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Happy Birthday, Federal Reserve

How the world's most powerful central bank was created

BY NEIL IRWIN

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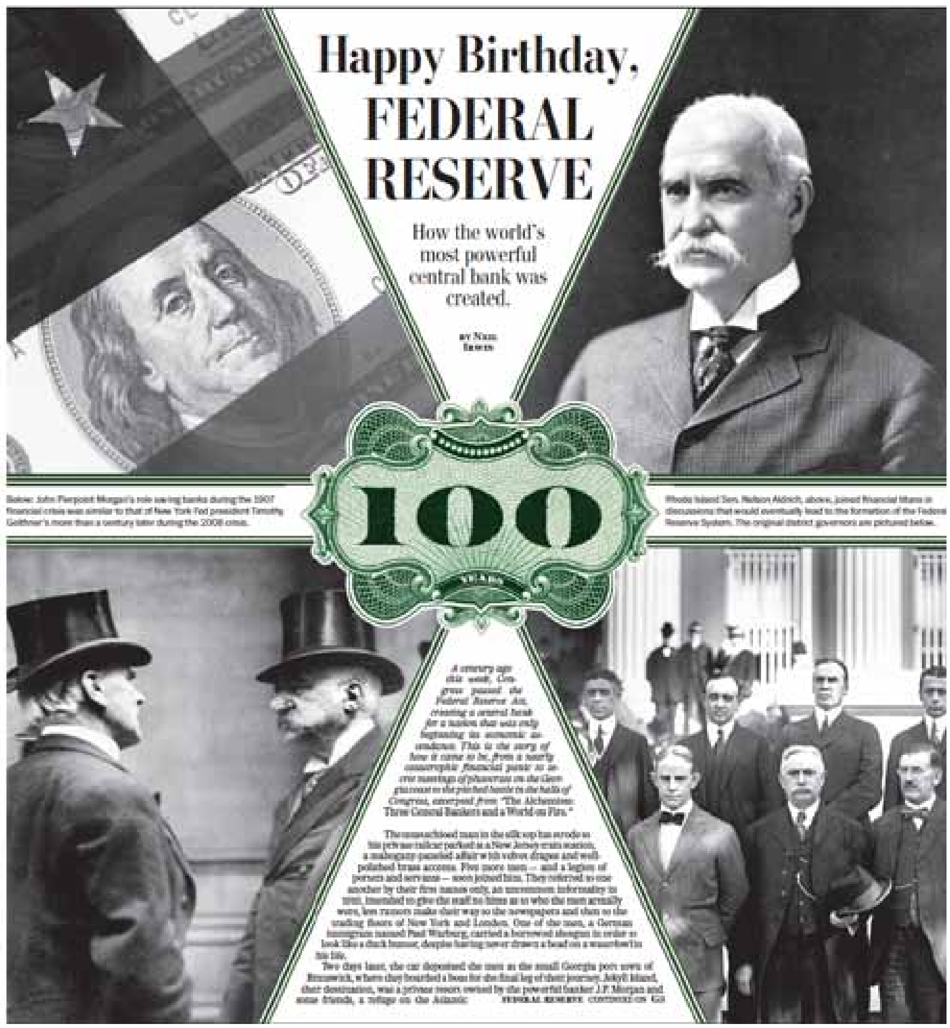
A century ago this week, Congress passed the Federal Reserve Act, creating a central bank for a nation that was only beginning its economic ascendance. This is the story of how it came to be, from a nearly catastrophic financial panic to secret meetings of plutocrats on the Georgia coast to the pitched battle in the halls of Congress, excerpted from The Alchemists: Three Central Bankers and a World on Fire.



CLOCKWISE FROM TOP LEFT: REUTERS FILE PHOTO, CORBIS, HARRIS AND EWING COLLECTION/LIBRARY OF CONGRESS, LIBRARY OF CONGRESS

Collage illustration commemorating the 100th anniversary of the Federal Reserve.

The mustachioed man in the silk top hat strode to his private railcar parked at a New Jersey train station, a mahogany-paneled affair with velvet drapes and well-polished brass accents. Five more men — and a legion of porters and servants — soon joined him. They referred to one another by their first names only, an uncommon informality in 1910, intended to give the staff no hints as to who the men actually were, lest rumors make their way to the newspapers and then to the trading floors of New York and London. One of the men, a German immigrant named Paul Warburg, carried a borrowed shotgun in order to look like a duck hunter, despite having never drawn a bead on a waterfowl in his life.

