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The Federal Reserve: Past and Present

Introduction

Every day in the United States, millions of consumers participate in the banking system. A mom uses the ATM before her son's soccer game. A couple purchases their first home. An investor calls his broker to sell a share of stock. All of these examples are little snapshots of the big picture. They all, no matter how disconnected, combine to form the U.S.'s financial system. The financial system has definitely experienced many fluctuations and changes since America's inception in 1776. Politicians have strongly debated monetary policy since the days of George Washington, and many of the debates were centered on the formation of a central bank and what powers, if any, it should hold. Today, the Federal Reserve (the Fed) stands as the U.S.'s central bank and makes many extremely important financial and economic decisions on behalf of the entire country. Even though its history is a rocky and controversial one, the Federal Reserve is now embedded in the U.S.'s economy.

History Through 1913

First Bank of the United States

The idea of central banking first started not long after the Declaration of Independence was signed. The first Secretary of the Treasury, Alexander Hamilton "was an early proponent of creating a central bank" (Hafer xii). Hamilton felt that the fledgling country needed to unite the states under one common monetary system, thereby increasing the structural integrity of the

country. At that time in America's history, citizens had just toppled the British monarchy's control in the New World and were very skeptical of a new central government. The states fought to keep power away from the central government. This meant that all the states had different currencies and banks, making interstate commerce more difficult and isolating the states' economies from one another.

Another problem with the decentralized banking of the time was that it "consisted mainly of gold and silver" which meant "increasing exports to other countries that would, in turn, pay for the goods with gold" (Hafer xii). If the United States printed its own notes then it would reduce its dependency on imports from other nations. The country needed time to find its place in the world economy and build trade ties to other prominent nations.

In late 1790, Hamilton went before the United States Congress and argued for the creation of a central bank. Congress heard his plea and, in less than two months, passed legislation for the First Bank of the United States. Congress also felt enough confidence to grant the new First Bank a 20-year, renewable charter. "The Bank was established with capital of \$10 million divided into 25,000 shares" (Beckhart 5-6). The U.S. government itself owned 5,000 shares. The headquarters of First Bank were erected in Philadelphia, but eight branches were built throughout the country. This structure mitigated the concern that only the North would have control over money concerns.

When the Bank's 20-year charter approached expiration, the debate began over whether or not to allow the Bank to continue in its operations. Albert Gallatin made the argument that "the bank had provided a safe depository for public funds, had distributed monies around the country, had collected public revenues, and had occasionally made loans to the Federal government" (Beckhart 8). First Bank was seemingly doing everything that Hamilton argued it

would do and under well-managed conditions. The charter of First Bank, however, was not renewed. The main problem was the states' need for independence and control as described above. Many citizens feared First Bank was too powerful and didn't understand the management of and the need for such a central bank.

Second Bank of the United States

Unfortunately for the opponents of First Bank, central banking was reinstituted only a year after its demolition. If there is one thing that puts a strain on a nation's financial situation, it's war. When the U.S. entered into another war against Britain in 1812, the Federal government found financing difficult with no central bank from which to borrow. The war put the U.S. economy into such ruin that Secretary of the Treasury Alexander Dallas began formulating ideas for a new central bank (Beckhart 9). This second attempt at central banking proved successful, and Second Bank of the United States was established in 1816.

The Second Bank, however, proved to end much the same way as the First Bank. The Second Bank was much more controversial than its predecessor. It was not controlled well and managed too loosely. Until Nicholas Biddle assumed control of Second Bank in 1823, it was an embarrassment to the nation's economy due to poor management and low standards. Biddle, however, was determined to bring Second Bank up to his very high standards. He ran the Bank very well, "and in fact he has been called 'the world's first conscious central banker'" (Beckhart 11). This is a very lofty statement considering the central-banking history of the Bank of England.

Even with all of Biddle's contributions, however, the Second Bank of the United States was not granted a charter extension in 1836. Andrew Jackson, seventh president of the U.S., very strongly opposed central banking because he felt that the banks would cause the money

supply to be monopolized by the more industrious Eastern U.S. (Hafer xiii). Andrew Jackson, both as a president and as a war hero, held great persuasion with ordinary citizens and politicians alike, so after great debate, Jackson won. Central banking was demolished in the U.S.

