Looking Back: The creation of the Federal Reserve

by: Tim Todd

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New series sheds light on pivotal moments in Federal Reserve history and service.

This year, TEN Magazine marks its 20th anniversary by taking a step back in time. When we published our first edition in the summer of 2005, one of our regular features explored the history of the Federal Reserve. At the time, as a new method for connecting with the communities of the Tenth Federal Reserve District, we believed it was appropriate for a magazine largely focused on our research to also provide some background of the institution.

Our history features were not only popular with our early readers, but they also helped to address some common questions about the central bank of the United States. For example—and as addressed in this article—why does the United States have a network of regional Federal Reserve Banks instead of a single bank in Washington, D.C.?

We hope you will find this article, as well as the ones to come in this new featured series, to be entertaining, informative and helpful in answering some of the questions that you might have about the Federal Reserve Bank of Kansas City and the work we do in the service of communities across the Tenth Federal Reserve District.

When Congress established the Federal Reserve in 1913, it was a compromise solution to a problem that had vexed the nation nearly since its founding: how to establish a viable central bank for a nation as large and diverse as the United States with a population that was understandably skeptical of the risks posed by consolidated power.

In the earliest days of the United States, Alexander Hamilton offered a solution, championing the Fed's initial ancestor: the First Bank of the United States. Founded in 1791, the Bank was unable to gain neither widespread public nor Congressional support and came to its end in 1811. It was followed by the Second Bank of the United States in 1816 when Congress recognized the need for a central bank to help stabilize the economy. Although the Second Bank was slightly more successful in maintaining Congressional support, public trust was again lacking, and a presidential veto brought its tenure an end in the early 1830s.

Today, visitors to Philadelphia's numerous historic sites can stroll past both former Bank buildings—each an easy walk from nearby Independence Hall—an area that, until the early 1830s, was also the heart of the nation's financial system—for all practical purposes, “the first Wall Street,” as historian Robert E. Wright titled a 2005 book.

Thus both monolithic banks operated at very nearly the intersection of political and financial influence. Even those living in western Pennsylvania, let alone their fellow Americans along the frontier or in the South, were skeptical that either bank conducted its operations with a focus on the general welfare, as Georgia Congressman James Jackson asked:

“*What is this general welfare? Is it the welfare of Philadelphia, New York and Boston: for as to the states of Georgia and New Hampshire, they may as well be out of the Union as to any advantages they will receive.*”

Such distrust, however, was not limited to those living in what we would today refer to as “flyover country.” For example, while President Andrew Jackson’s populist base saw in the Second Bank of the United States an institution worried only about the interests of the nation’s business elite, some of those early champions of business and industry also were opposed because it could restrict the availability of credit. When Jackson assured the Second Bank’s dissolution through a presidential veto, some on both sides of the issue celebrated while Jackson was propelled to a second term.

However, as it turned out, any celebration was likely premature and perhaps a bit misguided.

After the veto

As described by Bray Hammond, who won a Pulitzer Prize for his study of the history of banking and politics, President Jackson “professed to be the deliverer of his people from the oppressions of the mammoth…(but) no more striking example could be found of a leader fostering the very evil he was angrily wishing out of the way.” Put another way: “It left the poor agrarian as poor as he had been before and it left the money power possessed of more money and more power than ever.”

In the years that followed the veto, the nation suffered financial crises and banking panics on a nearly regular basis amid the westward expansion, railroad construction, increasing industrialization and debates about the nation’s monetary system. Among the more substantial of these was the Panic of 1837 and depression that bankrupted nearly one-third of the states, the Panic of 1873 and the Long Depression, where 18,000 businesses failed, and the Depression of 1893, that saw an estimated jobless rate in double digits for five years.

Finally, after the Panic of 1907, momentum for monetary reform gained critical mass, leading to the Federal Reserve Act of 1913, a compromise piece of legislation that established the nation’s central bank with an innovative structure. Rather than an institution isolated in Washington, D.C. or along New York City’s Wall Street, the Fed’s congressional founders created a decentralized structure with a system of regional Federal Reserve Banks dedicated to serving specific geographic Districts.

Structure and governance

However, geographic decentralization was only one part of the equation.

There was also the question of governance. This was an area where there was not broad agreement – some favored private sector control while others wanted a central bank under tight government authority. The solution was a system similar to the "checks and balances" design utilized by the nation's most important institutions.

