

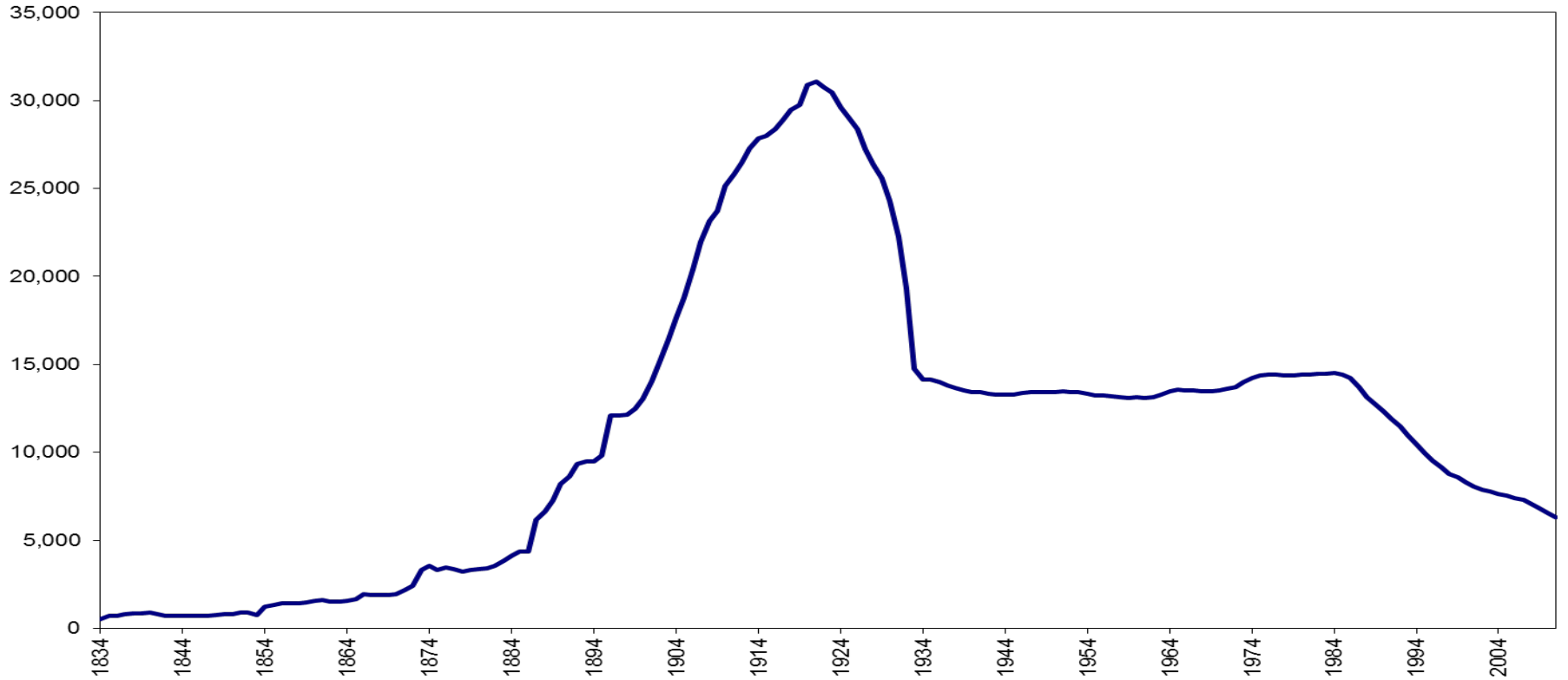


A Look Back at the History of the Federal Reserve

Jeffrey M. Lacker
August 29, 2013

On Twitter: [#fedhistory](#)

