THE FEDERAL RESERVE ACT OF 1913 IN THE STREAM OF U.S. MONETARY HISTORY

*James Parthemos**

Cursory histories of United States money and banking usually link the origins of the Federal Reserve System to the panic of 1907, to the Aldrich-Vreeland Act of 1908, and to the monumental work of the National Monetary Commission established by that act. It is probably more revealing to interpret the original Federal Reserve System as a key stage in a process of monetary and banking experimentation that dates back to the beginnings of the nation.[1]

The first 125 years of the nation's history were marked by sharp and often bitterly divisive controversies over money and banking arrangements. Much of the history of the period can be written around the divisions over the First and Second Banks of the United States, the free banking movement of the middle nineteenth century, the national banking system, the greenback and free silver movements in the post-Civil War period, the move toward an unambiguous gold standard in the 1890s, and the groundswell of reform sentiment at the turn of the century that culminated in the Federal Reserve Act. All these developments might properly be viewed as a fledgling nation's experimental efforts to establish a set of money and banking arrangements congenial to its unique circumstances and political values.

For better or worse, Americans of the nineteenth century showed little disposition to look to Western Europe for monetary precedents. While recognizing and reflecting the cultural legacy of Western Europe, American society had developed early in its history a strong sense of its many differences with the nations of Europe. It harbored a general awareness of sharp differences in historical experience, in political and social values, in geography, and in economic potential. Given such differences, Europe was not to be emulated. Rather there seemed to be general agreement that the country had to work out its own solutions, consistent with its own political and social values and with the need to subdue a vast continental expanse of great potential. The legacy of the frontier did much to shape these social and political values. That same legacy placed a premium on individual initiative and fostered a pragmatic approach to public problems that contrasted with the rigid and often doctrinaire traditionalism that characterized much of Europe.

I.
Political and Geographic Influences on U.S. Monetary Evolution

The principal factors affecting money and banking evolution in the nineteenth century were the nation's unique political values and its vast, untamed geographic expanse.

More than any other contemporaneous society, the United States of that period valued individual freedom and abhorred concentrations of power, private or governmental. These characteristics comprised an important element shaping the country's monetary experience. The political structure of the nation, a federation of quasi-sovereign states, reflected these values. Tension between the federal government and individual states figured importantly in the country's early efforts to establish a satisfactory payments system. For the first forty years of the new nation's existence the federal government, following Alexander Hamilton's carefully drawn blueprint, provided monetary and banking leadership. Crucial to this leadership, which ran from 1791 to 1833, with a five-year hiatus, 1811-16, were the First and Second Banks of the United States. These were quasi-governmental institutions, chartered by the federal government, with the issue privilege and empowered to act as fiscal agent for the United States

* Mr. Parthemos retired in 1985 as Senior Vice President and Director of Research, Federal Reserve Bank of Richmond.

[1] Monetary experimentation typified the colonial period as well, as the colonies sought to establish an adequate payments system. Banking and paper money schemes were important issues exacerbating relations with the mother country. See Horace White, *Money and Banking, Illustrated by American History* (Boston, U.S.A. and London: Ginn & Co., 1896), pp. 4-22, 248-58; A. Barton Hepburn, *A History of Currency in the United States with a Brief Description of the Currency Systems of All Commercial Nations* (New York: Macmillan Co., 1915), pp. 1-12; Leslie V. Brock, *The Currency of the American Colonies, 1700-1764* (New York: Arno Press, 1975), passim.

Treasury. Through branches located in the more settled centers of the country they operated nationwide. They were in position to monitor the note-issues of state-chartered banks and to enforce specie redemption of these notes.

These institutions fell afoul of strong states' rights sentiments and of the Jefferson-Jackson party's equally strong aversion to concentrations of power. The removal of the government's deposits from the Second Bank in 1833 and the negation of the Bank's fiscal agency powers mark a temporary end of federal government domination of banking arrangements. From 1833 to the Civil War period the individual state governments directed their own banking evolution, with no interference from the federal government. The federal government again assumed a dominant role in the Civil War period and in the decades that followed, asserting the right to charter so-called national banks and to use the taxation power to deny the note-issue privilege to nonnational institutions. Nevertheless state governments, through their undiminished authority to charter banks, were still exercising an important role in the country's monetary affairs on the eve of the establishment of the Federal Reserve System.