Free Banking Era

After the collapse of Biddle's Second Bank of the United States in 1836, states became much more responsible for banking operations. States independently issued currency and wrote laws governing banks. The federal government felt the irony of demolishing its own fiscal agent when it began losing a considerable amount of money by making deposits in state institutions. State banks were not as stable or dependable as a central bank and also did not hold nearly as much capital to match government deposits. States banks competed hotly with one another, and since banks printed their own notes, competition and reputations were a large part of the free banking era. If a bank's reputation fell or the bank collapsed completely, currency issued from that particular bank became worthless, and some depositors lost a lot of their savings. The Federal Deposit Insurance Corporation (FDIC) was not yet around to insure bank deposits.

As with the expiration of First Bank, the country again demonstrated a need for a more cohesive form of banking with the onset of the Civil War, when states fought to take power away from the central government. Bad relations between states and the federal government broke down the free banking system since many states were capitalized with state bonds (Hafer xiv). Before the Civil War began, however, politicians were already arguing about the future of central banking once again. The Independent Treasury Act (adopted two different times but for the last in 1846) proved to be a setback from Hamilton's original central bank idea. The Act reconstituted the system of gold- and silver-backed transactions and took banking power even further away from the U.S. government.

The National Banking Act

During the Civil War, new banking rules were needed to keep the country afloat. The National Banking Act of 1863 was designed to not only establish central banking once again but to pull power back into the central government and unite states. The National Banking Act also began to modernize banking. It instituted specified reserves, increased management oversight, and provided a safer depository than the free banking era. The National Banking Act, however, had some major flaws

The first major flaw was that national banks did not have “the right to circulate asset-backed notes similar to those issued by Canadian banks...notes were issued against only a specific asset, United States obligations” (Beckhart 21). This greatly reduced the ability of the money supply to shift with demand, making it highly inelastic and subject to the “inability...to meet panic demand” (Beckhart 22). A combination of this and low reserve requirements (the second major flaw) created turmoil in the banking industry and the economy.

By 1907, banking and the economy were gasping for breath, but the Panic of 1907 sent both spiraling even further downward. Stock price declines and a low money stock led to sheer consumer panic. When banks could not cover customer deposits, reformation of the banking industry (again) was an obvious need. This need was met by the Federal Reserve Act of 1913.

The Formation of the Federal Reserve

The Federal Reserve Act of 1913

Between the Panic of 1907 and the Federal Reserve Act of 1913, politicians again strongly debated what the next step in banking should be. Some argued for the establishment of a central bank able to print non-asset backed currency, and some, of course, were decidedly in favor of the gold standard. The Alrich-Vreeland Act of 1908 established a National Monetary

Commission. The Commission studied both domestic and foreign banking operations and came to the following conclusions:

first, formation of a central bank that would create and hold reserves; second, creation of a coordinated system of check clearing and collection; and third, establishing a fiscal agent that could satisfy the needs of the federal government. (Hafer xv-xvi)

The work of the National Monetary Commission spawned the Federal Reserve Act of 1913. Interestingly, a Democrat and a Republican were responsible for pushing the final legislation through Congress. Representative Glass (D, VA) and Senator Robert Owen (R, OK) were able to quiet the feud between political parties and draw up legislation that compromised between Republicans and Democrats every step of the way. The Federal Reserve continues to serve as the U.S.'s central bank to this day, but changes have since been made to the original legislation of 1913.

World War I

Unfortunately, the newly built Federal Reserve faced its first challenge shortly after establishment. World War I broke out across Europe in 1914 and eventually drew the U.S. overseas and into conflict. At this point, the Federal Reserve was too new to deal with the financial distress caused by war. "It had no open-market portfolio to use as a counterweapon, and it lacked power to raise member-bank reserve requirements" (Beckhart 142). Since the Fed was so new, all it could really do was sit back and not aggravate the U.S. economy with new, aggressive policies.

The Great Depression

The next challenge for the Federal Reserve came October 29, 1929, or Black Tuesday. On this day, U.S. stock prices fell, and millions of investors were left with nothing. Some blame

Federal Reserve policies for the crash and its deep financial impact. Before the stock market crashed, it had been doing rather well, and many investors sought to reap market benefits by borrowing funds to invest. The Fed, “trying to fight the speculative excesses in the stock market...moved to raise interest rates in summer 1929” (Hafer xvii). This, combined with other reasons, caused the decline of the stock market. The Panic of 1907 was then replayed on a larger scale as people rushed banks, and the economy tumbled.

