On the Origins of the Federal Reserve System and Its Structure*

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America’s experiences with both the first and second Banks of the United States—central banks patterned after the Bank of England—left the term “central bank” redolent of monopoly and special privilege; it became a word and concept to be avoided during much of the nation’s development. Between 1836 and 1913, the United States, like Canada, had no central bank. A laissez-faire spirit generally prevailed until the turn of the century when risky structural developments within the banking industry produced calls for reform that eventually led to the creation of the Federal Reserve System. The severe Panic of 1907, however, proved the System’s proximate cause. The panic, against the backdrop of structural change, abundantly illustrated that relying on the banks themselves had become insufficient for the task of mitigating financial crises. The powerful New York Clearing House’s slow, discriminative, and insufficient response to the panic gave credence to concerns about growing financial risks and galvanized calls for reform.

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In passing the Federal Reserve Act of 1913, Congress primarily intended to accommodate the public’s desire to shift funds rapidly out of bank deposits and into currency, a situation that occurred during the nation’s all-too-frequent and disruptive financial crises. In such circumstances, banks could satisfy the public’s preferences by paying out reserves—funds that they held specifically for that very purpose—but banks operated with reserves equal only to a fraction of their deposits. Paying out reserves under a fractional-reserve system could force a multiple reduction in deposits and a corresponding cutback in loans. The stock of money declined; interest rates rose; prices weakened, and the business climate soured. Banks had only a few options in such circumstances: Under the gold standard, the situation eventually could create a gold inflow, an ex post accommodation. More immediately, banks with deficient reserves might borrow funds from those with a surfeit. Alternatively, banks might simply suspend the conversion of deposits into cash, an option with potential legal implications.

One consistent and critical factor during the era, the “pyramiding” of reserves in New York City, clearly exacerbated the consequences of rapid shifts in the public’s demand for currency. In 1864, during the Civil War, Congress passed legislation that sought to bring the nation’s commercial banks under federal charters and regulations. At that time, all commercial banks operated under state charters. To entice the participation of the large New York City banks—crucial to the plan’s success—the act mandated correspondent relationships that resulted in banks keeping a substantial portion of their reserves in the New York banks. These correspondent relations proved mutually beneficial to the banks, but left a large portion of the nation’s bank reserves vulnerable to the management decisions of relatively few New York banks.

As the nineteenth century rolled into the twentieth century, the banking sector saw a number of structural changes that heightened these vulnerabilities. The government’s 1864 bid to bring all commercial banks under federal charters ultimately failed, and by 1906, the number of state-chartered banks again exceeded that of nationally chartered banks. They competed against their national counterparts within a much looser regulatory environment. Similarly, trust companies had also become formidable competitors. The trusts took deposits, acted much like banks and profitably served segments of the investment market precluded to national banks. By 1903, they held assets on par with the national banks. During this time, America witnessed a wave of corporate consolidation that investment bankers such as J. P. Morgan facilitated to their great gain. To serve their corporate clients, several of the nation’s largest banks—notably those same New York City banks holding many of the nation’s reserves—began blurring the lines between commercial and investment banking through mergers, acquisitions, and the formation of holding companies. They began creating and selling stocks and bonds. They also acquired state-chartered banks and trust companies, which allowed them to enter lines of business that their national charters ostensibly precluded. As these events transpired, an atmosphere of distrust enveloped the banking sector, pitting the small, mostly western and rural, conservative commercial banks against their more free-wheeling eastern contemporaries.

As the aforementioned structural changes emerged, a series of less obvious, but equally as risky, technical developments evolved. The ratio of bank deposits to currency in the nation tripled between 1879 and 1907. At the same time, national banks began reducing their excess reserves. They mainly did this by lowering the amount of cash in their vaults, which earned no interest, closer to the legal minimum, while keeping any excess reserves on deposit with their New York correspondents, which received interest. After 1900, even the New York banks, which traditionally maintained few excess reserves, began trimming theirs even closer to the legal minimum. As a consequence, the ratio of bank deposits to vault cash more than doubled between 1879 and 1907. These developments left the banking system increasingly vulnerable to shifts in the public’s desire for cash instead of deposits.
The Panic of 1907, the worst financial crisis in the nation’s history to date, confirmed the gravest fears of many, including several of those New York bankers who ostensibly had an interest in the status quo. The panic breathed a sense of urgency into the reform movement. The all-important New York Clearing House had responded slowly and insufficiently as the panic unfolded; it had discriminated against trust companies, which now became a focal point of the crisis. Relief relied immediately on J. P. Morgan and a consortium of respected bankers who made loans to troubled banks, trusts, brokerages, and the city itself, but eventual on an inflow of gold.

In the proposals for reform that followed the panic, the operational aspects were largely uncontroversial; these generally recommended pooling the nation’s reserves in a bankers’ bank capable of lending them at a penalty rate against the safe short-term commercial paper that banks typically held. Organizational issues, however, became paramount in subsequent debates. They centered on the degree of centralization and the extent of government control. The Federal Reserve Act—a compromise measure—adopted a structure intended to accommodate disparate regional needs and to minimize the influence of any one stakeholder, while giving both the bankers’ and the government significant influence over the System. Twelve regional districts emerged, each with ample resources to support a Reserve Bank, all roughly equal in terms of banking resources, and each sufficiently diverse in financial resources so that regional savings might satisfy regional borrowing needs, independently, as far as possible, of other Districts. The criteria ideally would insure that one or more Districts did not dominated the System.

The Federal Reserve Act, however, proved to be ambiguous about the lines of authority between the District Banks and the Board of Governors and about the relationship between the System and the Treasury. Disagreements even arose among the District Banks. In response, the Banking Act of 1935 delineated authority more clearly and essentially created the modern structure of the Federal Reserve System. The Act concentrated power in the Board of Governors while simultaneous removing any direct Treasury influence over the System’s policies. The changes gave the Board of Governors a majority on the Federal Open Market Committee, but within this structure, a new and important policy role for the District Banks soon emerged. The District Banks can accumulate antidotal information on economic developments that often can foreshadow national economic trends in advance of the standard economic data. Their separate research functions also promote a diversification of research interests within the System and foster debate about policy among the banks and the Board. Such divers and useful ideas might not emerge in a monolithic structure.
About the author

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