

Chicago Fed Letter

Seventy-five years

"We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon, and step by step we shall make it what it should be."

—Woodrow Wilson, 1913

Woodrow Wilson's observation on the passage of the Federal Reserve Act is surprisingly apt in 1989. The Federal Reserve System, including the Federal Reserve Bank of Chicago and its peers across the country, has never had "a clean sheet of paper to write upon." Instead it has had from the beginning to respond to an evolving financial and economic system. As the Bank celebrates its 75th anniversary, a look back at this continuing process may be useful.

Origins

The panic of 1907, which occurred in the midst of general prosperity, illustrated one indisputable fact—the U.S. banking system was not meeting the financial needs of the country. Shortcomings included two basic problems—an inelastic currency and immobile reserves. The supply of national bank note currency, tied to government bonds, changed in response to the bond market rather than the needs of business. In addition, bank reserves were scattered throughout the country—banks in 50 different cities served as reserve depositories. Even when reserves were sufficient, it was difficult to move the money where it was most needed.

It was widely agreed that some form of central bank was needed. But, how to structure it? On one side small businesses and the small town and farm population were suspicious

of concentrating too much power in the hands of government and bankers. On the other, the most powerful business and banking groups insisted on the need to avoid political interference in central banking.

Representative Carter Glass of Virginia, and H. Parker Willis, an advisor to the House Committee on Banking and Finance, worked through most of 1912 and finished a draft proposal just prior to Wilson's election as president in November. To their plan for a system of regional Reserve Banks, Wilson added an important balancing feature—a central board to coordinate the work of the regional banks. The central board, a public agency, would be appointed by the President and approved by the Senate. To supply the elastic currency required by the economy, the central bank would rediscount bank notes and issue a new national currency, Federal Reserve notes. National banks would be required to become members of the Federal Reserve System, while banks chartered by the state would have the option of not joining. After much compromise, the bill was passed by Congress on December 23, 1913. The U.S. had a central bank.

The Federal Reserve Bank of Chicago, along with the other eleven district Fed banks, opened for business on Monday, November 16, 1914. While the Bank and its 41 employees were ready to carry out their duties, exactly what these would be was to some extent unclear.

Startup and war

As specified in the Federal Reserve Act, the Bank issued Federal Reserve currency and rediscounted some bank notes. But, with little demand

for either function initially, the Chicago Bank focused on developing a check collection system—one of the responsibilities that fell under the vague category of "other purposes" in the preamble of the Federal Reserve Act. Throughout its history the U.S. banking system had been hampered by an inefficient collection process. But a check collection plan faced one basic problem: Many bankers depended on the exchange fees they charged out-of-town banks for check collecting and were reluctant to make changes.

After unsuccessfully trying a voluntary approach, the Federal Reserve instituted a compulsory system for member banks in July 1916. They were required to accept at par a check drawn upon themselves and presented for payment by a Federal Reserve Bank. In spite of some lingering resistance, par collection became standard practice.

When the U.S. declared war on Germany in April 1917, the Reserve Banks were authorized to handle the financial operations associated with the war, including the sale of Liberty bonds. The nationwide goal of the first Liberty Loan drive was to sell \$2 billion in bonds—then a staggering amount of money.

Four more Liberty Loan campaigns were undertaken in the next two years. Bond sales for the Seventh District totalled \$3.29 billion—the largest subscription per person in any of the Federal Reserve Districts. The Illinois portion of the District alone accounted for \$1.45 billion, more than the total U.S. bonded debt in 1916.

The war effort had an important long-term effect. In the spring of

1915, the Federal Reserve Banks were, in the blunt opinion of Chicago banker J. B. Forgan, “not of much benefit anywhere.” The Liberty Loan campaign accelerated the Fed’s integration into the banking system, and by October 1917 Forgan wrote, “The stronger the Federal Reserve banks are, the stronger will the [banking] system be.”

Prosperity, crash, recovery

Throughout the 1920s, the Federal Reserve moved toward increased centralization and coordination in monetary policy. The concept of 12 regional policies based on the needs of each district was slowly replaced by a coordinated national policy.

In 1921, when the Reserve Banks began to buy and sell government securities to build their earnings, the potential impact of open market operations on monetary policy was realized. In 1923, the Federal Reserve Board established the Federal Open Market Investment Committee composed of the heads of the Chicago Fed and four other Reserve Banks. Operating under the supervision of the Federal Reserve Board, the Committee was instructed to conduct operations “with the primary regard for the accommodation of commerce and business and to the effect of these purchases and sales on the general credit situation.”

As the Federal Reserve refined its monetary policy efforts, the U.S. experienced a giddy period of industrial growth and high employment through most of the 1920s. In keeping with the confidence of the times, many felt that financial panics had become a thing of the past. But others worried about the high levels of speculative spending. In February 1929 the Federal Reserve Board, in an unsuccessful campaign to curb speculation, decried the “excessive amounts of the country’s credit absorbed in speculative security loans.”

That summer the stock market began to sour. On October 29th, the stock market crashed. The Fed responded by easing credit through open mar-

ket operations and reductions in the discount rate, a policy it continued through the first half of 1931.