Two days later, the car deposited the men at the small Georgia port town of Brunswick, where they boarded a boat for the final leg of their journey. Jekyll Island, their destination, was a private resort owned by the powerful banker J.P.

Morgan and some friends, a refuge on the Atlantic where they could get away from the cold New York winter. Their host — the man in the silk top hat — was Nelson Aldrich, one of the most powerful senators of the day, a lawmaker who lorded over the nation's financial matters.

For nine days, working all day and into the night, the six men debated how to reform the U.S. banking and monetary systems, trying to find a way to make this nation just finding its footing on the global stage less subject to the kinds of financial collapses that had seemingly been conquered in Western Europe. Secrecy was paramount. "Discovery," wrote one attendee later, "simply must not happen, or else all our time and effort would have been wasted. If it were to be exposed publicly that our particular group had got together and written a banking bill, that bill would have no chance whatever of passage by Congress.

For decades afterward, the most powerful men in American finance referred to one another as part of the "First Name Club." Paul, Harry, Frank and the others were part of a small group that, in those nine days, invented the Federal Reserve System. Their task was more than administrative. Because the men at Jekyll Island weren't just trying to solve an economic problem — they were trying to solve a political problem as old as their republic.

Banking's rough beginning

The U.S. financial system needed remaking. The United States had a long but less than illustrious history with central banking. Alexander Hamilton, the first Treasury secretary, believed a national bank would stabilize the new government's shaky credit and support a stronger economy — and was an absolute necessity to exercise the new republic's constitutional powers.

But Hamilton's proposal faced opposition, particularly in the agricultural South, where lawmakers believed a central bank would primarily benefit the mercantile North, with its large commercial centers of Boston, New York and Philadelphia. "What was it drove our forefathers to this country?" said James "Left Eye" Jackson, a fiery little congressman from Georgia. "Was it not the ecclesiastical corporations and perpetual monopolies of England and Scotland? Shall we suffer the same evils to exist in this country?" Some founding fathers, including Thomas Jefferson and James Madison, believed that the bank was unconstitutional.

By 1811, Madison was in the White House. The Bank of the United States closed down. Until, at least, Madison realized how hard it was to fight the War of 1812 without a national bank to fund the government. The Second Bank of the United States was founded in 1816. It lasted a little longer — until it crashed against the same distrust of centralized financial authority that undermined the first. The populist Andrew Jackson managed its demise in 1836.

Running an economy without a central bank empowered to issue paper money caused more than a few problems in late 19th-century America. For example, the supply of dollars was tied to private banks' holdings of government bonds. That would have been fine if the need for dollars was fixed over time. But one overarching lesson of financial history is that that's not the case. In times of financial panic, for example, everybody wants cash at the same time (that's what happened in fall 2008).

Without a central, government-backed bank able to create money on demand, the American banking system wasn't able to provide it. The system wasn't elastic, meaning there was no way for its supply of money to adjust with demand. People would try to withdraw more money from one bank than it had available, the bank would fail, and then people from other banks would withdraw their funds, creating a vicious cycle that would lead to widespread bank failures and the contraction of lending across the economy. The result was economic depression. It happened every few years. One particularly severe panic in 1873 was so bad that until the 1930s, the 1870s were the decade known as the "Great Depression." There were lesser panics in 1884, 1890 and 1893.

Then came the Panic of 1907, the one that finally persuaded American lawmakers to deal with their country's backward financial system. What made the Panic of 1907 so severe? A bunch of things that happened to converge at once.

It started with a devastating earthquake in San Francisco in 1906. Suddenly, insurers the world over needed access to dollars at the same time. In what was then still an agricultural economy, it was also a bumper year for crops, and an economic boom was under way — so companies nationwide wanted more cash than usual to invest in new ventures. In San Francisco, deposits were unavailable for weeks after the quake: Cash was locked in vaults so hot from fires caused by broken gas lines that it would have burst into flames had they been opened.

All of that meant the demand for dollars was uncommonly high — at a time when the supply of dollars couldn't increase much.

