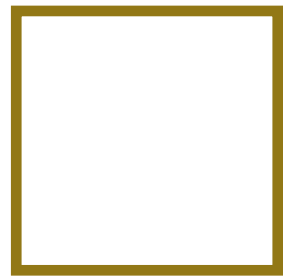
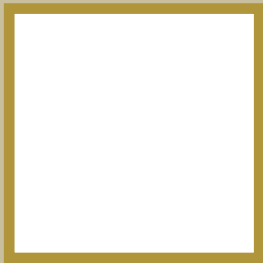


HISTORICAL  
BEGINNINGS...

THE FEDERAL  
RESERVE





*The signing of the Federal Reserve Act by President Woodrow Wilson, December 23, 1913, is depicted in this painting by Wilbur G. Kurtz, Sr. Commissioned by the Federal Reserve Bank of Atlanta in 1923, the painting is presently on loan to the Federal Reserve Board of Governors in Washington, D.C. from the Woodrow Wilson Birthplace Foundation in Virginia. While more people were present at the actual signing of the Act, Mr. Kurtz chose to picture the following men. Left to right: Lindley M. Garrison, Secretary of War; Josephus Daniels, Secretary of the Navy; Franklin K. Lane, Secretary of the Interior; A.S. Burleson, Postmaster General; Senator Robert Owen, Chairman of the Senate's Banking and Currency Committee; Champ Clark, Speaker of the House; William G. McAdoo, Secretary of the Treasury; Woodrow Wilson, President of the United States; Representative Carter Glass, Chairman of the House Committee on Banking and Currency; Representative Oscar W. Underwood; and William B. Wilson, Secretary of Labor. Courtesy, Woodrow Wilson Birthplace Foundation*

# HISTORICAL BEGINNINGS... THE FEDERAL RESERVE

*by Roger T. Johnson*



*Approved 23 December, 1913.*  
*Woodrow Wilson*

Roger T. Johnson was a member of the Public Services  
Department of the Federal Reserve Bank of Boston.

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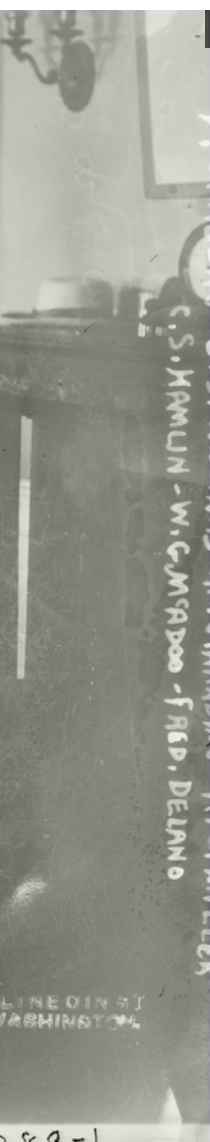
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# CONTENTS

INTRODUCTION	5
CHAPTER 1: EARLY EXPERIMENTS IN CENTRAL BANKING	7
1791: The First Attempt	7
1816: The Controversial Second Bank	9
1863: The National Banking Act	12
Banking Problems Persist	14
CHAPTER 2: FINANCIAL REFORM IN THE 20TH CENTURY	16
1908: The Monetary Commission	16
Bankers and the Aldrich Plan	18
The “Money Trust”	19
Back to the Drawing Board: The Glass-Willis Proposal	21
Battle Lines Drawn	22
Political Compromises	25
Opposition from Bankers	28
Passage by Congress	29
CHAPTER 3: MAKING THE SYSTEM WORK	33
District Line Dilemmas	34
Opinion in Boston	36
Canvassing the Nation	38
Hello, Boston—Goodbye, Baltimore	41
Crossfire	44
Getting It Together	48
Electing Local Directors	50
Wilson’s Choices: The Federal Reserve Board	51
FOOTNOTES	58
BIBLIOGRAPHY	59
OTHER BIBLIOGRAPHY MATERIAL	60



*Federal Reserve Board members, 1914.  
Seated left to right: C.S. Hamlin, Governor; W.G. McAdoo, Secretary of the  
Treasury; F.A. Delano, Vice Governor. Standing left to right: P.M. Warburg;  
J.S. Williams, Comptroller of the Currency; W.P. Harding; and A.C. Miller  
Courtesy, Federal Reserve Board of Governors, Washington, D.C.*