The country's vast geographic expanse, stretching by mid-century from ocean to ocean, was a second factor in its monetary evolution. Until late in the nineteenth century much of the country was sparsely settled. Especially in the period before the Civil War transportation and communication facilities were primitive and high-cost over large areas of the country. For such a broad, undeveloped area a payments system based on banks and bank liabilities was a practical necessity. For local payments bank notes, especially those of state-chartered banks, were the standard medium. In parts of the country, notably in New England, bank notes were used for intercity payments as well, owing largely to the so-called Suffolk System through which the notes of most New England banks were redeemed at par in Boston. Other states, notably New York, South Carolina, Louisiana, and later Indiana, had state-chartered or state-owned banks whose notes circulated widely at par. But in much of the country, especially in the newer states of the South and the West, efforts to establish a trouble-free bank note circulation encountered problems many of which were attributable to the sparseness of settlement, to high costs of transportation and communication, and to ineffectual bank supervision. Notes circulating at a distance from the issuing bank in many cases could be presented for redemption only at considerable cost and therefore tended to go to a discount.[2] Some unscrupulous bankers deliberately located their offices with a view to maximizing the cost of presentments. The notes of these so-called "wildcat banks" invariably went to substantial discount. In any case, for much of the period between 1833 and 1860, and in much of the West and the South, lax bank supervision coupled with high transportation and communication costs produced a note circulation that was a confused hodgepodge of obligations of a large number of small banks, many of doubtful viability, circulating at various rates of discount.[3]

Neither bank notes nor specie were efficient means of mediating interregional trade, which became increasingly important as the frontier was pushed westward. In the pre-Civil War period interregional—and, in much of the South and West, intercommunity—payments involved the use of trade acceptances and bank drafts drawn on regional centers and were much like international payments. The business journals of the day regularly carried exchange quotations on New York, Chicago, New Orleans and other regional centers. In the West, in particular, private banks joined state-chartered banks in providing facilities for interregional payments.

For most of the country banking markets in that period were highly local and, except in New England, banking systems were confined within state boundaries. The climate of strong states' rights sentiments and popular suspicions of concentrations of power militated against nationwide, or even any significant

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[2] Unless, of course, the point of issue enjoyed a favorable payments balance with the point at which the note was circulating. In that case a note circulating at a distance from the issuer could actually go to a premium. There are numerous instances in pre-Civil War America of notes of respected banks in the East circulating in distant parts at a premium.

[3] The function of monitoring the note issues of state banks and enforcing convertibility was served in the earlier period by the First and Second Banks of the United States. In the absence of these institutions "note brokerage" emerged as a profitable private activity. Note brokers bought up notes at a discount and undertook the task of presenting them for redemption. Interestingly, note brokers were not a popular group in the business community and were often referred to pejoratively as "note shavers." For an account of this activity in the 1833-60 period see Davis R. Dewey, ***State Banking Before the Civil War***, National Monetary Commission, Senate Document No. 581, 61st Congress, 2nd Session (Washington, D.C.: Government Printing Office), pp. 74, 107-12.

At that time periodicals called bank note reporters were indispensable equipment for businessmen. Such periodicals carried listings of current bank notes with their respective rates of discount or premia.

degree of interstate, branching.[4] Given the predominantly local nature of banking markets, some degree of cooperation between banks in different regions of the country was necessary to effective payments arrangements. Out of this necessity grew a system of correspondent banking unique to this country.

The Civil War and the resulting constitutional changes radically altered the relationship of the federal government to the states and established the former's primacy in shaping the monetary order. Nevertheless state governments, through their authority to charter banks and to regulate state-chartered institutions, continued to exercise an important role in the country's monetary affairs. They played a leading role in setting branching restrictions and in developing arrangements for protecting depositors against bank failures.[5] But control over the nation's monetary base passed definitively to the federal government after 1863. The so-called "dual banking system" that emerged after the war continued, however, to involve important tensions between the federal government and the states.

The vast expanse of the country continued to affect its monetary evolution even after the development of state-of-the-art transport and communications in the latter half of the nineteenth century. In that period of rapid economic growth, the number of banks multiplied quickly. Deposit banking grew apace and the use of the check in intercommunity and interregional payments became commonplace. The banking system was confronted with the problem of collecting an increasingly large number of checks drawn on an increasingly large number of out-of-town points, with many checks having to travel large distances. Long delays and high costs involved in collecting out-of-town checks, with the resulting magnified check float, represented an important deficiency in the payments system and in arrangements for the management of bank reserves in the period before the Federal Reserve was established.[6]

Finally, the continental expanse of the country embraced a diversity of resource patterns. As the frontier was pushed steadily westward, a corresponding diversity of regional interests emerged. Economic sectionalism, always a major factor in United States political history, figured importantly in the nation's money and banking history as well. Credit requirements of the several distinct regions were popularly viewed as being in conflict. Moreover, in the newer capital-short states of the South and the West, the natural tendency of the settled and more highly developed centers of the Northeast to provide financial leadership was viewed with suspicion. The "money monopoly" of the East, real or fancied, was often the focal center of political dialogue. It played a major role in the undoing of the First and Second Banks of the United States, in the free banking movement at mid-century and, in the post-Civil War period, in the greenback and free silver movements. It was a major factor in the dialogue leading to the passage of the Federal Reserve Act.

