

# The federal reserve system

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Even before the creation of the Federal Reserve, banks were used by the public just as we use them today. Deposits were made into savings accounts. Loans were taken out to mortgage a home or finance a new business. Banknotes were issued and spent when the public borrowed from the banks. Borrowers spent these banknotes just as paper money is spent today. These bank notes were valued as money since they were backed by the promise that they would be exchanged on demand for either gold or silver. There was the occasional belief on behalf of the public that banks would not be able to, or outright refuse to honor their banknotes. This fear, if held by enough of a community, could lead to a run on the banks. In a single day, demands for exchange of banknotes for gold and silver would be made by a majority of the people if there was doubt concerning the ability of a bank to redeem its notes. This problem would be compounded when this fear spread to other banks. Runs on a single bank would escalate and spread from one bank to another causing financial panic (<http://www.dallasfed.org>). Another problem prior to the establishment of the Federal Reserve System was the inelasticity of bank credit and the supply of money. Small banks placed their excess reserves in large central reserve banks. Whenever a bank's depositors wanted their funds, the smaller banks would be covered by the central banks. The system worked well during normal conditions. Some banks would draw down on their reserves as other banks would be building up their reserves. In times of excessive demand, however, the problem became quite serious. When the public wanted large amounts of currency, the demand for funds quickly became powerful and widespread. During these periods of high demand, banks from across the nation called on the central banks to supply

the funds (Federal Reserve System 5th ed pp. 10-11). At the time, there were not adequate facilities available to meet the demand for additional funds. Bank's reserves of money were stored around the nation at 50 locations. The reserves were not able to be shifted quickly to the areas that were experiencing increases in withdraw demand. The immobility of reserves only added another element to the financial panic (Schlesinger pp. 41). The credit situation would become tense. Since the banks could not get the funds from their central banks, the smaller banks had to take more drastic measures. Banks would have to sell securities, call in loans, refuse to renew loans, and decline any new loans. These actions led to the fall in prices of securities. Loans were liquidated and borrowing from banks and other lenders became difficult. Interest rates would rise rapidly and sharply. This type of financial hardship led to the liquidation of bank credit. Over a long enough span, this liquidation would lead to money crises (Federal Reserve System 5th ed pp. 10-11). These periods of financial panics along with the inelastic money supply had long beleaguered the country. Bank failures, business bankruptcies, and unstable economic development were results of the lack of a central banking system (Federal Reserve System 8th ed. pp. 6-7). The Panic of 1907 was a bank run of epic proportions that exacerbated the problem. Depositors withdrew their savings from the second and third largest banks in the country. These banks were not able to generate enough funds to cover the demand and subsequently closed their doors. Their closings rapidly spread fear across the country leading to one of the largest runs on the banks the nation had ever witnessed (Schlesinger pp. 41). Fortunately, J. P. Morgan, the exorbitantly rich New York businessman came

to the aid of the financial system. He organized a group of bankers who shifted their funds to the failing banks. Depositors were assured their savings were protected and could be withdrawn whenever they wanted. The demand subsided and deposits were allowed to remain in the banks. Although the panic had successfully ended, bankers and politicians knew they needed a stable agency that worked like a central bank (Schlesinger pp. 41-43). The first step toward a solution was the Aldrich-Vreeland Act of 1908. During times of financial crises, the act authorized the emergency issue of new currency. Additionally, it provided for the creation of the National Monetary Commission. This commission was established to review the nation's banking and money systems. It was also tasked to formulate a long-term solution to a banking system prone to panics and an inelastic currency that was unresponsive to changes in demand (Schlesinger pp. 41-43). The recommendations, named after the commission's chairman, Senator Nelson Aldrich, became known as the Aldrich Plan. It called for the formation of a central institution to be known as the National Reserve Association. The plan included setting up 15 branch offices across the country while all gold reserves would be kept at a central repository. This new body would also be given the power to issue a central currency and establish a national interest rate for borrowing. The plan faced the same criticism that led to the demise of the first two U. S. banks. It was argued that the country could not safely place control of nation's money and banking with too few powerful bankers. Still, the money supply was unstable. Wide-ranging speculation existed in the stock and commodities markets. Banking activities were remained unregulated. The problems were identified but there was not a simple

solution. (Federal Reserve System 5th ed pp. 11-12). Although the need for banking reform was undisputed, the problem was finding a balance between national and regional interests. Nationally, the central bank had to facilitate the exchange of payments among regions and improve the U. S. standing among world economies. Regionally, it had to respond to varying local liquidity. Another critical balancing act was that between the private interests of banks and the centralized responsibility of government (<http://www.stlouisfed.org/publications/pleng/history.html>). By 1912, newly elected President Woodrow Wilson knew changes in the nation's banking system had to be made. The recurrence of bank panics along currency instability demonstrated the necessity of major reform. President Wilson, who was not thoroughly competent in the technicalities of banking, worked closely with advisors during the drafting of reform plans. Representative Carter Glass and Senator Robert Owen, along with prominent economist, H. Parker Willis drafted what became known as the Glass-Willis proposal. This plan was similar to the Aldrich plan but had some significant differences. It was more of a regional, rather than fully centralized, approach to banking reform (<http://www.u-s-history.com/pages/h1052.html>). Under the Glass-Willis proposal 20 or more regional reserve banks would be established under private control. These institutions would perform the central banking functions of the nation. Just like the Aldrich plan, this new body would be given the authority to issue currency and store reserve funds. Senator Owens later made some significant and powerful changes to the proposal. Most significant was the addition of a public supervisory board that would be based in Washington, D. C. This new board would be tasked with control and

