Research Department
Federal Reserve
Bank of
San Francisco

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FRB SF Weekly Letter

Origins

Since the Federal Reserve System reached the 70th anniversary of its creation by the Congress on December 23, a review of some of the principal events that led to its establishment and which subsequently shaped its structure and expanded its objectives and responsibilities, including the concept of monetary policy and Fed "independence," is timely. This *Letter* will focus on the developments leading up to the passage of the Federal Reserve Act. In particular, it will review the structure of early banking in this country and the inadequacies the Act was intended to correct.

In the beginning...
Except for two brief periods early in its history, the United States did not have a federal "central bank" until the passage of the Federal Reserve Act in 1913. Banks chartered by their state legislatures dominated. Derived from English banking, these banks issued private banknotes backed by deposits of gold and silver in their vaults. Knowing that not all notes would be redeemed at the same time, some banks issued more notes than there was backing in gold and silver specie, leading to what we call inflation. Also, because each bank issued its own banknotes, transfers among banks was difficult. Moreover, their variety was confusing and allowed easy counterfeiting.

In the periods 1791 to 1811 and 1816 to 1836, the United States Congress chartered two national banks, known as the First and Second U.S. Banks, respectively. In part, the purpose of these banks was to control both the expansion of state banks and the proliferation of banknotes. In the five-year interval between the two U.S. Banks, for example, the volume of state banknotes almost tripled and prices rose by about 20 percent. They were able to achieve a substantial degree of monetary stability by periodically presenting for redemption in specie the currency issued by state banks, thus placing the latter under some constraint to limit the issue of such notes. Both Banks also acted as fiscal agents of the U.S. government (receiving and disbursing government funds) and engaged actively in direct lending to businesses.

Neither U.S. Bank survived because of hostile attitudes toward centralized control embodied in federal chartering, as well as potential implications of restricted credit availability. Many farmers, in particular, welcomed the inflation caused by state banks as a means of repaying their debts in "cheaper" dollars than those they borrowed. Moreover, both Banks were 80 percent privately owned and controlled and much of the opposition towards the First Bank, at least, stemmed from the fact that English interests held a significant share of the Bank's stock. The Second Bank's charter expired largely because of opposition by President Andrew Jackson, who was concerned that it would lead to a concentration of economic power in large banks in the Northeast.

Many also were hostile to the concept of a national bank because they doubted that the Constitution allowed the Congress to charter banks. However, in a landmark decision in 1819 (McCulloch vs. Maryland), the Supreme Court upheld the constitutionality of the Second U.S. Bank as a "necessary and proper" exercise by the Congress of its power "to coin money and regulate the value thereof."

Following President Jackson's veto of the bill to renew the charter of the Second Bank of the United States, the Treasury undertook various central banking functions. Meanwhile, the number of state banks more than doubled to 1,600 between 1836 and 1860. Among them were issued almost 9,000 different kinds of notes that were subject to widely varying, and in many cases, very substantial discounts.

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The National Banking Act

In 1864, the National Banking Act was passed to provide a market for government bonds and to help establish a uniform currency. The Act was also designed, in part, to help stabilize the currency as prices had risen over 65 percent from the outbreak of the Civil War in April 1860. Millions of dollars of non-interest bearing "greenbacks" not officially redeemable in specie had been issued by the government to meet its financing needs and these had contributed to the inflation during the War.

The Act provided for the federal chartering of private banks on the basis of stipulated minimum capital requirements and the maintenance of required reserves against deposits. National banks were divided into three tiers: central reserve city banks (originally banks in New York, Chicago, and St. Louis), reserve city banks, and country banks. Country banks had a 15 percent reserve requirement, 9 percent of which could be kept as deposits with their correspondent reserve city banks. Reserve city banks had a 25 percent reserve requirement, up to half of which could be kept as deposits with their correspondent central reserve city banks. Central reserve city banks had to keep all of their 25 percent reserve requirement as vault cash. This system of reserve "pyramiding" meant that, in particular cases, a given dollar of reserves held in support of deposit liabilities could be counted as reserves three times.

In addition, national banks were given authority to issue their own notes to the value of 90% of their holding of specific U.S. government bonds. In this way, the amount of notes in circulation at any time would depend upon national banks' holdings of bonds. Greater control over currency issues also was achieved by the imposition in 1865 of a confiscatory 10 percent federal tax on all state banknotes (which, in 1860, accounted for almost one-half of all currency and coin in circulation). The tax forced all but a small volume of these notes out of circulation, and for a while, led most state banks to switch to a national charter. However, the development and spread of checking deposits enabled state banks to make loans by crediting deposits rather than simply by issuing notes. As a result, the number of state banks soared from 325 in 1870 to 5,000 by 1900.