II.
Halting Movement Toward a National System

The pre-Civil War period of state domination of banking presents a variety of experiments in banking arrangements. All states at one time or another tried special charter banking. Some states experimented with outright state ownership and operation of state institutions. A few states for a time even outlawed banking. The Suffolk System in New England and the Safety Fund System in New York were successful experiments in note-issue banking. In the 1850s virtually all states adopted free banking, involving general laws of incorporation under which entry into banking was open to any who met specified conditions. These included a requirement that all notes issued be secured fully by state bonds or other specified assets. This free banking principle was later incorporated into the National Banking Act of 1863.

The essential point here is that this was a period of experimentation, with experiments in individual states often having more destabilizing than stabilizing effects. Nor did the experimentation end following the Civil War reforms. Rather the focus of it, like the authority over money and banking matters, shifted towards the federal government. For the

[4] There were, however, some cases of multistate banking. The most notable case is that of the Wisconsin Marine and Fire Insurance Company, which was a bank in everything but name. Its notes, which came to be called "George Smith's money" (after the company's founder), circulated over much of the present-day Midwest in the 1840s and 1850s. Smith maintained offices in Milwaukee, Chicago, Detroit, St. Louis, Buffalo, and Galena for purposes of redeeming these notes either in specie or New York exchange. His company was chartered first in Wisconsin. When that charter expired Smith, after some difficulty with the Wisconsin legislature, operated under a charter issued by the Georgia legislature. See Horace White, op. cit., pp. 387-94.

Banking was prohibited in some states and in these states notes of out-of-state banks were frequently introduced through agents.

[5] See Eugene Nelson White, "State-Sponsored Insurance of Bank Deposits in the United States, 1907-1929," *Journal of Economic History* 41 (September 1981): 537-57.

[6] See infra, p. 23.

fifty years following passage of the National Banking Act, periodic banking crisis tended to call forth adjustments in banking and currency laws that were more in the nature of patchwork than reform. In the case of both the state and the federal governments, the nature of the experimentation was often dictated more by political pressures than reasoned economic analysis. As one observer, writing in the middle 1890s, noted:

> It is safe to say that at some time in the history of this country nearly every theory evolved in connection with the business of banking has been tried and its development attempted. It is equally true that at all times in the country's history, in all sections of it, and among all classes false principles of monetary science and bad practices in finance have without exception resulted disastrously to all concerned.[7]

For the entire century, trial and error, as it were, were the order of the day, leading frequently to serious, though usually short-lived, monetary disturbances.

Experimentation was directed, for the most part, toward establishing a banking and currency system free of the tendency to periodic crises. But there were also problems with the monetary standard and the coinage system that remained unsolved for a century after the adoption of the Constitution. The first Congress adopted a bimetallic standard, passed a coinage act, and provided for the establishment of the United States Mint. Yet until the middle of the nineteenth century, coins of foreign mintage constituted a large fraction of the country's metallic money. A truly national gold coinage system was established by the middle 1850s, following the large influx of gold from California mines.[8] But the larger gold supplies made problems for the bimetallic standard. The silver coinage was reduced to subsidiary status in 1853 but became the focus of new sectional controversy following large new silver discoveries in the years following the Civil War. Large new gold discoveries in the 1890s put an end to the agitation over silver and finally led to the formal adoption of the gold standard in 1900. The coinage system, including the fractional denominations that are familiar today, was not firmly established until nearly a century after passage of the first coinage act.

A uniform bank note circulation current in all parts of the country was not achieved until passage of the National Banking Act in 1863. This act established the office of the Comptroller of the Currency to issue bank charters under specified conditions and to supervise the institutions so chartered. These national banks, so called, were authorized to issue circulating notes against collateral of government securities.[9] The levy in 1866 of a 10 percent tax on the notes of state-chartered institutions effectively gave national banks a monopoly of the circulating privilege. From that year until the establishment of the Federal Reserve System national bank notes comprised a key component of the nation's chief currency.

These notes, gold certificates, and the greenbacks issued in the Civil War period constituted the currency of the immediate post-Civil War years. But the slow growth in the money stock in the 1870s, coupled with rapid economic growth, led to a secular deflation that soon produced strong popular movements for monetary expansion, the greenback and free silver movements of the 1870-95 period. The first of these movements succeeded in ending the progressive redemption of the Civil War greenbacks, leaving $347 million of these as a permanent part of the circulation. The second led to passage of two silver purchase acts and the issue of some $500 million of silver dollars and silver-backed U.S. Treasury notes.