- The Board of Governors is a government agency, and its seven governors are appointed by the President of the United States and confirmed by the Senate. The Board has oversight responsibility for the entire Federal Reserve System.
- The 12 regional Reserve Banks and their affiliated Branches, meanwhile, are members of the private sector, operating under the leadership of their own boards of directors – individuals from a wide range of backgrounds in business, community service and other areas. The Reserve Banks are sometimes referred to as the Fed's operating arms.

Because the entire Federal Reserve System is accountable to Congress, lawmakers have on occasion made changes to the Fed. One of the most notable examples of this was the creation of the Federal Open Market Committee in the 1930s. Other changes within the Fed have also been made to improve efficiencies, particularly related to technological development which has allowed for consolidation of some operations and the evolution of others. One example here relates to the Fed's payment system operations as consumers moved away from written checks to electronic transactions.

Today, the Federal Reserve Bank of Kansas City, like its peers across the Federal Reserve System, is engaged in each of the Fed's three mission areas: monetary policy, bank supervision and financial services. Importantly, it serves as the regional connection to the nation's central bank, ensuring that the residents of the seven-state District have a voice in the Fed's policy deliberations and that their banks are well-run and treat them fairly, and that the nation's payment system remains secure, efficient and accessible.

Download free historical publications and learn more about the Federal Reserve.

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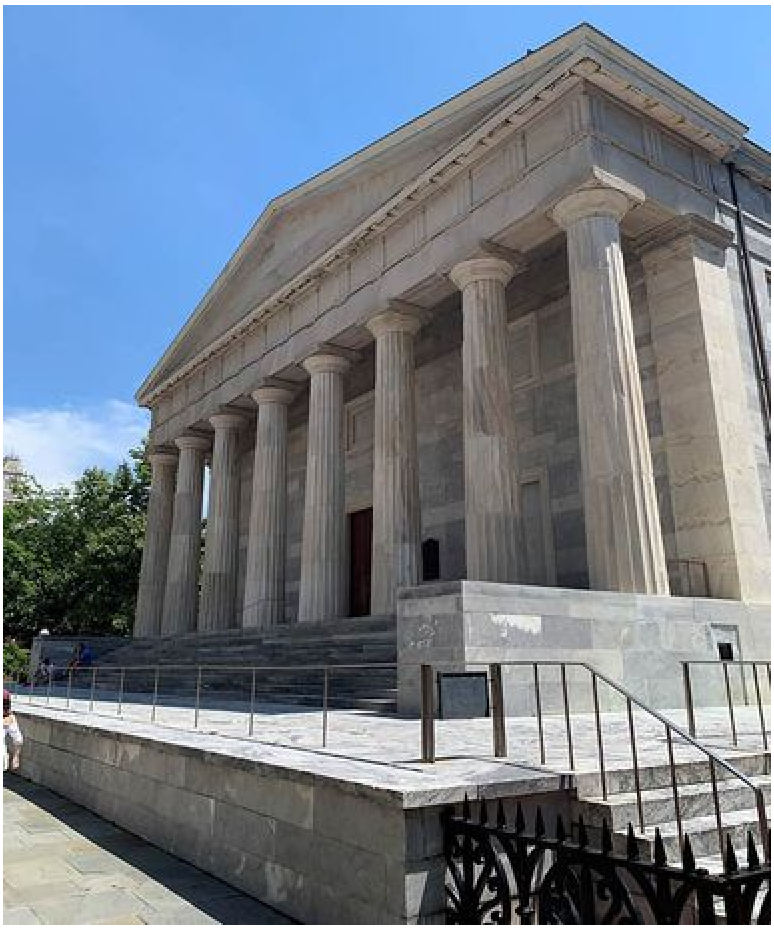
Timothy Todd is a writer engaged in historical research at the Federal Reserve Bank of Kansas City. He is the author of nine books on the history of banking and financial services, including most recently, "In the Public Interest: The Tenth District's Federal Reserve Bank." His previous work has focused on the intersection of politics and the Fed, and the history of banking in the United States. He has published two books on the history of Black-owned banks, "A Great Moral and Social Force: A History of Black Banks," and "Let Us Put Our Money Together." Among his numerous presentations and media appearances, he has been a featured speaker for the Smithsonian's African American History and Culture Museum, the Black History Museum and Cultural Center of Virginia, the Maggie L. Walker National Historic Site and the Dillard University Center for Racial Justice. In addition, he served as a writer and associate producer for a documentary about the history of the Federal Reserve that was produced by Kansas City PBS station KCPT. Prior to joining the Federal Reserve, he was a journalist for 10 years.

Media



This building in Philadelphia housed the Second Bank, which was dissolved following a presidential veto in the early 1830s. Photo by Tim Todd