This manifested itself in the form of rising interest rates and withdrawals. Withdrawals begat more withdrawals, and before long, banks around the country were on the brink of failure.

Then in October 1907, the copper miner turned banker F. Augustus Heinze and his stockbroker brother Otto tried to take over the market of his own United Copper company by buying up its shares. When he failed, the price of United Copper stock tumbled. Investors rushed to pull their deposits out of any bank even remotely related to the disgraced F. Augustus Heinze.

First, a Heinze-owned bank in Butte, Mont., failed. Next came the huge Knickerbocker Trust Co. in New York, whose president was a Heinze business associate. Depositors lined up by the hundreds in its ornate Fifth Avenue headquarters, holding satchels in which to stuff their cash. Bank officials standing in the middle of the room and yelling about the bank's alleged solvency did nothing to dissuade them. The failure of the trust led every bank in the country to hoard its cash, unwilling to lend it even to other banks for fear that the borrower could be the next Knickerbocker.

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Treasury Note, by Henry R. Robinson, 1837, lithograph on wove paper. The political cartoon parodies the worthless fractional currencies or "shinplasters" issued by banks, businesses and municipalities in lieu of coin.

The power of J. P. Morgan

It is true that the United States, in that fearful fall of 1907, didn't have a central bank. That doesn't mean it didn't have a central banker. John Pierpont Morgan was, at the time, the unquestioned king of Wall Street, the man the other bankers turned to to decide what ought to be done when trouble arose. He was not the wealthiest of the turn-of-the-century business titans, but the bank that bore his name was among the nation's largest and most important, and his power extended farther than the (vast) number of dollars under his command. His imprint on the financial system has long survived him. Two of the most important financial firms in America today, JPMorgan Chase and Morgan Stanley, trace their lineage to John Pierpont Morgan.

When the 1907 crisis rolled around, Morgan held court at his bank's offices at 23 Wall St. while a series of bankers came to make their requests for help.

Morgan asked the Treasury secretary to come to New York — note who summoned whom — and ordered a capable young banker named Benjamin Strong to analyze the books of the next big financial institution under attack, the Trust Company of America, to determine whether it was truly broke or merely had a short-term problem of cash flow — the old question of insolvent versus illiquid. Merely illiquid was Morgan's conclusion. The bankers bailed it out.

It wouldn't last — with depositors unsure which banks, trusts and brokerages were truly solvent, withdrawals continued apace all over New York and around the country. At 9 p.m. on Saturday, Nov. 2, 1907, Morgan gathered 40 or 50 bankers in his library.

The bankers awaited, as Thomas W. Lamont, a Morgan associate, put it, "the momentous decisions of the modern Medici." In the end, Morgan engineered an arrangement in which the trusts would guarantee the deposits of their weaker members — something they finally agreed to at 4:45 a.m. Medici comparisons aside, it is remarkable how similar Morgan's role was to that of Timothy Geithner, the New York Fed president, a century later during the 2008 crisis. Both knocked heads to encourage the stronger banks and brokerages to buy up the weaker ones, bailing out some and allowing others to fail, working through the night so action could be taken before financial markets opened.

With a big difference, of course: Geithner was working for an institution that was created by Congress and acted on the authority of the government. His major decisions were approved by the Fed's board of governors, its members appointed by the president and confirmed by the Senate. His capacity to address the 2007-08 crisis was backed by an ability to create dollars from thin air.

Morgan, by contrast, was simply a powerful man with a reasonably public-spirited approach and an impressive ability to persuade other bankers to do as he wished. The economic future of one of the world's emerging powers was determined simply by his wealth and temperament.

Time for a change

Enough was enough. The Panic of 1907 sparked one of the worst recessions in U.S. history, as well as similar crises across much of the world. Members of Congress finally saw that having a central bank wasn't such a bad idea after all. "It is evident," said Sen. Aldrich, he of the silk top hat and the trip to Jekyll Island, "that while our country has natural advantages greater than those of any other, its normal growth and development have been greatly retarded by this periodical destruction of credit and confidence."