At the turn of the century, the nation's currency comprised national bank notes supplemented by fixed quantities of United States notes and Treasury notes of 1890. A gold redemption fund was held by the Treasury against the U.S. notes. The Treasury notes of 1890 were backed dollar for dollar by silver and were, in effect, silver certificates. Gold certificates, backed dollar for dollar by gold coin, also circulated. A uniform circulation was at last in place, with all

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[7] U.S. Treasury, *Annual Report of the Comptroller of the Currency*, 1896, vol. 1, (Washington: Government Printing Office, 1896), p. 36. For a discussion of the "unscientific" nature of the efforts at monetary and banking reform before 1908 see Henry Parker Willis, *The Federal Reserve System: Legislation, Organization and Operation* (New York: Ronald Press, 1923), pp. 4-21. For continued experimentation by state governments see Eugene Nelson White, "State-Sponsored Insurance of Bank Deposits in the United States, 1907-1929," loc. cit., pp. 537-43.

[8] *Reports of the Secretary of the Treasury of the United States*, 1845 (Washington, D.C.: Printed by John C. Rives, 1851), vol. 5, pp. 18-20. Hereinafter cited *Reports of the Secretary of the Treasury* with appropriate year. See also vol. 6, pp. 9-10.

It should be noted that in the 1840s gold and silver coins moved freely in foreign trade. There was always a good probability that gold coin arriving in this country would be shipped out again before long. Hence there was an understandable reluctance to recoin foreign coins. Secretaries of the Treasury in the 1840s and 1850s urged recoinage and sought establishment of a mint at New York City, where most foreign coin arrived, to facilitate "Americanization" of the gold coinage. See *Reports of the Secretary of the Treasury* for the years 1845-55.

For a contemporary's description of the coinage circulating in the western states before the California gold discoveries see Hugh McCulloch, *Men and Measures of Half a Century* (New York: Charles Scribner's Sons, 1900), p. 119.

[9] Initially, the collateral requirement called for $100 of securities backing $90 of notes. This was later reduced to a dollar-for-dollar backing. See A. Barton Hepburn, *A History of Currency in the United States* (New York: Macmillan Co., 1915), pp. 308-9.

National and State Banks and Deposits, 1870-1910

	National Banks		Nonnational Banks	
	Number	Deposits (mil. dol.)	Number	Deposits (mil. dol.)
1870	1,612	1,566	325	215
1880	2,076	2,036	1,279	1,364
1890	3,484	3,062	4,717	3,296
1900	3,731	4,944	9,322	6,444
1910	7,138	9,892	18,013	13,030

Source: *Historical Statistics of the United States*, 1975, pp. 1025-27, 1028-30.

forms of money required by law to circulate at parity with gold.

The banking industry changed drastically in the decades following the Civil War. The number of banks multiplied rapidly to keep pace with accelerating economic and population growth as the frontier was pushed steadily westward. Banks chartered under the National Banking Act accounted for most of the banking expansion in the early postwar years, largely because of their legislated monopoly on note issue. But state banks adapted by emphasizing deposit banking, which soon submerged note-issue banking in importance. While the numbers and total deposits of both national and nonnational banks increased sharply between 1880 and 1910, the latter group grew more rapidly by a considerable margin and by 1910 accounted for more than 50 percent of total deposits.

Banks in both groups were required to hold minimum legal reserves. For nonnational banks, the legal requirements were governed by state laws and varied from state to state. The National Banking Act established a system of reserve requirements for national banks, which for reserve purposes were classified as country, reserve city, and central reserve city banks. Country banks were allowed to hold up to 60 percent of the required reserve on deposit with reserve city or central reserve city banks. Similarly reserve city banks were allowed to hold half of the required reserve with central reserve city banks. New York, Chicago, and later St. Louis, were designated as central reserve city banks. The number of reserve cities increased from 13 in 1880 to 28 in 1900 and 46 in 1910, reflecting the rapid growth of the country and of the number of banking institutions. Some part of the reserves of nonnational banks were also held as deposits with reserve city and central reserve city banks.[10]

On the eve of the establishment of the Federal Reserve System the nation was served by more than 25,000 banking institutions. Included in this number were commercial banks, both state and national, mutual savings banks, trust companies, and private banks. For most of these institutions markets were primarily local, although correspondent connections provided limited entry to other markets. Banks in the reserve cities and central reserve cities operated clearinghouses, some of which were in position to render limited central bank services to banks over a limited market area. Supervision of this large multitude of institutions, at the federal as well as the state level, was of questionable effectiveness.[11]

The U.S. Treasury, through its Independent Sub-Treasury System, could influence banking and credit markets and often performed important central banking functions. It systematically moved funds between the subtreasuries and the banking system to affect credit conditions and especially to meet seasonal credit demands in agricultural areas. It sometimes made advance payments of interest and principal on outstanding government bonds by way of relieving pressures on money market banks. It handled the issue and redemption of U.S. notes and Treasury notes of 1890 and supervised the issue and redemption of national bank notes. It was custodian and manager of the nation's gold reserve and was empowered to buy and sell government securities incident to the maintenance of this reserve within legally specified limits.[12]

[10] See *Annual Reports of the Comptroller of the Currency*, 1880, p. CXVI; 1900, p. 356; 1910, p. 250 and footnote.