Number of U.S. Banks: 1834-2011



Coin



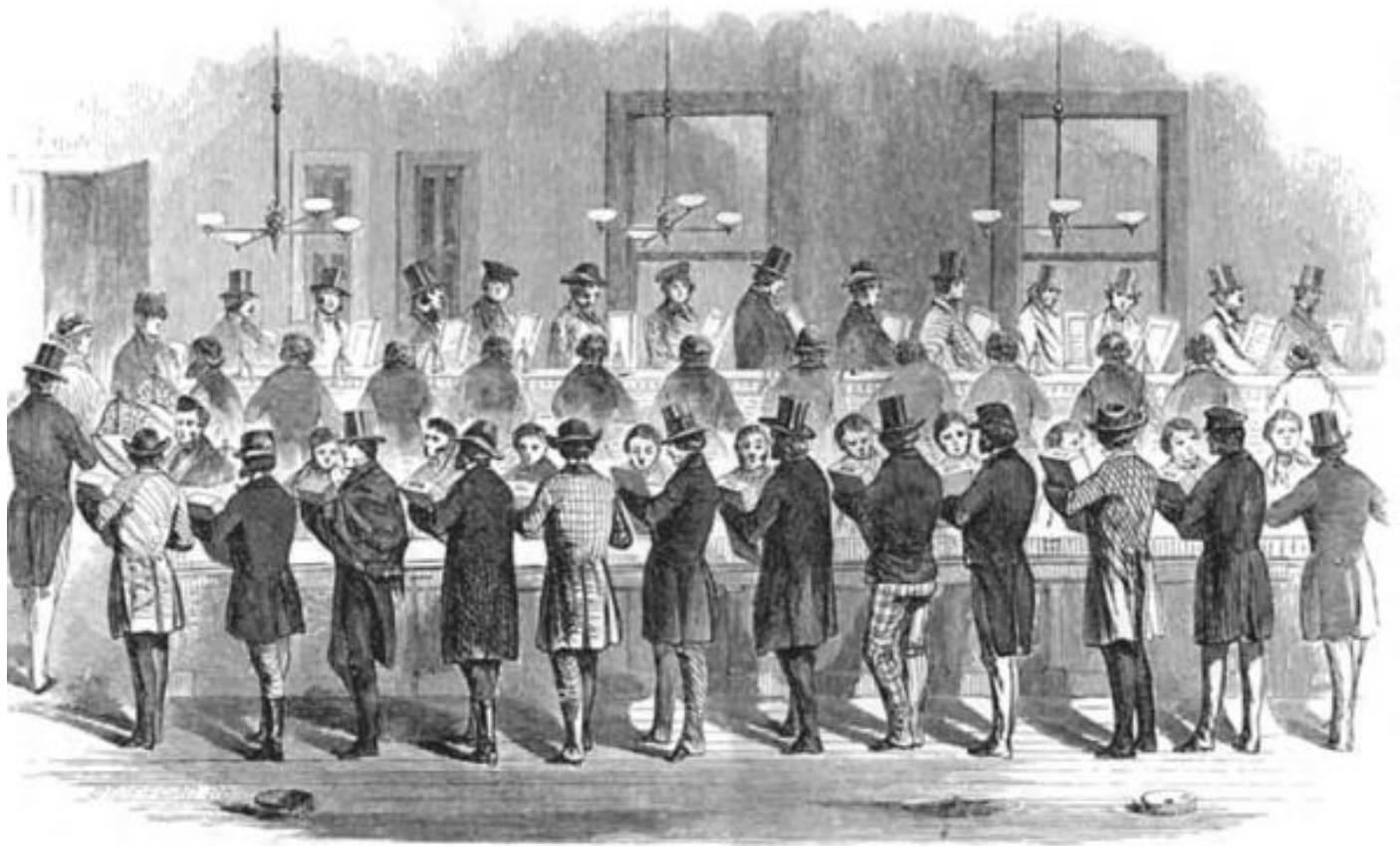
National Bank Currency



Checks



Clearinghouses



Correspondent Banking

VIRGINIA

2990

DESK EDITION

NEWPORT NEWS, 5 (Continued.)