## INTRODUCTION

At 6:00 P.M. on December 23, 1913, President Woodrow Wilson entered his office. He was smiling as he looked around the circle of friends and associates who had assembled there. Spotting Carter Glass, the slightly built but exceedingly influential congressman from Virginia, at the far end of the room, the President beckoned him to join Senator Robert Owen of Oklahoma at his side. After shaking Glass's hand warmly, the President sat down at his desk and, using four gold pens, signed into law the Federal Reserve Act. As Arthur S. Link, Wilson's principal biographer, has written, "Thus ended the long struggle for the greatest single piece of constructive legislation of the Wilson era and one of the most important domestic Acts in the nation's history."<sup>1</sup>

With this law, Congress established a central banking system, which would enable the world's most powerful industrial nation to manage its money and credit far more effectively than ever before. As essential as our central banking system appears to be in today's complex economy, the political and legislative struggle to create the Federal Reserve System was long and often extremely bitter, and the final product was the result of a carefully crafted yet somewhat tenuous political compromise.



Indeed, until nearly the beginning of the 20th century the United States had been a nation dominated by its frontier and its enormous expanse of rich and fertile land. Born in the dawn of the modern age, the United States in its first decades was a land of small farms and nearby towns with few cities of any consequence, and the young nation seemed far more interested in becoming a successful experiment in democracy rather than an economic power. As a result, the institutions necessary to a commercial society—large cities, a common medium of exchange, and a mechanism to regulate that medium—were greeted with indifference if not outright hostility.

Yet, America's very success as an experiment in democracy, and its tremendous agricultural production, provided the base for an urban and, ultimately, an industrial society. "The United States was born in the country and has moved to the city," Professor Richard Hofstadter wrote.<sup>2</sup> Yet, some of the young nation's most eloquent leaders were strong champions of the agrarian way of life who disdained urban life, and the continuing conflict between rural values and urban reality has been one of the most important themes of American history.



*State Street in 19th century, Boston  
Courtesy, Boston Public Library, Print Department*





*N.C. Wyeth's Alexander Hamilton Mural, painted for the Federal Reserve Bank of Boston in 1922  
Courtesy, Federal Reserve Bank of Boston*

# CHAPTER 1

## EARLY EXPERIMENTS IN CENTRAL BANKING

### 1791: THE FIRST ATTEMPT

The conflict between rural values and urban reality was sharply etched in the first major political controversy following the ratification of the Constitution in 1789, a controversy, in the first years of George Washington's presidency, which dealt with the myriad of issues regarding the monetary and fiscal powers of the new federal government. Secretary of the Treasury Alexander Hamilton advocated the creation of a central bank, a Bank of the United States, to manage the government's money and to regulate the nation's credit. Secretary of State Thomas Jefferson strongly disagreed, arguing that since the Constitution



*Alexander Hamilton*  
*Courtesy, Library of Congress*



*Thomas Jefferson*



*James Madison*



*Andrew Jackson*

did not specifically empower the Congress to create a central bank Congress could not constitutionally do so. Hamilton responded that Congress could create just such a bank under the constitutional clause giving it all powers “necessary and proper” to the exercise of its specifically enumerated responsibilities; since Congress had been given so many monetary and fiscal powers, Hamilton argued, it would be perfectly proper for it to create a central bank to carry them out. Hamilton won the argument, and the First Bank of the United States was created in 1791.

The First Bank of the United States had a capital stock of \$10 million, of which \$2 million was subscribed by the federal government, while the remainder was subscribed by private individuals. Five of the 25 directors were appointed by the United States government, while the other 20 were chosen by the private investors in the bank. It was not only easily the largest bank of its time, but it was also the largest corporation in the United States; it was a nationwide bank, headquartered in Philadelphia but with branches in other major cities, and it performed the basic banking functions of accepting deposits and issuing bank notes, of making loans and of purchasing securities.

Its power made it useful to American commerce and to the federal government but frightening to many of the American people. Its charter ran for 20 years, and when it expired, in 1811, Jefferson’s Virginia colleague, James Madison, was President. An opponent of the initial bill in 1791, Madison, like many other Jeffersonian Republicans, had changed his mind, and now subordinated his initial constitutional objections and favored the bank’s recharter on the grounds of economic expediency. The vote in Congress was extremely close, but the bill to recharter the bank failed in both houses by the margin of a single vote.