[11] The Comptroller of the Currency had broad authority over national banks and required regular reports of them. Neither he nor the Secretary of the Treasury were in position to monitor effectively the reserve base of the banking system. Comments of bankers operating under national charters before 1914 suggest that the Comptroller and the Secretary were the functionaries who really controlled national bank activities and that they could at times be heavy handed. But bankers always had the option of shifting to state charters and this option no doubt had a moderating effect on the federal regulators. Comment at the time of the establishment of the Federal Reserve often implied that bankers preferred regulation by the seven-man Federal Reserve Board to the two-man arrangement existing before 1914.

[12] Esther R. Taus, *Central Banking Functions of the United States Treasury, 1789-1941* (New York: Columbia University Press, 1943). Taus writes: ". . . [The U.S. Treasury's] powers frightened cautious businessmen and contributed to the establishment in 1913 of an organization which was intended to handle exclusively the central banking functions previously assumed by the Treasury," p. 98. See also Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, N.J.: Princeton University Press, 1963), pp. 149-52.

III.
Perceived Deficiencies in the Pre-Federal Reserve Arrangements

Contemporary critics found serious deficiencies in both the currency and the banking arrangements that existed at the turn of the century. The currency was deemed to be "inelastic," that is incapable of variation as required to meet the changing needs of trade. The banking system was considered to be inadequately supervised and to suffer from seriously defective reserve arrangements. Arrangements for clearing and collecting interbank claims were widely viewed as impeding the development of an efficient payments system and promoting abuses in bank practices.

Of the principal currency types, the quantity of U.S. notes was fixed. The silver component could be increased only by act of Congress. The gold component was at the mercy of the balance of payments. Increases in the national bank note circulation were limited, though loosely, by the outstanding volume of appropriate government securities. These were the characteristics that gave rise to the criticism that the currency was incapable of variation to meet the needs of trade.[13] This criticism was not always separable from that focusing on the vulnerability of the banking system to recurring panics. To some observers "inelasticity" consisted in the system's inability to accommodate a significantly heightened demand for currency without producing monetary contraction and serious problems for many banks.

Contemporaneous criticism of the system of reserves was not always consistent. Some critics complained of the scattering of reserves over numerous reserve cities, while others complained of the concentration of reserves in New York.

Much discussion centered around the so-called "pyramiding" of reserves and certain abusive practices resulting from city bank competition for correspondent balances. Critics noted that a country bank's reserve balance at a reserve city bank, when redeposited by the latter at a central reserve city, actually served as a legal reserve for both the country and the reserve city bank. In that fashion reserves were "pyramided" and the banking system's lawful money[14] reserves were less than the reserves shown on the books of banks. The alleged overconcentration of reserves in New York was widely viewed as a source of volatility in money markets, especially precarious when large interregional transfers of funds within the banking system had to be made.[15]

Considered equally serious was the effect on reserves of banking practices that developed in connection with the handling of out-of-town checks through city correspondents. By the turn of the century, competition among city correspondents for the accounts of country banks led many of the former to offer collection services for respondents. Among the inducements offered was immediate credit for items sent for collection. In the absence of effective reserve monitoring, country banks often counted as reserves checks en route by mail to a reserve city correspondent serving as its reserve agent. In like fashion, the reserve city bank would send some of the same checks to its central reserve city, counting them as reserves as soon as they were in the mail. Thus the same check in transit often served to meet the reserve requirements of both the country and the city bank and stated reserves appear to have included large amounts of uncollected funds.

Other questionable banking practices characterized the system for collecting out-of-town checks. Collection entailed costs and to cover these, banks sometimes levied direct collection charges. Many smaller ones levied exchange or remittance charges through remitting less than the face value of presented checks. In the context of the time out-of-pocket costs could frequently be reduced—though real costs increased—through a variety of interbank arrangements that had the effect of delaying presentation, often through highly circuitous and uneconomic routing.[16] As a result, the outstanding check float at any given time was far greater than it needed to be.

IV.
Structuring the Remedies

Among serious students of monetary affairs sentiment for basic reform in the currency and the banking system was strong even before the panic of 1907.

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[13] For a discussion of two interpretations of the term "inelasticity" as applied to the currency of the time see Friedman and Schwartz, op. cit., pp. 168-69.

[14] Lawful money was defined to include gold and silver coin, greenbacks, silver certificates, gold certificates, and Treasury notes of 1890.

