FEDERAL RESERVE ACT (38 Stat. 251)

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To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

How to regulate the financial affairs of its government and its citizens was one of the earliest and most enduring political fissures in the American republic. Congress formally resolved this debate only in 1913 with the passage of the Federal Reserve Act, which created, for the first time, a permanent national central bank charged with ensuring financial stability. The product of this Act, the Federal Reserve System, was an awkward compromise among all sides of the national debate: it was both public and private, it was neither wholly independent of Congress and the Executive nor truly politically accountable, and it was simultaneously centralized and decentralized. As a result, the System would evolve almost continuously for fifty years after its creation, driven by further legislation, advances in economic theory, and the catastrophe of the Great Depression. By the end of the 20th century, the Federal Reserve System would be one of the most respected American public institutions, and would be used by the European Union as a model for its own European Central Bank.

1 Historical Development

From the founding of the Republic to the Civil War there was no national consensus on banking or monetary policy. Agrarian and populist interests were deeply suspicious of the concentration of wealth in Eastern financial institutions, and

[1]The analysis, opinions and conclusions expressed in this document are mine alone and do not necessarily reflect those of the Board of Governors of the Federal Reserve System, the Federal Reserve System as a whole, or its staff.

sought regulations to constrain their power; at the same time, business and manufacturing interests sought regulations to ease commerce and expand trade.

As one of its first acts, Congress chartered the First Bank of the United States in 1791. The Bank was to act as the fiscal agent of the Federal Government and to oversee a unified national currency; Congress limited the Bank's charter to 20 years. Congress declined to renew the Bank's charter upon its expiration in 1811; however, five years later, the Congress chartered the Second Bank of the United States, again with a 20 year lifespan. This Bank was seen as corrupt and as giving undue power to Eastern capital interests. When its charter expired in 1836 the ensuing political struggle became known as the "Bank War." President Andrew Jackson vetoed a bill renewing the Bank's charter, effectively ending central banking in the U.S. until after the Civil War.

After the Civil War, the political debate centered on the **gold standard**, which the U.S. had left in 1861; agrarian, populist and labor interests opposed the **deflation** required to resume the standard. Because of the massive expansion in incomes following the war, the gold standard was resumed with relatively little pain in 1879; see Friedman and Schwartz (1963).

Nonetheless, opposition to the gold standard continued under the **free silver** movement, championed by William Jennings Bryan. Indeed, the novel *The Wizard of Oz* by L. Frank Baum is an extended allegory favoring free silver.[2]

The period after the Civil War was also marked by successive financial panics and crises. Banks at that time were required to hold only a fraction of their deposits in **reserve**, that is, in the form of gold, vault cash, or government securities. The rest of their deposits they were free to lend to businesses and individuals. These loans were often illiquid, in the sense that although they were fundamentally sound investments in the long run, in the short run they could only be converted into cash for a fraction of their value. Such a system is prone to **bank runs**. The largest of the post-Civil-War banking panics struck in 1907, following the collapse of two major businesses, the Knickerbocker Trust and the Westinghouse Electric Company. As in previous crises, a group of wealthy private individuals, working

Gold standard *A monetary regime in which the government commits to converting currency into gold at a specified rate.*

Deflation *A period of time in which prices for most goods and services fall; these are usually bad times for debtors (who have to repay their loans with more valuable money).*

Free silver *A catch-all term for the Progressive movement's economic policies, advocated from 1863 to 1914; generally, these involved opposition to the gold standard and inflationary policies.*

Reserve, reserve requirement *Cash, gold and other liquid assets held by banks; the Federal Reserve Act regulated the fraction of deposits that banks had to hold in reserve (called the reserve requirement).*

Bank run *A financial crisis in which bank depositors race each other to their bank in order to liquidate their deposits.*

[2] In the novel, as opposed to the film, the magic slippers Dorothy uses to save herself are not ruby; instead the slippers are *silver*. (For an engaging exploration of this topic, see Rockoff 1990.)

under the direction of J. P. Morgan, worked to head off a full-scale collapse of the nation's financial system. Despite their success, after the Panic of 1907 had receded, all political parties agreed that a mechanism had to be found to supply banks with short-term liquidity (known at the time as an *elastic currency.*)

