system. Without a central bank, however, problems remained—financial crises and banks failures continued to be frequent and severe. Two characteristics of the National Banking System (NBS), created by the 1863 Act, exacerbated this volatility: (i) immobile bank reserves in a system lacking a lender of last resort and (ii) an inflexible supply of currency.

During the NBS era (1863-1913), banks under distress were unable to obtain short-term cash loans to meet extraordinary (mostly seasonal) increases in money demand.[3] Such increases usually came from farmers and businesses in need of greater amounts of currency and bank credit during the harvest season. Ordinarily, the resulting limited cash supply did not prove detrimental. However, if a sharp decline in stock prices or the failure of a major bank or firm occurred in the harvest season, demand for money would soar even further as panicked depositors withdrew cash from banks *en masse* (a "bank run"). With no central bank to lend cash freely, banks were unable to obtain sufficient amounts of cash from the reserve and central reserve cities to meet short-term obligations, causing widespread bank failures.

Under the NBS, currency (national bank notes) was backed by government bonds held by national banks, where the amount of currency each national bank could issue was determined by its bond holdings. This relationship limited the ability of the money supply to expand or contract because the amount of currency in circulation could change based only on fluctuations in the stock of government bonds rather than the needs of the economy. Combined with the problem of immobile reserves, the limited money supply caused sharp declines in economic activity and made overhauling the NBS imperative.

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[1] A central bank is "the authority responsible for policies that affect a country's supply of money and credit" (see Bordo, Michael D. "A Brief History of Central Banks." Federal Reserve Bank of Cleveland *Economic Commentary*, December 2007).

[2] For further information, see Bryan, Michael F. and Champ, Bruce. "Fear and Loathing of Central Banks in America." Federal Reserve Bank of Cleveland *Economic Commentary*, June 2002.

[3] Rural national banks had to maintain part of their cash holdings at one or more of the 50 major "reserve" or "central reserve" city banks. This dispersion of bank reserves limited the ability of individual banks facing liquidity problems to obtain additional cash quickly (the problem of immobile reserves).

The Panic of 1907 reignited the debate about banking reform. In response to the recession the Panic caused, Congress set the reform process in motion by directing the National Monetary Commission (through the Aldrich-Vreeland Act) to study European central banks and propose a viable plan for restructuring the U.S. banking system. The Commission's findings led to the Aldrich Plan, named after the influential Republican senator who chaired the Commission, Nelson Aldrich.[4] The Plan called for the establishment of a single central bank, known as the National Reserve Association, with 15 branches throughout the country. More importantly, the proposed Plan provided solutions to the shortcomings of the banking system. Specifically, the National Reserve Association would issue currency and maintain a money supply based on the needs of the economy and provide monetary support (lend cash) to banks in distress (the lender-of-last-resort role).

The election of 1912 gave control of the White House and Congress to the Democrats, which killed the Aldrich Plan. The lack of public ownership and governmental control made Democrats wary of the National Reserve Association, as implementation of the Plan would have consolidated power among Wall Street bankers. President Wilson, nonetheless, was pragmatic and recognized the pressing need for banking reform. He favored a more-decentralized organization that both restricted the power of East Coast bankers (such as J.P. Morgan) and represented the diverse regional and sectoral interests of the country.

Representative Carter Glass and his associate Henry Willis drafted a new proposal that carried over many features of the Aldrich Plan, yet met President Wilson's requirements for greater government oversight and less dominance by bankers. The initial draft of the Glass bill called for the creation of 20 or more regional Reserve Banks (later reduced to 12 Reserve Banks, the number today.) These Reserve Banks would provide member banks in their given districts with (i) a centralized pool of bank reserves, (ii) additional credit in times of need, and (iii) a more-flexible currency backed by commercial loans and gold. The final bill included a central board of government-appointed officials (which later became the current Board of Governors) to oversee the regional Reserve Banks. After months of deliberation, the House and Senate finally reached a consensus and President Wilson signed the Federal Reserve Act into law in December 1913.[5]

The implementation of the Federal Reserve Act brought key reforms that stabilized a financial system previously ill-equipped to deal with banking crises. Although the Federal Reserve's role in the nation's economy has broadened over time (especially since the Great Depression), its establishment in the early twentieth century was significant in setting the foundation for greater economic stability and growth in the United States.

—By David Lopez, Research Analyst

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[4] Senator Aldrich and influential bankers such as Paul Warburg and Benjamin Strong Jr. met in 1910 in Jekyll Island, Georgia, to develop the Plan, which detailed the formation of a central banking system for the United States.

[5] For further information, see Dunne, Gerald T. "A Christmas Present for the President: A Short History of the Creation of the Federal Reserve Sytem." Federal Reserve Bank of St. Louis, 1990.

Additional Resources on the Founding of the Federal Reserve

"The Fed: A Central Bank with a Regional Structure," by James Bullard, *Regional Economist*, Federal Reserve Bank of St. Louis, April 2010, p. 3.

Explains the historical reasons for the regional structure of the Federal Reserve System.

Historical Beginnings…The Federal Reserve, by Roger T. Johnson, Federal Reserve Bank of Boston, December 1999.

Provides a historical narrative of the formation of the Federal Reserve, the political compromises involved, and the implementation of the Federal Reserve Act in 1913-14.

The Balance of Power: The Political Fight for an Independent Central Bank, 1790-Present, by Tim Todd, Federal Reserve Bank of Kansas City, 2009.

Discusses the congressional actions and political debates that led up to, created, and modified the Federal Reserve System.

"Paul Warburg's Crusade to Establish a Central Bank in the United States," by Michael A. Whitehouse, Federal Reserve Bank of Minneapolis *Region*, May 1989.

Examines how Paul Warburg, a first member of the Federal Reserve Board, helped design and defend the Federal Reserve System.

Free Data Sources and Reports

Resource: Central Bank History
Description: Provides links to a timeline of the founding of the Federal Reserve, a glossary of banking terms, and numerous articles on the history of the Federal Reserve.
Published by: Federal Reserve Bank of Minneapolis
Location: http://www.minneapolisfed.org/community_education/student/centralbankhistory/

Resource: The Federal Reserve Act of 1913 – A Legislative History
Description: Detailed chronology of and links to banking legislation leading up to the establishment of the Federal Reserve System in 1913.
Published by: Law Librarians' Society of Washington, DC
Location: http://www.llsdc.org/FRA-LH/

Resource: *First-Choice Vote for Reserve-Bank Cities*
Description: Tabulated results of the votes cast by the various national banks of the United States to determine the locations of the Reserve Banks for the Federal Reserve System.
Published by: Government Printing Office (digitized by the Federal Reserve Bank of St. Louis)
Location: http://fraser.stlouisfed.org/historicaldocs/RBOC/download/76936/hr1914_firstchoicevote.pdf

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