Nevertheless, the economic decline continued. By mid-1931, a financial crisis abroad added momentum to the Depression. England abandoned the gold standard in September 1931, a move that shook the international financial community. Fears of a dollar devaluation triggered a flow of gold out of the U.S. The Federal Reserve reacted by tightening credit, the traditional central bank method of slowing the flight of gold.

The tightening of credit, however, put increased pressure on the economy. The Depression deepened and unemployment rose to 11 million.

Spurred by these economic problems, Congress passed the Glass-Steagall Act of 1932, which enabled the Fed to use government securities instead of commercial paper as backing for its notes. During the first nine months of 1932, the Reserve Banks bought an unprecedented \$1 billion of securities in an effort to ease money conditions.

Still the economy declined and industrial activity reached a low point in July 1932. Banks began to feel extreme pressure. In addition to growing loan defaults, the country experienced a wave of currency hoarding. State and local governments began to announce bank holidays. The governor of Michigan declared a state-wide bank holiday on February 14, 1933. That closing was a severe shock. During the rest of the week, the currency drain on the Chicago Fed was three times greater than for the same period in 1932.

During the first three days of March, panic reached a peak across the U.S. as bank customers withdrew huge sums. On March 3, the day before the inauguration of Franklin D. Roosevelt, the governors of Illinois and New York declared a bank holiday. The executive committee of the Chicago Fed’s board of directors met at 10:30 p.m. that night and passed a resolution urging a “bank holiday ...

in order to give the banks and the ... authorities sufficient time and an opportunity to provide the necessary measures for the protection of the public interest”

Although a host of factors caused the collapse, many beyond the reach of the Federal Reserve, the fact remained that the System did not head off the very catastrophe it had been established to prevent. In addition to being hindered by out-of-date legislation, the Fed did not yet have a full understanding of its capabilities. Throughout the crisis, the Federal Reserve’s progress on the monetary policy learning curve was a step behind the sequence of events.

President Roosevelt took quick action once he assumed office. Under the Emergency Banking Act of 1933, banks were reviewed by the Fed and other regulators and licensed to reopen if they were solvent. Confidence was restored to a degree and the crisis passed. The cost was high—bank suspensions soared in the early 1930s, reaching 4,000 in 1933. Thirty percent of the suspensions were in the hard-hit Seventh District.

Congress then took on the task of reforming the financial system. The FDIC was created to protect small depositors against loss. Banks were restricted from engaging in securities activities and prohibited from offering interest on demand deposits. The Federal Reserve was authorized to limit interest on time and savings deposits of member banks. It was also given a powerful new monetary tool—the authority to change member banks’ reserve requirements. The legislation also capped the Federal Reserve’s trend toward centralization by creating a new Federal Open Market Committee (FOMC) to conduct the System’s open market operations. Despite the legislation and the New Deal efforts to stimulate spending, the Depression persisted through the 1930s.

War and prosperity again

Suddenly thrust into the Second World War on December 7, 1941,

the U.S. girded itself for a major financing effort. Once again, the Chicago Fed found itself responsible for coordinating the Seventh District's bond drives. The first bond drive was a huge success, raising \$13 billion nationwide—\$4 billion more than originally targeted.

It was only a beginning. The U.S. Treasury held eight war loan drives that raised a total of \$157 billion. In each drive, the District and the nation as a whole oversubscribed, and the World War I total of \$21 billion worth of Liberty bonds was dwarfed.

But as the Fed concentrated on the war effort, it assumed an accommodative role in monetary policy. Essentially, this meant that the Federal Reserve pegged interest rates on Treasury bonds. The *Federal Reserve Bulletin* noted in February 1943 that the "policy of the Treasury and of the Federal Reserve System has been directed toward the stabilization of prices and yields of marketable securities. Investors ... know that prices and yields are stabilized and that they will obtain no higher yields by deferring purchases"

In 1946, concerned by rising inflation, the Federal Reserve discontinued pegging interest rates for short-term securities. In March 1951, after numerous conferences, the Federal Reserve and the Treasury announced a "Full Accord" on future policy. Bond prices and yields were gradually allowed to seek their own level.

At the time of the Accord, the Federal Reserve had its three monetary policy tools in hand—open market operations, reserve requirements, and the discount rate. Through the 1950s, the Fed generally followed a policy aimed at moderating the severity and duration of cyclical readjustments, a strategy described by Federal Reserve Chairman William McChesney Martin as "leaning against the wind."

Buoyed by a general policy of monetary and fiscal stimulus, the U.S. economy grew at a steady clip through most of the 1950s and early

1960s. The Seventh District prospered with the rest of the nation.

The District's economic growth was fueled by a healthy farm sector and heavy industry such as steel and autos. In its 1955 *Annual Report* the Bank noted that the District states accounted for 19 percent of the nation's personal income, one-fourth of factory output, and nearly one-fourth of farm income.