Instead of aggressively trying to counter the slipping economy, however, the Federal Reserve remained quiet and didn't make policies to counteract the economic downfall. The Fed also didn't lend banks money to counter bank runs. Banks and corporations alike began failing at an increasing rate:

The failure of banks and the Federal Reserve's policy led to a sharp reduction in the supply of money...while the Federal Reserve's policies are not the sole reason for the Depression, many economists believe that their restrictive actions and failure to act as lender of last resort turned a relatively normal economic downturn into the nation's worst economic catastrophe. (Hafer xvii)

The Great Depression, spawned by the economic disaster of 1929, was a slap in the face for both politicians and economists.

Reforming the Federal Reserve

Shortly after Franklin Roosevelt took office in 1933, he quickly signed the Emergency Banking Act, which called for insolvent national banks be taken over, “provided for the issue of Federal Reserve bank notes against direct obligations...[and] authorized the Federal Reserve banks to lend directly to individuals, partnerships, and corporations” (Beckhart 272). The

Emergency Banking Act gave the Federal Reserve more authority to deal with instability caused by the Great Depression.

The Banking Act of 1933 was the next step to deal with the nation's banking problems. Importantly, the Act gave birth to the Federal Deposit Insurance Corporation (FDIC). The FDIC's purpose was, and still is, to insure a bank's depositors. With insured deposits, a bank does not have to worry about panics spurred by customers' fears of losing everything if the bank should close. The Act also called for a Federal Open Market Committee (FOMC), the arm of Federal Reserve mostly concerned with policy decisions. The Committee is still a very important piece of the Fed today.

The Banking Act of 1935 was responsible for structurally transforming the Federal Reserve into its current form, learning from the mishap of the Great Depression. More federal legislation would not be passed for more than 40 years, and during that time, the Federal Reserve was able to establish monetary policy and embed itself in the U.S. economy.

The Federal Reserve Structure

The Three Main Parts

The Federal Reserve is composed of three main parts: The Board of Governors, Federal Reserve Banks, and the Federal Open Market Committee. The current structure of the Fed addresses many historical problems surrounding central banking. Its power is spread throughout all regions of the nation and is overseen by many, providing checks over top managers. Also, all three components share responsibility and work together much like the three branches of the federal government.

The Board of Governors

Located in Washington, D.C., the Board of Governors is a seven-member federal government agency. Each of the seven members is personally appointed by the President of the United States but must be approved by the Senate, and all 7 members are granted 14-year terms. Once a member has served 14 years, he may not return as a governor. The Board “along with a host of economists and support staff, help write the policies that make our banks financially sound and help formulate the policies that make our nation economically sound” (*In Plain English* 3). These important tasks put the Board of Governors at the center of the Federal Reserve. The Board even serves on the FOMC, another main arm of the Fed.

From the seven members, a chairman and a vice chairman are chosen by the President to lead the Board of Governors in four-year, renewable terms. The chairman of the Board of Governors is an extremely important and powerful position. He is the face of the Fed to the nation, and the world. He must speak to Congress twice a year on behalf of the Federal Reserve and report policy decisions. The Chairman is not only responsible for the domestic operations of the Federal Reserve, but he also represents the U.S. at several international meetings and advises the president on international policy. Alan Greenspan is the most notable Chairman of the Board, serving almost two decades on the Board.

Federal Reserve Banks

To mitigate the fear of a money monopoly being concentrated in the Northeast, 12 Federal Reserve banks are disbursed throughout the contiguous U.S. Also, since all the U.S.’s regions are very different, the Federal Reserve banks can monitor every region’s economic movements and markets. The 12 sites housing Federal Reserve banks are Boston, Chicago, Philadelphia, New York, Cleveland, Richmond, Atlanta, Kansas City, St. Louis, Dallas,

Minneapolis, and San Francisco. Each Reserve bank has at least one branch. Essentially, Federal Reserve banks are the banks of bankers. They handle bank deposits and also process bank loans as a lender of last resort. Federal Reserve banks also serve as the depository institution and fiscal agent for the federal government. Treasury notes, bills, and bonds are issued and administered through Federal Reserve banks.

Each regional bank is managed by a board of directors, which is composed of nine members including a chairman and deputy chairman. Six of the nine members “represent the public while three represent banking” (Grey 5). This ensures that the communities and nation at large are considered in the banking process. All the decisions made by the board of directors, including election of a bank president, are monitored by the Board of Governors.

