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The Fed: A Central Bank with a Regional Structure

Urban vs. rural. East Coast vs. the rest of the country. Big bankers and big business vs. everyone else. More vs. less government control.

Familiar as these controversies may seem, they aren't references to the battles of today but to the forces that were at play a century ago in the years immediately preceding the founding of the Federal Reserve System.

By the time the Banking Panic of 1907 struck, the country had been without a central bank for 70 years. The first two central banks (the First and Second Banks of the United States, 1791-1811 and 1817-1837) were each shut down after two decades, in part because most of the country was hostile toward a centralization and concentration of banking power. But after a succession of bank runs, credit shortages and financial crises, by the early 20th century most people recognized that an overhaul of the banking and monetary system was needed. Wall Street bankers wanted a more efficient system—a private central bank that they controlled. Those outside the power centers of New York and Washington wanted a structure that would meet the needs of all regions of the country; many of these people felt that bankers—especially big city bankers—served primarily the wealthy. This group also wanted at least some public oversight in the system.

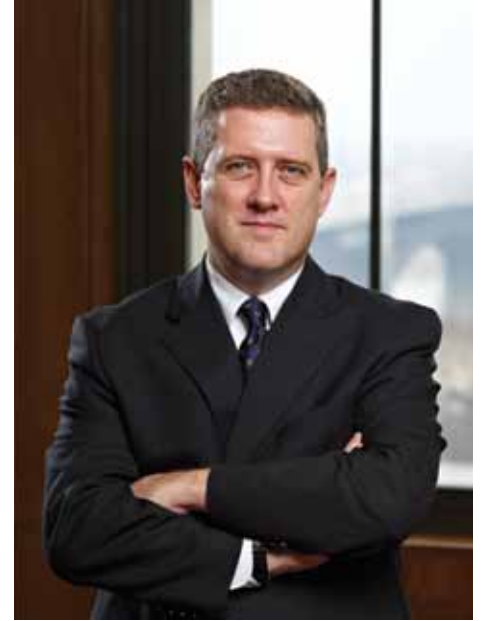
The need for reform was basic: The supplies of currency and bank loans were inflexible, tied more to the nation's gold reserves and supply of government debt than to the needs of business and agriculture. This "inelastic currency" led to high interest rates and tight credit when demand for money was high and couldn't be met—for example, at harvest time. Although banks held reserves in about 50 cities, the largest volume was kept in New York. Hence, sharp increases in the

demand for money around the country created major liquidity problems for banks in New York, at the nation's financial center. Financial crises provoked suspension of payments and significant recessions.

In the wake of the 1907 Panic and resulting recession, Congress set up the National Monetary Commission to study central banks and banking in other countries and propose a structure for the United States. Three years later, the commission presented the Aldrich Plan, named for its chairman, Sen. Nelson Aldrich, R-R.I. The most powerful senator of his day, he was viewed as a stand-in for the banking and business elite of the East. His plan called for one central institution with branches across the country. Control would rest with a board dominated by bankers. Unlike the First Bank and Second Bank of the United States, the government would have no financial stake in this proposed structure.

Aldrich's timing couldn't have been worse. His party had just lost control of Congress, thanks to the growing popularity of the Progressive movement. Like the populists of the previous century, the progressives were wary of the concentration of economic and political power. They fought the monopolization of key industries, which usually was assisted by powerful bankers. Although progressives supported banking reform, they advocated some controls by the government to protect society at large, and they insisted on a structure that allowed the varying credit needs of the different parts of the country to be met.

The election of Democrat Woodrow Wilson to the presidency in 1912 killed Aldrich's plan. Wilson opposed the creation of a central bank and had railed in his campaign against "the money monopoly." Wilson's advisers presented an alternative plan: about 20 private, locally controlled regional reserve



banks. They would not only hold the reserves of their member banks so that the money was close at hand when needed locally, but would meet member banks' other currency and credit needs. Eventually, the plan also called for the reserve banks to supervise those member banks, issue currency against commercial assets and gold, and perform other central banking functions. Wilson approved of the plan but, reflecting the progressives' desire for some government oversight, proposed a central board of government appointees in Washington to control and coordinate the work of the regional banks. (At its inception, this board was relatively weak—and certainly not as powerful as it exists today.) In a nod to bankers, Wilson proposed the Federal Advisory Council; each regional bank would elect one banker to serve on this council and meet occasionally with the central board.

Though wrangling continued over the number of regional reserve banks (the final number was 12) and their locations, Wilson's plan was, for the most part, what was passed by Congress in 1913. Although the structure took many turns in subsequent years, the Federal Reserve System was born—and still stands—as a central bank with a decentralized structure, one with regional representation, but public oversight—a classic example of checks and balances in U.S. democracy. ¹⁹