Crown Savings Bank †1925.....25,000

W. P. Dickerson, Pres.

* **First National Bank**

(4635) Capital, 200,000 1891 \$90

H. L. Ferguson, Pres. S. H. Plummer, Cash.

J. R. Swinerton & Saxon W. Holt, V.-P.'s. Sur..200,000

J. A. Willett, Act. V.-P.

W. A. Shell & D. L. Downing, A.C's.

Loans. 3,100,000 Dep. 5,130,000 Undiv. prof. 70,000

*Irr. B - Col. T. Co. & Chase NB, N. Y. C. & C. N. B, Chic.
B'k of N. A. & T. Co, Phila. Am. & First N. B's, Richm.*

* **Jefferson Bank** †1902 \$92.....35,000

G. F. Lenz, Pres. F. B. Longan & L. U. Noland, V.-P's.

J. Newit Pepper, Cash. C. R. Blassenham, Jr., A.C.

Loans. 400,000 Dep. 660,000 Sur. & Prof. 25,000

N. B. of Com, N. Y. N. B. of Balto., Md. Seab. N. B, Norf.

* **SCHMELZ NATIONAL BANK**

(11028)

Capital, 200,000

1912 \$89

The Problem

What problem was the Federal Reserve designed to solve?

Inelasticity

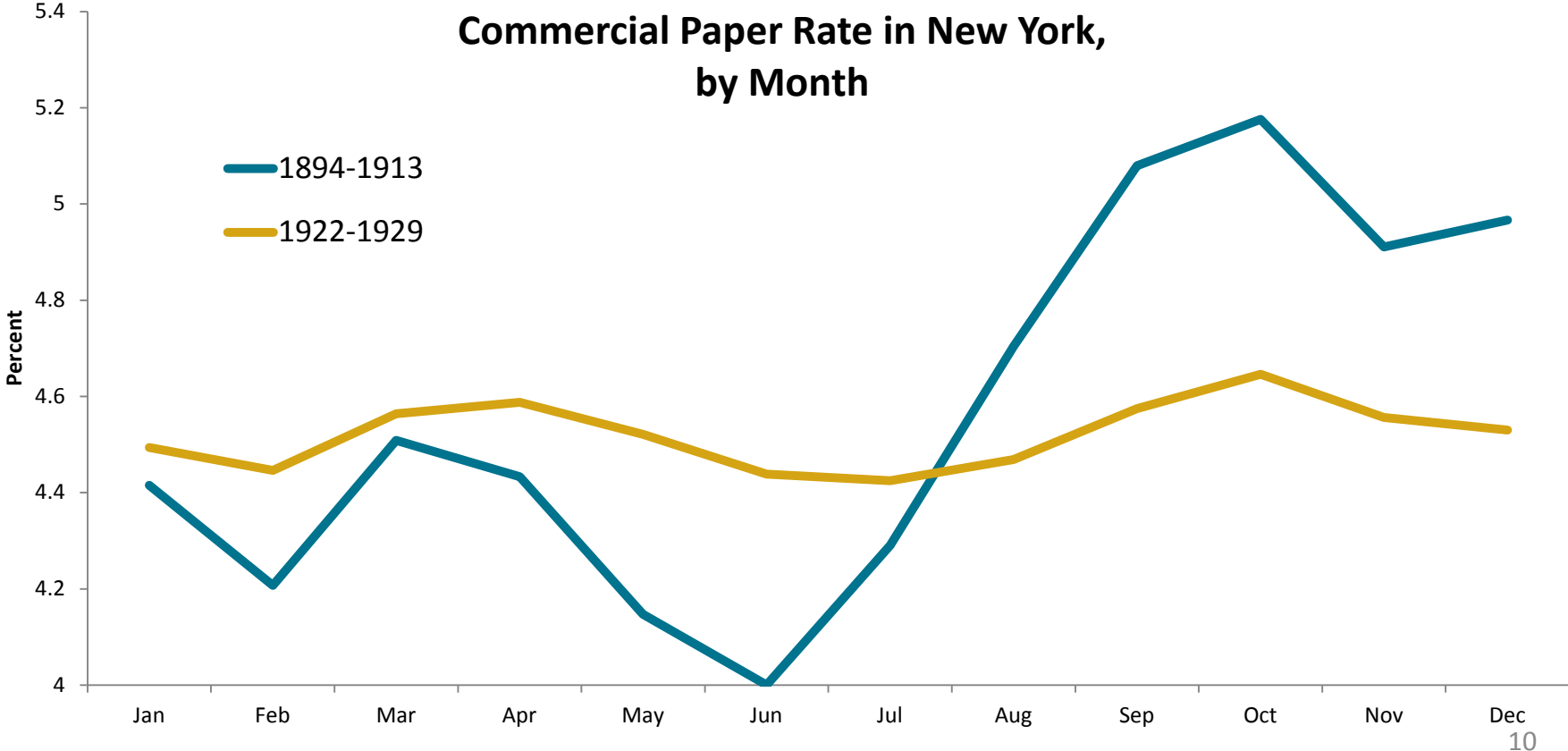


UNCLE SAM'S NEED OF AN ELASTIC CURRENCY

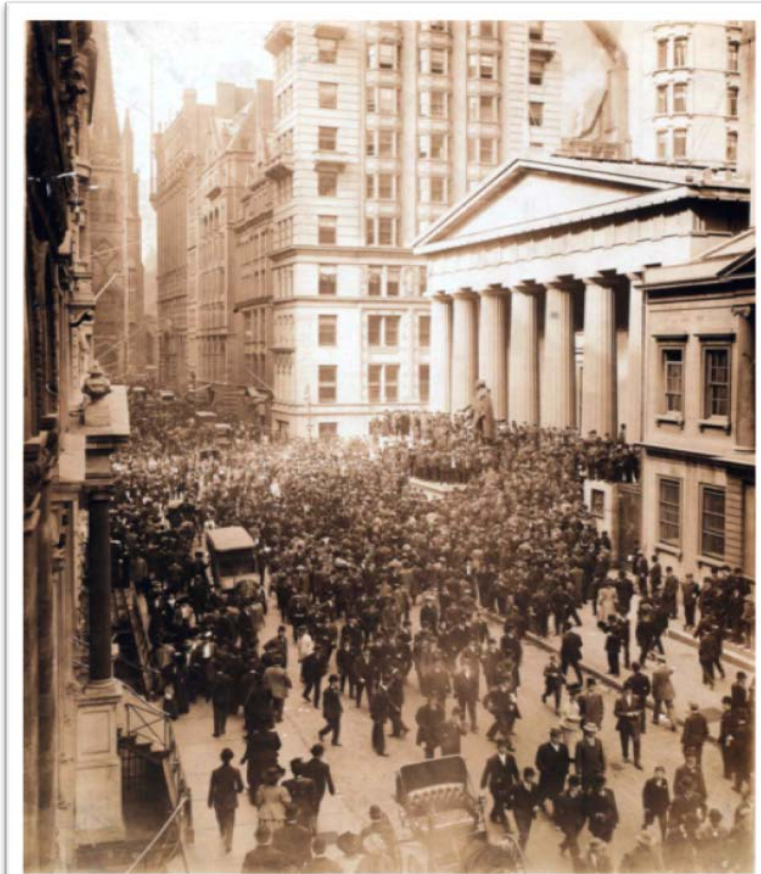
PRESIDENT ROOSEVELT: "You see, those galluses ought to have rubber in them, so that when Uncle Sam stoops to move the sheaf there won't be much strain on the buttons."

From the *Pioneer Press* (St. Paul)

Interest Rates Rose in Autumn



Financial Panics



Financial Panics

Key features of financial panics before the Fed

Sizable movement out of deposits into currency

Often occurred in autumn, when currency supply was already stretched.

Interest rate spikes

Banks scrambled to borrow scarce currency.

“Suspensions”

Banks and clearinghouses would not allow depositors to withdraw currency.

Transfers to account holders at other clearinghouse allowed.

Clearinghouse banks effectively banded together in mutual support

Clearinghouse banks would at times refuse to ship currency to country bank correspondents!

Founding the Fed

Purpose of the Federal Reserve Act:

- 1) To provide for the establishment of Federal Reserve Banks
- 2) to furnish an elastic currency**
- 3) to afford a means of rediscounting commercial paper
- 4) to establish a more effective supervision of banking in the United States
- 5) and for other purposes.

(numbers added)

Founding the Fed

Reserve Banks as government-sponsored clearinghouses

Natural model, given the example of private clearinghouses

Key innovation: *universal membership*

Authorized to:

- Accept deposits from member banks (“reserves”).
- Issue notes, but without inflexibilities of the NBA.
- Examine member banks for safety and soundness.
- Clear and settle checks.
- Do other things national banks could do.

Founding the Fed

Key issue: Structure

One reserve bank with many branches?