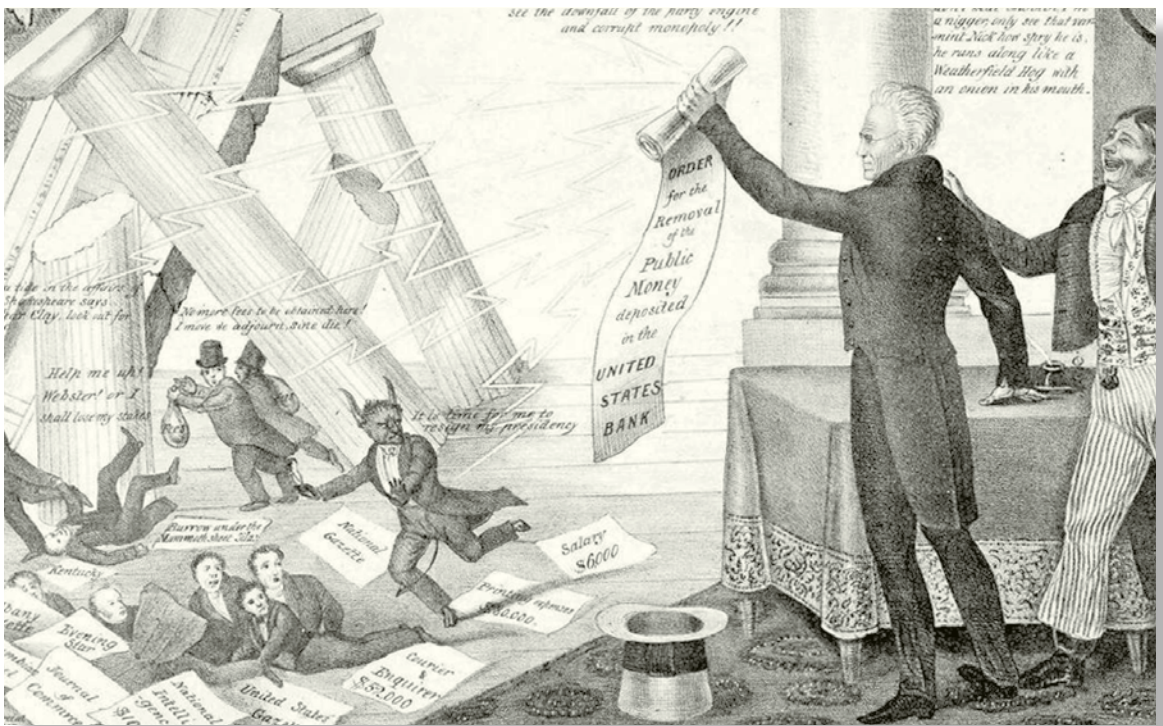
Chaos quickly ensued, brought on by the disruptions of the War of 1812 and by the lack of a central regulating mechanism over banking and credit. State-chartered private banks proliferated, and issued a bewildering variety of bank notes that were sometimes of little value. Moreover, the federal government lacked a safe repository for its own funds, a reliable mechanism to transfer them from place to place, and adequate means to market its own securities.



## 1816: THE CONTROVERSIAL SECOND BANK

By 1816, Madison's final year as President, a bill to charter a Second Bank of the United States was introduced in Congress. Henry Clay, Speaker of the House, had opposed recharter of the first bank five years earlier on the grounds that Congress had no right to charter such an institution. "The force of circumstance and the lights of experience," Clay now said, persuaded him that Congress did have this power. Enough other congressmen felt the same force and saw the same light so that the bill chartering the Second Bank of the United States narrowly passed both houses and received the President's signature.

Second Bank of the United States was very much like the first, except that it was much larger; its capital was not \$10 million but \$35 million. Like the first, one-fifth of the stock was owned by the federal government and one-fifth of the directors were appointed by the President; also, like the first, the charter was to run for 20 years.



*"The Downfall of Mother Bank"*  
Courtesy, New York Historical Society, New York

So powerful was the Second Bank of the United States that many citizens, politicians, and businessmen came to view it as a threat to themselves and as a menace to American democracy. Andrew Jackson, who became President in 1829 when the charter still had seven years to run, made clear his opposition to the bank and its recharter. Jackson has occasionally been labeled an economic illiterate, and it does appear that he neither understood nor sympathized with the functions of money and banking. Nevertheless, many diverse groups in the nation feared the bank's power and supported Jackson's opposition to it.

Henry Astor  
 83-  
 Bazalget Wells & the  
 heirs and Representatives of  
 Arnold W. Doehman vs.  
 This cause came on to be heard on  
 the Transcript of the Record and was  
 argued by Counsel on considera-  
 tion thereof. It is decreed and  
 ordered, that the decree of the Circuit  
 Court for the District of Ohio in this  
 case be and the same is hereby  
 affirmed with Costs. March 6<sup>th</sup>