2 Congressional Passage and Early Implementation

Congress passed the Aldrich-Vreeland act in 1908 in reaction to the Panic of 1907. The Act provided for a system of temporary liquidity for banks (slated to expire in 1914) and it also created a National Monetary Commission chaired by Senator Nelson Aldrich to find a permanent solution to the problem of bank runs and financial crises. The Aldrich Commission's report was submitted to Congress in 1912. Although Woodrow Wilson, a Democrat, won the 1912 election, the Republican Aldrich's plan shaped the extensive debate that followed. A Democrat, Carter Glass of Virginia, shepherded the Federal Reserve Act through the Congress, and on Dec. 23, 1913, Congress adopted the Federal Reserve Act, also known as the Owens-Carter Act. Although Glass went to some lengths to distinguish the Federal Reserve Act from the Aldrich Commission's plan, the two systems had quite a bit in common (Friedman and Schwartz 1963, page 171).

Discount window *A lending facility available to member banks of the Federal Reserve System.*

Real bills doctrine *A monetary theory requiring the central bank to only make loans backed by "real" or "good" collateral, e.g. trade receivables.*

The Federal Reserve Act provided for the creation of between eight and twelve Reserve Banks in cities throughout the United States. These institutions were to be capitalized by the member banks within each Reserve District; the member banks would control the Board of Directors of each Reserve Bank, which would appoint its president and chairman. The entire system was to be overseen by an appointed Federal Reserve Board, based in Washington DC. By 1914 a full complement of twelve Federal Reserve Banks had been established in Boston, New York, Philadelphia, Richmond, Atlanta, Dallas, Cleveland, Chicago, St. Louis, Kansas City, Minneapolis and San Francisco.

In keeping with the Act's central requirement that the Federal Reserve System provide an elastic currency (that is, one whose quantity could grow or shrink as required by economic policy), the System required its member banks to keep a certain fraction of their assets on deposit with the Reserve Banks as Federal Reserve

deposits. In addition, the System issued Federal Reserve notes, the immediate ancestors of the familiar paper banknotes used today. The founders of the System hoped to prevent further banking panics by providing their member banks with ready and immediate access to liquidity via the **discount window** at which member banks could borrow at a published discount rate. Finally, as the United States was still on the gold standard in 1914, all Federal Reserve notes and deposits were backed by gold.

The System's initial design, however, assured a continuing struggle between the twelve Reserve Banks and the Washington-based Federal Reserve Board. The Federal Reserve Bank of New York, in particular, had a relatively sophisticated understanding of financial markets, and often advocated policies different from those pursued by the Board (Friedman and Schwartz 1963, page 190). The tension between the Reserve Banks and the Board was heightened by the fact that the Secretary of the Treasury and the Comptroller of the Currency were *ex officio* members of the Board.

The System officially opened for business in November 1914, shortly after start of World War I. Conceived in peacetime to prevent banking panics, the System's first duty would be to manage the monetary dislocations of the period of American neutrality, and then to assist the Treasury in financing the war expenditures.

After the war, the United States was one of the first nations to resume the gold standard. Other nations attributed the relatively easy resumption of the gold standard in the U.S. to, in part, the newly-established Federal Reserve System. In the 1920s the System was held in high regard domestically and abroad. Indeed, the period is sometimes known as "the high tide of the Federal Reserve" (Friedman and Schwartz 1963, pp. 240-298).

In October 1929 the U.S. stock market crashed, losing a considerable fraction of its value. This in itself probably would not have enough to cause the Great Depression; however, beginning in October 1930 a series of small Midwestern banks failed and a full-scale nationwide banking panic began. This panic was the first of three banking crises that would culminate with the long banking holiday of March 1933, when the entire U.S. banking system was closed by presidential directive. The System, along with all mainstream academic and government economists, firmly believed in the **real bills doctrine**, which held that providing

liquidity against purely financial claims (including U.S. government bonds) was bad policy. In short, when banks came to the discount window, they were required to present as collateral claims against viable business interests, which they did not have. The Great Depression began, in essence, as a classic banking panic of the late 1800s. Because the U.S. economy had become more complex and dependent on the smooth functioning of capital markets, the damage wrought by the bank runs of the early 1930s was much greater than in previous episodes (Friedman and Schwartz 1963).