New York bankers and Republicans favored this approach.

Several regional reserve banks?

Country bankers and Democrats favored this approach.

Feared domination by New York banks, corrupting influence on federal government.

Resolution: Democrats take Congress and White House in 1912

Carter Glass, D-Va., chairs House Banking and Currency Committee, works with Woodrow Wilson to draft bill.

Between eight and 12 Reserve Banks – in the event, 12 (Glass' influence)

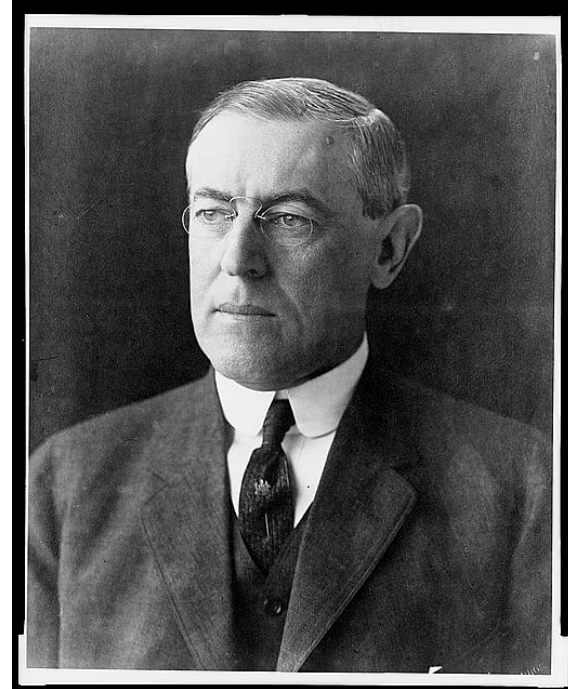
Federal Reserve Board, an agency (Wilson's influence)