James W. McCulloch  
 66-  
 The State of Maryland &  
 John James as well for the  
 State as for himself  
 This cause came on to be heard on  
 the Transcript of the Record of the  
 Court of Appeals of the State of  
 Maryland, and was argued by Counsel  
 in consideration thereof. It is the

opinion of this Court, that the act of the Legislature of Maryland  
 entitled "An act to impose a tax on all Banks or Branches thereof  
 in the State of Maryland not chartered by the Legislature" is  
 contrary to the Constitution of the United States and void, and  
 therefore that the said Court of Appeals of the State of Maryland  
 erred in affirming the Judgment of the Baltimore County Court  
 in which Judgment was rendered against James W. McCulloch  
 but that the said Court of Appeals of Maryland ought to have  
 reversed the said Judgment of the said Baltimore County Court  
 and to have given Judgment for the said Appellant McCulloch.  
 It is therefore adjudged and ordered, that the said Judgment of the  
 said Court of Appeals of the State of Maryland in this case be  
 and the same is hereby reversed and annulled, and this Court  
 proceeding to render such Judgment as the said Court of Appeals  
 should have rendered; It is further adjudged and ordered, that  
 the judgment of the said Baltimore County Court be reversed  
 and annulled, and that Judgment be entered in the said Bal-  
 timore County Court for the said James W. McCulloch. -

March 5<sup>th</sup>



It was essentially the bank's vast economic power which made it politically vulnerable. State-chartered banks, farmers, businessmen on the rise, and many politicians saw the bank as a giant monster standing in their way.

Despite the deep opposition to the bank, Henry Clay, Jackson's opponent in the 1832 presidential election, was able to push a bill through Congress to recharter the bank and intended to use Jackson's veto of the bill as a campaign issue. Jackson's powerful veto message denounced the bank as unconstitutional and described the dangers of "such a concentration of power in the hands of a few men irresponsible to the people." Though the President was on shaky grounds in challenging the bank's constitutionality (the Supreme Court in the famous 1819 case of *McCulloch v. Maryland* had specifically affirmed the constitutionality of the bank), his attack on the bank's power touched a popular nerve. Clay and his supporters widely circulated Jackson's veto message, but they greatly misjudged the popular response to it, and the President's impressive victory in the election was the beginning of the end of the Second Bank of the United States. When its charter expired in 1836, it ceased its role as America's central bank.

*The Supreme Court in the famous 1819 case of *McCulloch v. Maryland* had specifically affirmed the constitutionality of the bank.*

For the next quarter century America's banking was carried on by a myriad of state-chartered banks with no federal regulation. Although in some areas of the country such as New York, New England and Louisiana, the area banking system functioned with restraint, in other areas of the country, banking was not so stable, and the difficulties in American finance hampered the stability of the American economy. Under this system of state-chartered banks exclusively, there were often violent fluctuations in the amount of bank notes issued by banks and the amount of demand deposits (that is, checking account deposits) held by banks. The bank notes, issued by the individual banks, varied in quality from the relatively good to the unrelievedly bad. Finally, this banking system was hampered by inadequate bank capital, risky loans, and insufficient reserves against the bank notes and demand deposits.



*Bank Note from Hampden Bank, Westfield, Massachusetts  
Courtesy, Federal Reserve Bank of Boston*



*The Abraham Lincoln Mural, by N.C. Wyeth, was painted for the Federal Reserve Bank of Boston in 1922  
Courtesy, Federal Reserve Bank of Boston*

## 1863: THE NATIONAL BANKING ACT

During the Civil War Congress passed the National Banking Act of 1863, along with major amendments in 1864 and 1865, and this legislation brought a much greater measure of clarity and security to American banking and finance. Basically, the legislation provided for the creation of nationally-chartered banks (all such banks are recognized by the word “National” or the letters “N.A.”—which stand for “National Association”—in their title), and, by effectively taxing the state bank notes out of existence, the legislation in reality provided that only the national banks could issue bank notes.

The legislation also provided stringent capital requirements for the national banks, and mandated that the circulating bank notes be backed by holdings of United States government securities. Other provisions dealt with

lending limits, examinations by the newly-created office of the Comptroller of the Currency, and reserves against both notes and deposits. To the surprise of many who had supported the national banking legislation, state-chartered banks were able to survive even though they no longer had the incentive to issue bank notes mainly because the use of checks was increasing rapidly. As a result, demand deposits (checking accounts) and not bank note issues became the most important source of funds to the banks.



*Check clearing in the 1860s: "The ten o'clock terrors who never made errors"*  
Courtesy, Boston Clearing House, Federal Reserve Bank of Boston Archives

Yet the national banking legislation of the 1860s ultimately proved inadequate. Though it provided for the national chartering of banks and national bank notes, it still did not provide the essentials of central banking. Accordingly, banking remained essentially a local function without an effective mechanism which would regulate the flows of money and credit and which would assure the security of the nation's system of finance. What institutional arrangements on a national level that were to develop in the next half-century (correspondent relationships and check clearing operations, for example) grew up in the vacuum of federal activity; such arrangements were private and quite beyond the control or regulation of national policy.