Legislation Congress enacted immediately after the panic, the Aldrich-Vreeland Act, dealt with some of the financial system's most pressing needs, but it put off the day of reckoning with the bigger question of what sort of central bank might make sense in a country with a long history of rejecting central banks. It instead created the National Monetary Commission, a group of members of Congress who traveled to the great capitals of Europe to see how their banking systems worked. But the commission was tied in knots.

Agricultural interests were fearful that any new central bank would simply be a tool of Wall Street. They insisted that something be done to make agricultural credit available more consistently, without seasonal swings. The big banks, meanwhile, wanted a lender of last resort to stop crises — but they wanted to be in charge of it themselves, rather than allow politicians to be in charge.

The task for the First Name Club gathered in Jekyll Island in that fall of 1910 was to come up with some sort of approach to balance these concerns while still importing the best features of the European central banks.

The solution they dreamed up was to create, instead of a single central bank, a network of them around the country. Those multiple central banks would accept any "real bills" — essentially promises businesses had received from their customers for payment — as collateral in exchange for cash. A bank facing a shortage of dollars during harvest season could go to its regional central bank and offer a loan to a farmer as collateral in exchange for cash. A national board of directors would set the interest rate on those loans, thus exercising some control over how loose or tight credit would be in the nation as a whole.

Happy Birthday, Federal Reserve | *continued*

The men at Jekyll drafted legislation to create this National Reserve Association, which Aldrich, the most influential senator of his day on financial matters, introduced in Congress three months later.

A rocky reception

It landed with a thud. Even though the First Name Club managed to keep its involvement secret for years to come, the idea of a set of powerful new institutions controlled by the banks was a non-starter in this nation with a long distrust of centralized financial authority.

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The Panic, by Udo J. Keppler, 1907. A crowd of capitalists on Wall Street flee a volcano labeled "Common Honesty" erupting in the background; they are carrying labeled packages.

Aldrich's initial proposal failed, but he had set the terms of the debate. There would be some form of centralized power, but also branches around the country. And what soon became clear was that the basic plan he'd laid out — power simultaneously centralized and distributed across the land and shared among bankers, elected officials, and business and agricultural interests — was the only viable political solution.

Carter Glass, a Virginia newspaper publisher and future Treasury secretary, took the lead on crafting a bill in the House, one that emphasized the power and primacy of the branches away from Washington and New York. He wanted up to 20 reserve banks around the country, each making decisions autonomously, with no centralized board. The country was just too big, with too many diverse economic conditions, to warrant putting a group of appointees in Washington in charge of the whole thing, Glass argued.

President Woodrow Wilson, by contrast, wanted clearer political control and more centralization — he figured the institution would have democratic legitimacy only if political appointees in Washington were put in charge. The Senate, meanwhile, dabbled with approaches that would put the Federal Reserve even more directly under the thumb of political authorities, with the regional banks run by political appointees as well.

But for all the apparent disagreement in 1913, there were some basic things that most lawmakers seemed to agree on: There needed to be a central bank to backstop the banking system. It would consist of decentralized regional banks. And its governance would be shared — among politicians, bankers, and agricultural and commercial interests. The task was to hammer out the details.

Who would govern the reserve banks? A board of directors comprising local bankers, businesspeople chosen by those bankers, and a third group chosen to represent the public. The Board of Governors in Washington would include both the Treasury secretary and Federal Reserve governors appointed by the president and confirmed by the Senate.

How many reserve banks would there be, and where? Eight to 12, the compromise legislation said, not the 20 that Glass had envisioned. An elaborate committee process was designed to determine where those should be located. Some sites were obvious — New York, Chicago. But in the end, many of the decisions came down to politics. Glass was from Virginia, and not so mysteriously, its capital of Richmond — neither one of the country's largest cities nor one of its biggest banking centers — was chosen.

The vote over the Federal Reserve Act in a Senate committee came down to a single tie-breaking vote, that of James A. Reed, a senator from Missouri. Also not so mysteriously, Missouri became the only state with two Federal Reserve banks, in St. Louis and Kansas City. The locations of Federal Reserve districts have been frozen in place ever since, rather than evolving with the U.S. population — by 2000, the San Francisco district contained 20 percent of the U.S. population, compared with 3 percent for the Minneapolis district.