Founding the Fed

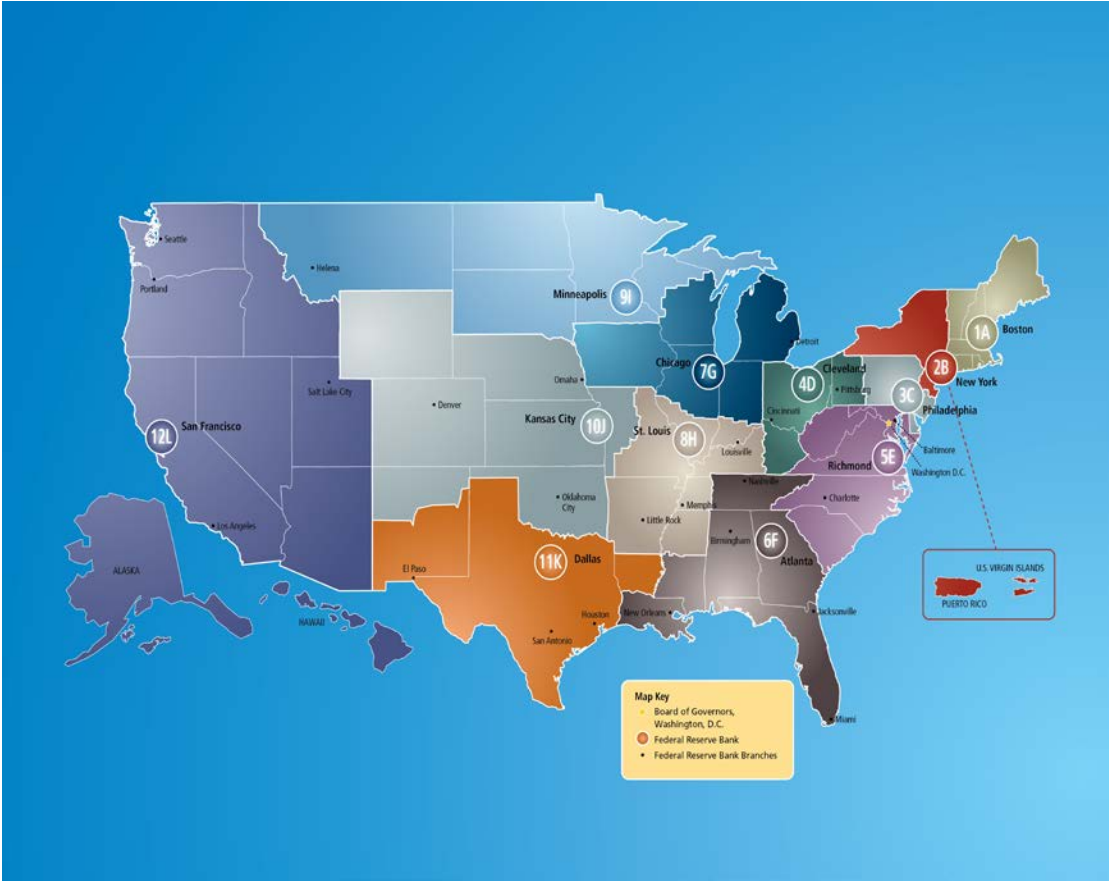
Carter Glass



Woodrow Wilson



Federal Reserve System Map



Founding the Fed

Key issue: Governance and Accountability

Private clearinghouses were owned and run by member banks.

Bankers proposed all-banker boards.

Progressives sought government role.

Resolution: private Reserve Banks, Boards made up of

- Three elected bankers
- Three elected nonbankers
- Three Board appointees

Federal Reserve Board, a federal agency, to oversee Reserve Banks.

This issue is still with us:

Dodd-Frank Act section 1107 restricts bankers' roles on Reserve Banks' boards.

Federal Reserve Leaders, 1914



Founding the Fed

Key issue: What assets should the Reserve Banks hold?

Gold, of course.

Government bonds? No.

Cumbersome under NBA, risks inflationary government finance.

Private assets? Yes, but which?

Private bonds and stocks were risky and “speculative.”

Resolution: “discounts and advances”

- Purchases of commercial paper issued by companies, endorsed by banks
- Loans to banks, secured by commercial paper

Envisioned as central monetary policy

Later, in WWI, government security purchases were also permitted.

Founding the Fed

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Founding the Fed

Key issue: What assets should the Reserve Banks hold?

Lending or buying assets creates reserve balances or puts notes into circulation.

- RB loans create reserve balances.
- RB asset purchases create reserve balances.
- Banks can convert reserve balances into Federal Reserve notes.

Solving “The Currency Problem” (i.e., monetary policy) is independent of what assets the Fed holds.

Monetary policy = managing total Fed liabilities

That is, the amount of currency and reserves

Credit policy = composition of Fed’s asset portfolio

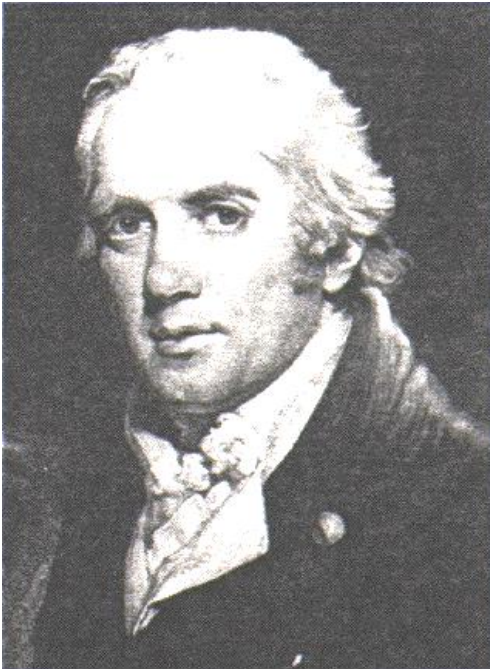
For example, lending or buying private assets

Fed’s crisis lending was credit policy, not monetary policy

Founding the Fed

“Lender of Last Resort” = monetary policy

Henry Thornton (1802)



Walter Bagehot (1873)



Final Observations

Two views of central banking

Expansive approach

Use asset portfolio to minimize financial system disruptions

Read charters liberally to include “financial stability mandate”

Grounded on “inherent fragility” view of financial markets

Narrow approach

Focus on core monetary policy mission

Credit policy could compromise governance arrangements

Grounded on “induced fragility” view of financial markets

Future evolution of central banking likely to depend on how tensions between these two views play out