[15] See *Annual Report of the Comptroller of the Currency*, 1914, vol. 1, pp. 8-10.

[16] For a discussion of check collection practices and problems in the pre-Federal Reserve period see Walter E. Spahr, *The Clearing and Collection of Checks* (New York: Bankers Publishing Company, 1926), pp. 96-130. See also Pierre Jay, "The Country Banker and the Federal Reserve System," a speech at a banquet given by the Jefferson County National Bank, Watertown, N.Y., April 17, 1916. In Federal Reserve Bank of Richmond Archives. Jay was the first chairman of the board of directors of the Federal Reserve Bank of New York.

The twenty years preceding that episode had produced a rich ferment of ideas for reform.[17] The panic of 1907 crystallized reform sentiment and gave it a strong popular base, making a basic overhaul of currency and banking arrangements virtually inevitable. The issue moved quickly into the political arena, there to be shaped into a reform package designed to meet political as well as economic tests. The National Monetary Commission, established by the Aldrich-Vreeland Act, produced a massive 23-volume study of banking, both here and in advanced foreign countries, which provided the economic input deemed necessary for rational reform.

From the political standpoint, the widespread suspicion of the existence of a sinister "money trust" had to be mollified, but without sacrificing the support and the skills of professionals in the financial community. Shifting of power in the banking system from large banks and clearinghouse associations to the federal government, while desirable, had to be limited and engineered with caution. The role of state governments had to be respected. Strong sectional feelings regarding real or fancied regional credit needs of a unique and often conflicting nature had to be satisfied. Popular antipathies to Europe's monolithic style of central banks had to be accommodated. In brief, peculiarly American political and cultural values placed restrictions on reform that sometimes took precedence over state-of-the-art economic logic.

The intensified reform dialogue after 1907 produced finally, and after several iterations, the Federal Reserve Act, passed in December 1913. The title of the act emphasizes the economic problems confronted: An act 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, and for other purposes. The "other purposes" were concerned with improving the payments system through more efficient collection and clearing of checks and with the provision of fiscal services to the U.S. Treasury. The detail of the act, however, clearly reflects the framers' deferences to prevailing political values.

The act provides for the division of the country into no more than twelve and no fewer than eight Federal Reserve Districts, with a Reserve Bank located in each. Division of the country into districts recognized the existence of differing regional interests. It also represented an attempt to effect a regional as opposed to a centralized deployment of the banking system's reserves and to set up machinery for efficient clearing and collection of interbank claims. Avoidance of a monolithic central bank in the style of European countries was also a consideration.

The Reserve Banks were incorporated under charters issued by the Comptroller of the Currency. The act prescribed a minimum capital of $4 million, to be subscribed by member commercial banks. National banks were required to become members of the new reserve system and to purchase stock of the Reserve Banks of their respective districts.[18] Membership for state banks was made optional, reflecting the framers' respect for state governmental authority. As the System took form, member banks emerged as the sole owners of the stock of the Reserve Banks,[19] but their ownership and management rights were closely circumscribed. Their right to share in Reserve Banks' earnings was limited to a cumulative dividend of up to six percent on their holdings of Reserve Bank stock.

Arrangements for managing the individual Reserve Banks were specified in detail in the act and reflect further limitations on ownership rights. Management was put in the hands of a board of directors of nine persons, grouped in three separate classes of three persons each: Class A to represent the stock-holding member banks of the district; Class B to represent the commercial, agricultural, and industrial interest of the district; Class C to represent the broad public interest. The act provided for election of Class A and Class B directors by the member banks, which themselves were divided into three size classes, large, middle size, and small,[20] with each size class electing one class A and one class B director.

The power to appoint the Class C directors was vested in the Federal Reserve System's chief coordinating body, the Federal Reserve Board. One Class C director was designated chairman of the board and Federal Reserve Agent. A second was designated deputy chairman and deputy Federal

[17] For an account of the dialogue and proposals in that period see Willis, *op. cit.*, pp. 3-23.

[18] A member bank was required to subscribe to the capital stock of its Reserve Bank in an amount equal to 6 percent of its paid-up capital and surplus. Initially only half of this was paid in, with the other half remaining on call. The act also provided for adjustment of the capital stock subscription as the members' capital and surplus grew. See Willis, op. cit., pp. 1674-75.

[19] The act provided for sale of Federal Reserve Bank stock to the public and to the U.S. government in case the minimum $4 million capital could not be raised through member bank subscriptions. Such sales never became necessary. Ibid., p. 1669.

[20] The act provided for division of the member banks into three groups "of similar capitalization," that is on the basis of capital and surplus, with approximately equal numbers in each group. Ibid., pp. 1672-73.