*The first Wells Fargo office, San Francisco, California*  
Courtesy, Wells Fargo Bank, History Room, San Francisco



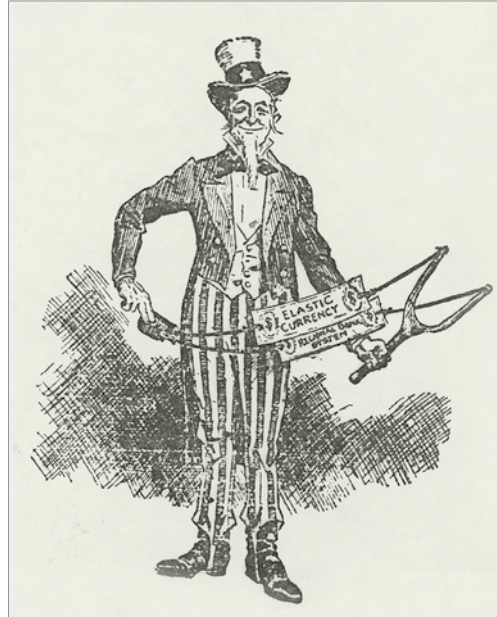
## BANKING PROBLEMS PERSIST

In the absence of a central banking structure, America's financial picture was increasingly characterized by inelastic currency and immobile reserves. The national bank note currency, secured by government bonds, grew or contracted in response to the realities of the bond market rather than in response to the requirements of American business. The amount of currency in circulation, therefore, depended upon the value of bonds which the national banks held rather than upon the needs of the economy. Such inelasticity in the currency tended to aggravate matters rather than alleviate them, causing the economy to gyrate wildly and somewhat uncertainly between booms and busts.

Moreover, under the national banking system the bank reserves were spread around the country, but they tended to be immobile where they sat. There were three types of national banks: country banks, reserve city banks, and central reserve city banks. Country banks (all national banks located in places other than the 50 cities which were reserve and central reserve cities) had to keep part of their reserves in the form of vault cash, and the rest in the form of a deposit with a national bank in a reserve or central reserve city. Reserve city banks (all national banks located in 47 specific and generally important cities) had to keep part of their reserves in the form of vault cash, and the rest in the form of a deposit with a national bank in a central reserve city bank. Central reserve city banks (all national banks within only three cities: New York, Chicago, and St. Louis) had to keep all of their reserves in the form of vault cash.

This meant that 50 different cities in the nation served as reserve depositories. Even though the total of reserves in the national banking system was very large, the economic value of this reserve was largely mitigated because it was so spread out; it was as if the American army were scattered all over the country, with each soldier assigned to protect his own specific area of several square miles. Such an army would clearly be infinitely less powerful than one whose forces were all gathered in a few strategic locations. The reserves of money could not be shifted easily to areas of the country needing them.

Also, the fact that reserve city banks held reserves for the country banks, and that their own reserves were held by central reserve cities, meant that the central reserve city banks, particularly those in New York, were unusually sensitive to the demands for currency from the country banks. When the country banks needed currency, particularly during the crop selling season, those banks would get their



*Courtesy, Philadelphia Record*

*This Dakota bank, pictured in 1877, was the forerunner of the First National Bank of the Black Hills, Deadwood branch*  
*Courtesy, West Glen Communications, New York*



currency by drawing down their reserve accounts with their reserve city banks. Those banks, now with less vault cash, were compelled to draw down their own reserve accounts with their central reserve city banks. It was much like a whip, where a little force at one end produced a tremendous force at the other; demands for currency from the country banks often put inordinate pressure upon the central reserve city banks.

As America's industrial economy became larger and more complex in the waning years of the 19th century and the early

years of the 20th, these weaknesses in the national banking system—inelastic currency and immobile reserves—became increasingly more critical. It had become clear that the national banking system did not provide the regulating mechanism for money and banking that the two Banks of the United States had provided early in the nation's history. And as the American economy became larger, more urban, and more complex, the inelastic currency and the immobile reserves contributed to the cyclical pattern of booms and busts. These wide gyrations were becoming more and more intolerable.

Financial panics occurred with some frequency, and they often triggered an economic depression. In 1893 a massive depression rocked the American economy as it had never been rocked before. Even though prosperity returned before the end of the decade—and largely for reasons which this nation could not control—the 1893 depression left a legacy of economic uncertainty.



*Wall Street's curb market, 1902*  
*Courtesy, Library of Congress*

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