3 Reforms of the New Deal and Beyond

The Roosevelt legislative program contained several measures designed to address the problem of bank runs and general financial instability. Many of the key New Deal laws affected the functioning of the Federal Reserve System.

Among the first laws passed under the Roosevelt administration was the Banking Act of 1933 (48 Stat. 162) also known as the Glass-Steagall Act. This act provided the first nationally-guaranteed system of insuring bank deposits by creating the Federal Deposit Insurance Company (FDIC). Deposit insurance ended forever the problem of bank runs and banking panics (although it would open the door to the thrift crisis of the late 1980s). The Glass-Steagall Act contained several other provisions that have since been modified or superannuated, but which in their time were extremely important. These included: (1) Prohibiting banks from paying interest on short-term deposits (known as "Regulation Q"); (2) Prohibiting banks from underwriting securities ("investment banking"); (3) Prohibiting banks from engaging in many other forms of non-bank activities such as underwriting insurance (Board of Governors 1998, page 3-001).

The Banking Act of 1935 (49 Stat. 722) renewed and extended many of the 1933 provisions to banks outside the Federal Reserve System. However, this act is of particular note because it finally clarified several of the institutional tensions designed into the Federal Reserve System. Under the act, the Federal Reserve Board became the supreme institution; it was renamed the Board of Governors of the Federal Reserve System and members of the Board were to be known as

"Governors," the traditional title for central bankers. In addition, the act ended the *ex officio* membership of the Secretary of the Treasury and Comptroller of the Currency on the Board. Finally, the act formally recognized the Federal Open Market Committee (FOMC) as a separate legal entity.

The Employment Act of 1946 (60 Stat. 23) directed the System to implement policies designed to balance the two goals of full employment and low inflation. Achieving these goals has been the guiding principle of the System, and indeed almost all modern central banks, since.

The final step in the modernization of the System was the Treasury Accord of 1951. Before the accord, the System acted as a buyer of last resort for Treasury debt; if investors demanded interest rates on government bonds above a ceiling (set to 2-1/2 percent at the time of the accord) the System would step in to buy the residual debt. With government spending hitting new records during the Korean War, this support rule demanded an inflationary monetary policy. Under the terms of the accord, the Federal Reserve System was relieved of the responsibility of keeping interest rates low.[3]

4 The Modern Federal Reserve System

The formal laws governing the conduct of monetary policy have remained largely unchanged since the 1950s. Monetary policy decisions are largely made by the Federal Open Market Committee (FOMC). The FOMC is a separately-recognized legal entity made up of the seven Governors in Washington D.C., the president of the Federal Reserve Bank of New York and the Presidents of four of the remaining 11 Reserve Banks (chosen on a rotating basis), and typically meets eight times a year. The FOMC dictates the conduct of **open market operations**, the technical means by which the System affects short term interest rates. (For a description and statistical analysis of open market operations, see Hamilton 1996.)

Open market operations *Purchases and sales of Federal Reserve Deposits designed to affect short-term interest rates.*

[3] The Federal Reserve Bank of Richmond devoted a special issue of its *Economic Quarterly* to the fiftieth anniversary of the Accord. Of particular interest are Leach and Hetzel (2001a,b).

The Full Employment and Balanced Growth Act of 1978 (92 Stat. 1897), also known as the Humphrey-Hawkins Act, amended the Federal Reserve Act to require that the Board of Governors submit reports on the state of the U.S. economy and the conduct of monetary policy twice a year (typically in February and July). In addition, the Chairman typically testifies before the relevant House and Senate Committees as part of the report. This appearance, referred to as the Humphrey-Hawkins testimony, has become a closely-watched event.

Several of the financial regulatory reforms of the 1980s involved the System to some extent, either in its role as a bank regulator or by amending the Federal Reserve Act directly. The most important of these include the Depository Institutions Deregulation and Monetary Control Act of 1980 (94 Stat. 132), the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (103 Stat. 183) and the Gramm-Leach-Bliley Act (113 Stat. 1338).

Finally, several consumer protection and anti-discrimination laws also involve the Federal Reserve System. Among of the most important of these are the Home Mortgage Disclosure Act of 1975 (89 Stat. 1125) and the Community Reinvestment Act of 1977 (91 Stat. 1147).

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