Reserve Agent. The Class C directors were thus the direct representatives of the Federal Reserve Board in the management of the individual banks. The act provided that no officer, director, employee, or stockholder of a commercial bank could serve as a Class C director and no officer, director, or employee of a commercial bank could serve as a Class B director. The term of office for directors was made three years.[21] Such detailed specification of the composition of the boards of directors reflects efforts of the framers of the act to ensure against domination by any interest group and especially by large banks.

To supervise and coordinate the activities of the Reserve Banks, the act established the Federal Reserve Board, consisting of the Secretary of the Treasury and the Comptroller of the Currency serving ex officio and five members appointed by the President with the approval of the Senate. No more than one of these five members could be selected from any one Federal Reserve District and the President was further required to choose them with "due regard to a fair representation of the different commercial, industrial and geographical divisions of the country." This seven-man body, to be chaired by the Secretary of the Treasury, provided a degree of centralization under federal authority, although it was envisaged that the Reserve Banks would act with a high degree of autonomy in meeting regional credit and currency requirements.[22]

While the framers of the act were careful to guard against banker domination, they were equally careful to encourage constructive participation in the new arrangement by the big city bankers. The latter group was amply represented in the give-and-take that shaped the specific provisions of the act. Yet many—perhaps most—remained especially skeptical of the significant shift of authority over banking to the federal government.[23] As a concession to this group, the act established the Federal Advisory Council consisting of prominent bankers, chosen one to a Reserve District by the Reserve Bank directors. Envisaged for this council was a purely advisory role.

The framers of the act were confident that the new system would eliminate definitively the basic defects in the old arrangements. A new national currency, Federal Reserve notes issued by the Reserve Banks, would supplant the "inelastic" national bank notes and provide the necessary variability to meet the changing needs of trade. These notes were made obligations of the federal government as well as the issuing Reserve Bank. They were to be issued against a 40 percent gold reserve and a 100 percent collateral of specified types of commercial paper that were eligible for rediscount at the Federal Reserve Banks. The theory here was that linking the Federal Reserve note issue to eligible commercial paper, which presumably reflected the variations in trade volume, would ensure that the note issue would vary with the "needs of trade."[24] Hence the problem of the "inelastic" currency would be solved.

Similarly the redeployment of the banking system's reserves in a few regional centers, along with other changes in reserve arrangements, was viewed as at once eliminating the problem of "pyramided reserves," allowing close monitoring of the quality of reserves, and putting the Reserve Banks in position to serve regional credit and currency requirements. The act reduced reserve requirements for all classes of member banks but provided that, after a transition period, reserves were to be held as cash in vault or deposits in the district Federal Reserve Bank, divided equally between these two.[25] Such a deployment of reserves, coupled with the Reserve Banks' authority to rediscount each others' paper, was thought to ensure that the banking system's reserve base could quickly be mobilized to meet extraordinary banking pressures in particular geographical regions. Moreover such a deployment of reserves was designed in part to place the Reserve Banks in position to be efficient collectors of interbank claims and, ideally, to serve as an effective clearinghouse for the entire banking system. Hence a solution was provided for the multiplicity of problems arising from the old system of clearing and collecting out-of-town checks.

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[21] In keeping with the principle of regionalism, directors were required to meet requirements of residency in their respective districts. Ibid.

[22] The virtual autonomy of the boards of directors of the regional banks in managing the discount function under broad guidelines issued by the Federal Reserve Board was repeatedly emphasized. See, for example, "Truth About the Federal Reserve System," Speech of Hon. Carter Glass of Virginia in the Senate of the United States, January 16 and 17, 1922 (Washington 1922), pp. 8-9. In Federal Reserve Bank of Richmond Historical Collection RG 1:2, Box No. 3.

[23] Willis, op. cit., pp. 385ff. See also *The Intimate Papers of Colonel House, Arranged as a Narrative by Charles Seymour* (Boston and New York: Houghton Mifflin Company, 1926), pp. 160-66. See also "Truth About the Federal Reserve System," Speech by Glass, loc. cit.

[24] This so-called commercial loan theory or real bills doctrine was a basic principle underlying the money functions of the new system. The essential fallacy in the doctrine was that note issue would also vary with the price level as well as the real volume of trade. Thus its operation would be inherently inflationary or deflationary. See Friedman and Schwartz, op. cit., pp. 191-92.

[25] Later amendments to the act provided for holding of all legal reserves with the Federal Reserve Banks.

Since reserve arrangements and the "inelastic" currency were widely viewed as the causes of recurring banking panics, the currency and reserve reforms were deemed to provide insurance against such panics. Working toward the same end was the provision of the act strengthening bank examination practices and procedures. The benign coordination of the Reserve Banks' operations by the Federal Reserve Board was expected to provide added insurance.[26]

V.
Central Bank or Central Banking System?

The original Federal Reserve System was the product of a uniquely American political process confronting a pressing need to remove systemic defects from the nation's money, banking, and payments arrangements. It was forged as a politically feasible solution to the interrelated problems of an unsatisfactory currency, deficiencies in the payments and banking systems, and recurring financial panics.