And in a concession to those leery of creating a central bank, the Federal Reserve System, like the First and Second Banks of the United States, was set to dissolve at a fixed date in the future: 1928. One can easily imagine what might have happened had its charter come up for renewal just a couple of years later, after the Depression had set in.

Creation of a central bank

The debate over the Federal Reserve Act was ugly. In September 1913, Rep. George Ross Smith of Minnesota carried onto the floor of the House a 7-by-4-foot wooden tombstone — a prop meant to "mourn" the deaths of industry, labor, agriculture and commerce that would result from having political appointees in charge of the new national bank.

"The great political power which President Jackson saw in the First and Second National banks of his day was the power of mere pygmies when compared to the gigantic power imposed upon [this] Federal Reserve board and which by the proposed bill is made the prize of each national election," he argued.


BETTMAN/CORBIS
Benjamin Strong Jr.

It wasn't just the fiery populists who opposed the bank. Aldrich, the favored senator of the Wall Street elite, complained that the Wilson administration's insistence on political control of the institution made the bill "radical and revolutionary and at variance with all the accepted canons of economic law." He wanted the banks to have more control, not a bunch of politicians.

For all the noise, the juggling of interests was effective enough — and the memory of 1907 powerful enough — for Congress to pass the bill in December 1913. Wilson signed it two days before Christmas, giving the United States, at long last, its central bank. "If, as most experts agree, the new measure will prevent future 'money panics' in this country, the new law will prove to be the best Christmas gift in a century," wrote the *Baltimore Sun*.

The government, of course, hadn't solved the problem of panics. It had just gained a better tool with which to deal with them.

And opposition to a central bank, rooted as deeply as it was in the American psyche, didn't go away. Instead, it evolved. Whenever the economic tide turned — during the Great Depression, during the deep recession of the early 1980s, during the downturn that followed the Panic of 2008 — the frustration of the people was channeled toward the institution they'd granted an uncomfortable degree of power to try to prevent such things.

But after more than a century of trying, the United States had its central bank. Before long, New York would supplant London as the center of the global financial system, and the dollar would replace the pound as the leading currency in the world. And as the years passed, the series of compromises that the First Name Club dreamed up a century earlier, and the unwieldy and complex organization it created, would turn out to have some surprising advantages — even in a country that had previously been better at creating central banks than keeping them.

■ *Adapted from* The Alchemists: Three Central Bankers and a World on Fire, *published in 2013 by The Penguin Press.*

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The Federal Reserve From 1913 to Today

The December 22, 2013, Business section article, "Happy Birthday, Federal Reserve," is written by Neil Irwin, *The Washington Post* economics reporter. The article is excerpted from *The Alchemists: Three Central Bankers and a World on Fire*, a 430-page work by Irwin.

After reading the article, answer the following questions on your own paper.

1. What were the arguments for and against a central bank during the founding of our country? Include in your answer what is meant by the term "central bank."

2. Explain the cycle that leads to bank failures and potential economic depression.

3. What events converged to create the Panic of 1907?

4. What concepts regarding a Federal Reserve were agreed upon in the midst of disagreement in Congress?

5. Read Henry R. Robinson's 1837 cartoon that illustrates the article and its caption. Editorial cartoonists will use symbolism and contemporary references that may be difficult to decipher years later. See what you can do. Using what you learned about the demise of the Second Bank of the United States in 1836 and populist President Andrew Jackson's role, select one panel or detail and comment on it.

6. What does Irwin state is the benefit of having the Federal Reserve?

e-Replica *Conduct an e-replica search for "Federal Reserve." Review the articles that are found and answer the following questions.*

7. How many Federal Reserve districts exist today? Where are they located? Who is the leader of the Federal Reserve?

8. What are the main duties of the Federal Reserve today?

9. For what action or issue is the Federal Reserve in the news?

10. Reporters conduct interviews and include informative or revealing quotations in their articles. Select a quotation and discuss how it provides balance, insight and a means for readers to make up their own minds about the issue or event. Be sure to include the headline, date, page and byline of the article.