Signs of change

When the Bank celebrated its 50th anniversary in 1964, it could look back on 20 years of general economic prosperity and stable banking conditions. But, by the end of 1968, the Bank reported that "most interest rates were at a new high in the experience of today's generation." Constrained by ceilings imposed under Regulation Q, bankers watched helplessly as deposits flowed to competitors that provided higher yields.

The 1970s provided little respite from the inflation problems that had built up in the late 1960s; the attempts to deal with those problems were not successful. Wage and price controls instituted in 1970 were, in the words of the Bank's economic review, "judged unsatisfactory by virtually everyone." Worse, 1974 was a "year of calamity," the Bank's review noted, in which the U.S. economy had been struck by an "unprecedented array of adverse developments" ranging from record price inflation to shortages, many of which were, at least in part, the consequence of the 1973 rise in oil prices engineered by OPEC.

The Federal Reserve tried to curtail the inflationary trend. In 1975, the Fed announced a policy of reducing money growth rates over a period of years to eliminate inflation, an attempt that generally failed. Four years later, the U.S. was jolted by another oil price shock, and experienced its worst inflation of the post-war period. A dramatic gesture was needed. On Saturday, October 6, 1979, the FOMC gathered for an emergency meeting in Washington,

D.C., to discuss the deteriorating economic situation. That evening, recently appointed Chairman Paul Volcker announced that the Federal Reserve's monetary policy efforts would focus on reaching target levels of bank reserves through open market operations. The announcement was a signal of the Fed's determination to wring inflation from the economy once and for all. The immediate market response was dramatic—a sharp increase in all interest rates.

As the U.S. entered into the 1980s, the financial system faced a host of problems triggered by the higher and more volatile interest rates of the 1960s and 1970s. As interest rates increased, banks squirmed under the constraints of Depression-era legislation as new competitors invaded their traditional turf. At the same time, the Federal Reserve found its ability to conduct monetary policy threatened as member banks fled the System to avoid the burden of holding non-interest bearing reserves.

In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act (MCA) in an attempt to resolve some of the problems facing the financial services industry. To enable financial institutions to compete more effectively, the Act phased out deposit ceilings and authorized NOW accounts. The Act also addressed the Fed's membership problem by imposing reserve requirements on all depository institutions. At the same time, the MCA

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Chicago Fed Letter is available without charge from the Public Information Center, Federal Reserve Bank of Chicago, P.O. Box 834, Chicago, Illinois, 60690, (312) 322-5111.

ISSN 0895-0164

required the Fed Banks to price many of their services and offer them to all depository institutions. As one of a number of competitors in the marketplace, the Federal Reserve was to recover "in the long run" the costs of providing priced services.

The pricing of Fed services received scant public attention initially compared to interest rate deregulation and uniform reserve requirements. The transition to priced services, however, posed a major challenge to the Reserve Banks and eventually had a ripple effect on financial institutions and their customers.

The MCA had a dramatic effect on the Bank itself. "It energized the organization and gave it a private-sector, bottom-line orientation," says First Vice President Daniel Doyle. "It produced a much leaner, efficient, and, I think, more satisfying organization. It's one thing to respond to internal standards, it's quite another thing to meet the standards of the marketplace. I think we were very successful."

Economic troubles, combined with increased competition, began to take a toll on banks in the early 1980s. The number of bank failures increased dramatically compared to previous decades. Agricultural

banks, feeling the effects of a severe slump in the farm sector, were especially hard-hit. By 1984, agricultural bank failures accounted for almost one-third of all bank failures nationally. But by 1986, the decline in ag bank performance began to ease.

At the other end of the spectrum, some large money-center banks experienced difficulties in the early 1980s. The uncertainty about the repayment of foreign loans, and the severe slump in sectors such as energy, contributed to the problems.

Readjustment in the Midwest

The Seventh District economy itself underwent a painful readjustment process in the early 1980s. By the fourth quarter of 1981, GNP was declining at an annual rate of 4.9 percent. The recession was particularly tough on the Midwest. The Bank's review noted in 1981 that "for almost two years the economy has stumbled on a rocky path marked by soaring inflation, record high interest rates, and a constant specter of fuel shortages. During this period ... the Seventh Federal Reserve District has shouldered a disproportionate share of the trouble."

As the Midwest economy faltered, the Bank became actively involved in

cooperative efforts directed at improving the long-run economic performance of the Seventh District. Working with various public and private groups, the Bank participated in economic development projects including studies of the Great Lakes region, Iowa and Wisconsin, and the cities of Chicago and Detroit.

A national turnaround began in late 1982. But the outlook for the Midwest did not much brighten until 1987. The U.S. had entered its sixth year of uninterrupted growth—the longest peacetime expansion in the nation's history. And the Midwest finally shared in the good news—its performance was the best of the decade. Manufacturing activity in the Midwest outpaced the rest of the nation. "While one year does not make a trend," the 1987 *Annual Report* concluded, "there is reason to be optimistic"

And, after 75 years of change and crisis, there is reason to be optimistic about the Federal Reserve and its component banks, as well. The lessons learned and the challenges met over the years suggest that this institution can deal "with our economic system as it is," in Wilson's words, in order "to make it what it should be."

—Jim Holland

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