By 1910, state banks numbered 14,000—double the number of national banks—but national banks now accounted for a quarter of all currency and coin in circulation, while gold and gold certificates accounted for 45 percent, and silver certificates, coins and miscellaneous coins, the remainder. The relative influence of these currency and deposit developments is evident in the fact that over the entire period since 1860, per capita currency in circulation increased from $30 to $34, while per capita deposits soared from $19 to $194.

The National Monetary Commission

The various efforts at currency and banking reform notwithstanding, the period from 1873 to 1913 was marked by six financial "panics" of varying degrees of intensity, the most serious occurring in the 1890s and in 1907. The "panics" resulted in the suspension of specie payments by large numbers of banks, in the inability of businessmen and farmers to obtain credits to finance inventories and the production and transportation of crops, and in large numbers of business failures. After "The panic of '07," the Congress called for the creation of a National Monetary Commission "to enquire and report to the Congress at the earliest date practicable" what changes were necessary

or desirable in the monetary system to avoid a recurrence of the financial panics that periodically had gripped the nation.

The National Monetary Commission was chaired by Senator Nelson Aldrich, a Rhode Island Republican who also was chairman of the Senate Finance Committee, and included in its studies an examination of the central and private banking systems in Western Europe. Submitted to the Congress in January 1912, the Commission's Report attributed the "currency problem" and the recurring financial panics to several specific and widely recognized factors.

First, the Commission identified the lack of provision for the mobilization of the cash reserves of banks and for their use wherever needed in time of trouble. Reserve pyramiding meant that a shortage in currency at country banks could lead to claims on a central reserve city bank's reserves. The central reserve city bank would sometimes have to meet this demand by calling in its short-term loans. As a result, interest rates could rise very sharply. Of course, if it failed to call in its loans, country banks would not get the needed currency and might fail, creating a financial panic. Second, due to its rigid dependence on the amount of U.S. bonds, national banknote currency was unable to respond to the changing needs of business, that is, the supply of money could not be adjusted to meet the changes in the demand for money. Third, the Commission cited a lack of cooperation "of any kind" among banks outside the clearing house cities, and fourth, the lack of a well-developed discount market and a market for commercial paper available for investment by banks. The last was blamed for an "unhealthy congestion" of funds in the main money centers, where they were used in "dangerous speculation" that often resulted in "injurious disturbance" to bank reserves.

Subsequently, Senator Aldrich formalized the Commission's recommendations in a bill, generally known as the "Aldrich Plan," to establish a "National Reserve Association of the United States." The measure garnered strong banker support but was specifically rejected, along with any proposal for a "central bank," by the Democratic party in its 1912 platform. The attitudes toward centralized control had not died with the First and Second Banks of the United States and President-elect Woodrow Wilson was particularly unreceptive to the Aldrich bill's provisions for a centralized organization controlled by private interests.

Consequently, under Wilson's guiding hand, Congressman Carter Glass (D-Va), the incoming chairman of the House Banking Committee, drafted and submitted an alternative proposal "to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, and to establish a more effective supervision of banking." It immediately came under savage attack from supporters of the rival "Aldrich Plan," including the American Bankers Association, as being, among other things, "socialistic."

In spite of subsequent (and current) claims of various Fed critics, the two proposals differed in their emphases upon government and private participation and centralism vs. regionalism, as well as in their specific provisions for reserve mobilization, note issue and discounting. These differences, and the resulting adoption of the Federal Reserve Act, will be the subject of the next *Letter*.

Verle B. Johnston

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/14/83	Change from 12/7/83	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	164,861	65	1,653	1.0
Loans (gross, adjusted) — total#	144,694	– 10	2,350	1.7
Commercial and industrial	43,949	– 247	– 1,113	– 2.5
Real estate	57,629	20	435	0.8
Loans to individuals	25,568	196	1,775	7.5
Securities loans	3,436	42	473	16.0
U.S. Treasury securities*	7,862	79	845	12.0
Other securities*	12,305	– 4	– 1,542	– 11.1
Demand deposits — total#	43,636	–1,801	– 431	– 1.0
Demand deposits — adjusted	30,516	– 632	2,091	7.4
Savings deposits — total†	66,366	– 303	29,044	77.8
Time deposits — total#	70,183	– 157	– 23,281	– 24.9
Individuals, part. & corp.	64,256	– 220	– 19,260	– 23.1
(Large negotiable CD's)	17,285	– 128	– 15,057	– 46.6

Weekly Averages of Daily Figures	Week ended 12/14/83	Week ended 12/7/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	55	80	113
Borrowings	5	5	110
Net free reserves (+)/Net borrowed(–)	49	75	3

* Excludes trading account securities.
# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of this and other Federal Reserve publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.