Federal Open Market Committee

As previously mentioned, the FOMC was created by the Banking Act of 1933 and is vital to the policy-making operations of the Fed. The FOMC’s operations and decisions are vital to the U.S.’s monetary policy and economy. The nation’s economic forecast, the amount of reserves held by banks, and interest rates are all strongly influenced by the FOMC’s decisions. To achieve its desired goals, the FOMC conducts open market operations, which is mostly the buying and selling of government securities like Treasury bonds. The federal funds rate will then adjust according to the Committee’s actions. For example, if the FOMC wants to decrease the federal funds rate, it will call for the open-market purchase of government securities. When the Fed buys government securities in the open market, the money supply and bank reserves increase. The more money banks have to lend, the lower the interest rate since competition for loans is also lower. If the Fed wishes to raise the rate, the Committee will sell securities thereby decreasing the available money banks have to lend and making loans more competitive.

Aside from the Board of Governors, five Federal Reserve Bank presidents also reside on the FOMC. The president from the Federal Reserve Bank of New York is always a residing member, but the other four presidents rotate every year. All Federal Reserve Bank presidents participate in discussions and contribute to economic assessment, but only five are allowed to vote at any one time (Grey 14).

Banks and Advisory Committees

Throughout the nation, thousands of state banks are self-elected member banks of the Federal Reserve. State banks may choose not to be part of the Federal Reserve, but if they do, the banks must adhere to the Fed's policies and rules. National banks are automatically considered members of the Fed.

Several advisory committees also exist to aid the Fed in its operations. The Federal Advisory Council, the Consumer Advisory Council, and the Thrift Institutions Advisory Council are three important groups that interact with the Fed.

Responsibilities

According to *In Plain English: Making Sense of the Federal Reserve*, the Fed has three main responsibilities: "conducting monetary policy, supervising banks, and providing financial services" (*In Plain English* 8). Although the Fed's breadth of responsibilities is very wide, these three activities are the most important to the banking industry.

Monetary Policy

Conducting monetary policies that influence both domestic and international economies is the primary responsibility of the Board of Governors. Decisions made about monetary policy are highly scrutinized and affect both rich investment bankers and blue-collar workers in the U.S. and abroad. The three main options the Board has to influence the economy are the buying and

selling of government securities, setting bank reserve requirements, and charging interest rates to banks that borrow from the Fed (discount rate). All three options deal with achieving a target interest rate by increasing and decreasing the amount of money banks can borrow or hold. If a bank has excess funds, it can make more, cheaper loans to consumers. A smaller money supply, however, means less money for banks to lend, so interest rates increase and spending decreases. All three policy tools are used in conjunction with one another to achieve the Fed's stated goal.

Monetary policy should be centered on price stability while considering both long- and short-term effects of policy decisions. Price stability "appears to be the condition most conducive to maximum sustained output and employment and to moderate long-term interest rates" (Grey 17). What might be good for the economy now may have a significant negative impact on the future. Also, no matter what decisions the Fed makes, outside forces will always be an issue and are often unpredictable. Both domestic supply and demand and fluctuating foreign economies can strongly influence the U.S. economy. Businesses and economies are globalizing faster than ever, so the actions of foreign economies should be watched just as closely as a domestic economy.

Supervising and Regulating Banks

The Panic of 1907, which fueled the need for banking reformation, is a good example of why banks need to be supervised. The Fed is responsible for providing both written rules, or regulating, and enforcing those rules, or supervising. The 12 Federal Reserve Banks are responsible for regulating and supervising member banks in their regions. Member banks are in competition with one another and trying to make a profit, so good, fair business practices should be implemented for the customer's benefit. Some examples of how the Fed ensures bank soundness are: 1) issuing bank ratings that reflect the institution's health 2) reviewing mergers

and acquisitions 3) conducting on-site examinations (*In Plain English* 13). Through these activities, the Fed can mitigate consumer uneasiness and potential runs.

Providing Financial Services

The creation of the Federal Reserve provided a connected banking system through the United States, and as technology has progressed, transactions and information can be transferred much more quickly. As mentioned above, the Fed is primarily the bank for other banks and the Federal government. It provides some of the same services as local banks do to individuals but on a much larger scale. As the lender of last resort, the Federal Reserve provides loans for banks that could not otherwise secure funds, and as the government's fiscal agent, the Fed concerns itself primarily with the issuance and administration of Treasury securities.