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ROBERT J. SAMUELSON

THE FED AT 100

The Fed turns 100 Monday. A century ago — on Dec. 23, 1913 — President Woodrow Wilson signed legislation establishing the Federal Reserve. Broadly speaking, it was charged with preventing financial crises and preserving prosperity. The record is mixed. Despite many successful years (the 1920s, 1940s, 1950s, 1980s and 1990s), the Fed's performance is marred by three huge blunders: the Great Depression of the 1930s, the Great Inflation of the late 1960s and 1970s and the 2008-09 financial crisis. Had the Fed acted differently in each case, the outcome would have been different and better.

There's a disheartening consistency to the Fed's cycles of success and failure. The beliefs and policies of one era aren't suitable to the conditions and challenges of the next, but the Fed adapts only slowly under the press of events.

Created after the Panic of 1907, the Fed first focused on averting bank runs. At the time, loan demand and interest rates were highly seasonal; they rose in the spring and the fall, reflecting the credit needs of planting and harvesting crops. Any nasty surprise (bad harvests, business failures, stock market losses) risked a run, as depositors feared that strapped banks couldn't return their money. After all, most of it had been lent out. Unlike today, deposit insurance didn't exist.

The Fed solved this problem, says Harvard economist Jeffrey Miron. Money became more "elastic." When credit demand was high, the Fed lent more. Seasonal interest-rate swings subsided. Confidence grew because depositors knew that, in a panic, banks could borrow from the Fed to meet currency demands. In the 1920s, there were no major bank runs.

But what succeeded in the 1920s backfired in the 1930s. Faced with a collapsing economy, "the Federal Reserve did next to nothing to foster recovery," writes economist Allan Meltzer in his exhaustive history of the Fed. It was passive, because — based on its 1920s experience — weak loan demand signaled that there was little for the Fed to do. Credit seemed easy; loanable funds seemed ample.

This was a fatal error. Weak loan demand mainly reflected the economy's devastated state. To promote revival, the Fed needed to pump money aggressively into the financial system. It didn't. From 1929 to 1932, real gross domestic product (GDP) fell 25 percent. (For comparison, GDP's drop in the recent Great Recession was 4.3 percent.) In 1932, the unemployment rate was 23 percent. Many, probably most, economists think a lax Fed converted an ordinary slump into the Depression.

By contrast, the mistake of the 1960s and 1970s was just the opposite: not passivity, but activism. The 1930s lesson — "do more" — was learned too well. The Fed assumed that shifts in interest rates could keep the economy near "full employment," defined as 4 percent unemployment. In practice, the commitment to full employment, also embraced by successive presidents beginning with John Kennedy, unleashed inflationary expectations (Why restrain wages and prices if government guarantees prosperity?) and easy credit. By the late 1970s, inflation was spiraling out of control at 13 percent.

Subduing it was a triumph of economic policy. After Paul Volcker, Fed chairman from 1979 to 1987, accomplished this with a brutal recession (unemployment reached 10.8 percent) in the early 1980s, the lesson seemed self-evident: Keep inflation low and stable. The uncertainties of volatile prices would fade. Steady growth and prosperity would follow. So it seemed. From 1982 to 2007, there were only two mild recessions. The Fed, mostly under Alan Greenspan, seemed omnipotent. It controlled inflation and repulsed threats to economic growth: the 1987 stock crash, the Asian financial crisis and the Sept. 11, 2001, attacks.

Unfortunately, this success abetted the 2008-09 financial crisis. Prolonged prosperity seemed to reduce risks; investors could rationalize taking more risks, because the downside seemed limited. Sloppy, dangerous and unethical practices spread at banks and other financial institutions. Meanwhile, low inflation reassured the Fed. It distracted attention from the financial system, whose overall stability, in any case, didn't worry most officials. An American financial collapse hadn't happened since World War II and was an unthinkable abstraction, outside their personal experience. The result was that "we were slow to recognize the crisis," as retiring Fed Chairman Ben Bernanke said recently.

What's clear is that the Fed isn't as powerful as it seemed under Greenspan. True, once Bernanke acknowledged the crisis, he acted forcefully to pump funds into the financial system. For this, he has been widely and deservedly praised. A second Great Depression was possibly avoided; the 1930s failure was not repeated. But the Fed has discovered that it lacks the power to resuscitate the economy single-handedly. Five years of short-term interest rates near zero and roughly $3 trillion of bond-buying have, at most, modestly improved a weak recovery. On its centennial, one word best describes the Fed: frustration.

— December 23, 2013