As in most political settlements, the chief feature of the act passed in December 1913 was compromise. To an important extent both regionalism and centralization were accommodated. The act incorporated a clear intent to serve regional interests but in the context of a greater degree of centralized coordination than had existed before. Provision for management of the Reserve Banks reflects an effort to harmonize borrower and lender interests while recognizing a higher public interest that was a proper concern of government. The authority of the federal government over the banking industry was enhanced but in a manner that avoided confrontation with state governments. While the shift of power away from the large money center banks encountered strong resistance, a compromise satisfactory to the private banking sector was worked out. The highly structured system it envisaged left room for a limited private sector participation in the discharge of a key public function. It came to be referred to as a quasi-private, quasi-public system although it is clear that the public feature predominated.

It is an interesting fact that the framers of the original system studiously eschewed the term "central bank," presumably for fear that the term may play on popular suspicions of centralized control over the nation's money and credit.[27] For the most part their commentaries on the System emphasized its primarily regional nature and limited Federal Reserve Board control over the rediscounting and currency issuing operations of the regional Banks. Much was also made of the provisions of the act that required that Reserve Bank directors, even those appointed by the Federal Reserve Board, be residents of their respective Federal Reserve Districts and therefore sensitive to peculiar regional needs.

Yet the act clearly envisaged a significant enhancement of centralized authority over the nation's money, banking, and payments systems. It gave the Reserve Banks a monopoly of the issue privilege and made the U.S. government a guarantor of the banks' notes. It made the Federal Reserve System the custodian of the banking system's reserves with authority to monitor the reserves of individual member banks. It vested in the System the power to set the terms on which rediscounting would be available to member banks. The Reserve Banks were given the authority to engage in open market operations in gold and in a variety of domestic credit instruments and foreign exchange. The act clearly envisaged a more effective system of federal bank examinations than had existed heretofore, with the System sharing that function with the Comptroller of the Currency. Finally, it was clearly envisaged that the Federal Reserve Board would become a major participant in the custodianship and management of the nation's gold reserve. In view of such a concentration of functions and powers in the new system, the denials of some of its chief architects that it was a central bank must be interpreted as emphasizing the diffusion of these powers over the System's thirteen units and the fact that the System was uniquely different from its foreign counterparts.

The system that was put in place in 1914 was not, and was not intended to be, a finished product. While confident that the deficiencies in the old system had been eliminated, the founders recognized that the dynamic of the U.S. economy would in time require adjustments. Indeed many minor amendments in the enabling legislation were made in the first few years of the System's life. The trials the System confronted in the 1929-33 period dispelled the founders' optimism that sharp financial disturbances were things

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[26] Glass, Harding, and Williams frequently stated publicly that the new system virtually guaranteed that there would be no more panics. See, for example, Richmond, Va. *News Leader*, May 14, 1914, p. 1. See also "Truth About the Federal Reserve System," Speech by Glass, loc. cit.

[27] See, for example, "Truth About the Federal Reserve System," Speech by Glass, loc. cit. See also "The Federal Reserve System, What it is and What it is Not," Address by W.P.G. Harding, Governor, Federal Reserve Board, at the 'Made-in-Carolinas' Exposition at Charlotte, N.C., September 22, 1921. Published by the Federal Reserve Bank of Richmond, September 1921, p. 4. Federal Reserve Bank of Richmond, Historical Collection, RG 1:2, Box No. 3.

of the past. These led to a major overhaul of the System in the mid-1930s. The major reforms of that period, along with further important amendments since that time, have produced a system fundamentally different, both in structure and in approaches to money and credit control, from the original. Since the reforms of the 1930s, in particular, the System has become undeniably a central bank or, more precisely, a central banking system.

The System today retains, however, sufficient vestiges of its pristine form to continue to be described as unique among the world's central banks. In particular, in the face of increased centralization of power in the System since the 1930s, the regional Reserve Banks continue to play an important role. Their operations are crucial to the maintenance of an efficient payments system for the country. Their information services constitute useful inputs into decisions of businesses large and small and by governments. Their role in monetary policymaking today differs considerably from what was envisaged in the original act but is no less significant. Rather it has been restructured to bring it into closer conformity with radically revised views regarding techniques of monetary and credit control. The directorates of the Reserve Banks continue to take the initiative in setting the discount rate. More important, the executive heads of the Reserve Banks, now styled presidents instead of governors,[28] serve actively on the Federal Open Market Committee, the System's chief policymaking body.

[28] Since 1936 the Federal Reserve Board has been named the Board of Governors of the Federal Reserve System and its members are now called "governors."