Another financial service of the Federal Reserve is ensuring that the economy has enough currency on hand to meet seasonal demand (Grey 58). A major problem of the National Banking Act was its failure to address the inelasticity of currency. Currency demand tends to fluctuate throughout the year, and the money supply should expand to meet consumer needs. Demand is at its peak, for example, during the holiday season when spending is at its highest but slows during the summer months. Before a Federal Reserve Bank can place currency into circulation, however, "the currency must be secured by legally authorized collateral, most of which is in the form of U.S. Treasury and federal agency securities held by Reserve Banks" (Grey 58). As seasonal demand for currency decreases, cash makes its way back into banking institutions.

Criticisms

Although the Federal Reserve Act of 1913 was passed to deal with seeming flaws of the banking industry and to unite the country under a common system, many academics, economists, and politicians question whether central banking is the best way to control the money supply. As

in Alexander Hamilton's day, a major concern for critics is the monopolization of money by the government. In *Denationalisation of Money*, F. A. Hayek argues that monetary policy and fiscal policy should be distinct from one another (Hayek 51). Since the government has control over the money supply, it shouldn't also be able to make laws governing it. What Hayek means by this is the fact that the government passes its own budget and controls the presses that print money. If the government can print money to cover its debt, then is it ever in debt? This might lead to loose government spending. Also, one of the Fed's main tools for controlling interest rates is the buying and selling of securities. Since the Federal Reserve almost always uses U.S. Treasury securities, a market always exists for U.S. obligations. The central government thus has the ability to borrow exorbitant amounts of money and has an assured stream of income from its securities.

In 1972, the U.S. finally retired the gold standard and transitioned to fiat money. The Federal Reserve Banks took all the gold out of the banking system in exchange for government-issued notes. Some economists see this transition as problematic and accuse the government of hoarding the nation's gold supply. Rather than setting more controls to keep currency backed by gold stable, the government abandoned the policy in favor of a fiat system. This caused a large supply of gold to trickle to other nations since the U.S. no longer needed the metal to back its currency.

The central bank's involvement with national member banks is also a source of controversy. One of the Fed's primary activities is bank oversight and lending. The Federal Reserve is the bank of bankers, so member banks are forced to hold reserves and deposits in a federal bank's vault. As a banker's bank, the Federal Reserve also acts as the lender of last resort. If a bank is in need of funds that it cannot secure in the financial market, it borrows from

a Federal Reserve Bank. The lender of last resort responsibility is criticized because if the Fed is always there to help a bank as a “last resort” then the probability of bank failure is low. This could lead to banks always lending up to the maximum limit, even taking on risky loans with a high probability of default. If a bank is inefficient, maybe the Fed should let it fail. Also, since banks must answer to the Fed, the Federal Reserve has control over banks’ operations and how large they can grow. A bank’s expansion is limited by the desires of the Federal Reserve.

Opposing Theories

The primary theory that opposes a central banking system is reminiscent of the mid- to late-1800s free banking era. In a free banking system, banks do not operate as members of a large, governmental bank, but they instead operate independently of the government and each other. Banks run like private businesses, each offering a different product, so they compete with one another for customers. In a free banking system, the product each bank offers is a form of currency. Supply and demand in the free market then determine the value of each currency. For a bank’s currency to have a high value, it must carry a high quality and reputation. The goal here is for the financial market to determine prices and rates instead of the central government. To accomplish a free banking system, though, public education and a very high-value currency are imperative.

If the government maintains control of the money in a central banking system, however, Hayek feels that a gold standard is necessary (Hayek 130). If currency is backed by gold, or another marketable metal, then the government could not print money at will. Imported gold would be necessary to raise the money supply. Also, financial markets set the price for gold, so the asset-backed currency would not be as easily manipulated as fiat currency.

The U.S. has currently maintained a central bank for almost a century, and as technology rapidly evolves, the banking industry might need change as well. Maybe the U.S. is much like technology. Only a new, better process can be found by changing the old one and beginning experiments.

Conclusion

After almost two centuries of controversy, the Federal Reserve System is the U.S.'s central bank. The long history of U.S. central banking is bathed in political debates and bank panics, but the Federal Reserve Act of 1913 has stood longer than any other central banking legislation. The Federal Reserve Act created a system of banks located throughout the country and headed by very influential people. The Fed has a lot of power over both domestic and foreign economies. Although the Federal Reserve has added some stability and structure to the U.S. economy, some economists question the credibility and power of the Fed. The critics, however, will probably not see the downfall of the Federal Reserve in the near future. The Federal Reserve is very much embedded in the economy, and any changes would likely shake both the U.S. and world economies tremendously.

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