coordination of the work of the regional banks. This "Federal Reserve Board" would be free banker domination that had caused the Aldrich Plan to fail to gain acceptance (Schlesinger pp. 45). Also, another primary difference in what would become known as the Federal Reserve Act was the provision that every bank with a national charter would have to become a member of the Federal Reserve System (<http://www.u-s-history.com/pages/h1052.html>). President Wilson said that banks under the Federal Reserve Act "would be the instruments, not the masters, of business and of individual enterprise and initiative" (Schlesinger pp. 45). The passage of the final legislation led to the creation of the 12 Federal Reserve Banks. These reserve banks would function as central banks for the national banks and state institutions that had federal membership. They would be the "operating arms" of the nation's central banking system ([www.federalreserve.gov](http://www.federalreserve.gov)). The Federal Reserve Banks would not be federal bodies, but private institutions owned by the member banks. The Federal Reserve Board would oversee the system and establish monetary policy. Membership of the Board would be by presidential appointment. This provided considerable federal direction over the system. Additionally, the act created a new form of currency, the Federal Reserve Note. This was the long awaited answer to the problem of inelastic money (<http://www.u-s-history.com/pages/h1052.html>). The enacting of the Federal Reserve Act has been called "the greatest single piece of constructive legislation of the Wilson era and one of the most important domestic acts in the nation's history" (Schlesinger pp. 46). The purpose Federal Reserve Act is "To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting

commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes" (Federal Reserve System 8th ed. pp. 7). In order to accomplish the Federal Reserve System's responsibilities, Congress gave it the autonomy to operate with insulation from political pressure (<http://www.stlouisfed.org>). Technically speaking, the Fed does not belong to a particular branch of the government. It is considered an independent, nonprofit regulatory agency (Schlesinger pp 75). The system is, however, subject to Congressional oversight. Congress delegated its authority to coin money and set its value with the Fed. Despite legislative supervision, the Fed operates independently of the federal government. Although it is considered an independent central bank the Federal Reserve must work to achieve the overall objectives of economic and financial policy established by the government (Fed Reserve System 8th ed. pp. 8). The Federal Reserve System structure is based on Congressional designs that give it a broad perspective on the economy and on economic activity in all parts of the nation. The Fed is basically comprised of a central governmental agency, the Board of Governors located in Washington, D. C., and the twelve regional Federal Reserve Banks. The reserve banks are found in major cities throughout the nation. These components share numerous responsibilities such as the supervision and regulation of certain financial institutions and activities. In addition, they provide banking services for depository institutions and the federal government. Lastly, they function to ensure customers receive adequate information and equitable treatment in their conduct of business with the Fed system. The Federal Open Market Committee is another major element of the Federal Reserve System. The

FOMC is comprised of the Board of Governors, the president of the Federal Reserve Bank of New York, and presidents of four other Federal Reserve Banks, who serve on a rotating basis. The final two groups that comprise the Fed are: depository institutions and advisory committees (Federal Reserve System 8th ed. pp. 8). The Board of Governors is the core component of the Federal Reserve. It is comprised of seven governors. They receive their appointment by the President of the United States and are confirmed by the Senate (<http://www.stlouisfed.org/>). The term of a governor on the board is fourteen years. Appointments are staggered so that one term expires on the 31st of January each even-numbered year. A member can not be reappointed after serving a full term. The member can, however, leave prior to his or her term's expiration and be appointed and confirmed to serve the remainder of the term. The member may later be reappointed to a full term. The Chairman and Vice Chairman of the Board of Governors must already be members of the board or must already be members of the board or be simultaneously appoint to the Board. The term length for these posts is four years (Federal Reserve System 8th ed. pp. 9). The Board of Governors, in conjunction with numerous economists and support staff, establish the policies that financially strengthen banks and the national economy. Reserve banks are the decentralized components of the Federal Reserve System. They function independently but are under the general oversight of the Board of Governors (<http://www.stlouisfed.org/>). The twelve Federal Reserve Banks and their twenty-five branches perform several functions including "operating a nationwide payments system, distributing the nation's currency and coin, supervising and regulating member banks and bank holding



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Additionally, each Reserve Bank acts as a depository for the banks within its district boundaries (Federal Reserve System 8th ed. pp. 12). Each of the twelve reserve banks has a board of directors that manages the activities of the organization. Each board is composed of nine members. These directors contribute local business experience, community involvement and leadership, and reflect the diverse interests of each district. (<http://www.stlouisfed.org>). The Federal Open Market Committee, or FOMC, is the primary organization for the creation monetary policy for the Federal Reserve System (<http://www.stlouisfed.org>). The FOMC also establishes ranges for the growth of the monetary aggregates. Membership of the FOMC is composed of the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York and four other Reserve bank presidents. These last four members serve one-year terms on a rotating basis. The chairman of the Board of Governors is also the chairman of the FOMC. Its principal duty as described under law is the supervision of open market operations that principal method of federal monetary policy (Federal Reserve System 8th ed. pp. 12). The Federal Reserve System will always be necessary to maintain economic stability and uphold the value of the dollar. The Fed is able to make the necessary decisions that protect the nation from unexpected threats to the economy. Through times of crises and prosperity the Fed will " be operating behind the scenes of the banking industry to make sure money is a positive force in American BIBLIOGRAPHY Author Unknown (1994). The Federal Reserve System: Purposes and Functions (5th

ed.) Published by Library of Congress Author Unknown (1994). The Federal Reserve System: Purposes and Functions (8th ed.) Retrieved Feb 3, 2005. <http://www.federalreserve.gov/pf/pdf/frspf1.pdf> Schlesinger, A. M. (1989). The Federal Reserve System. (pp. 41-45, 75). Chelsea House Publishers <http://www.dallasfed.org/fed/understand.html> <http://www.stlouisfed.org/publications/pleng/history.html> <http://www.u-s-history.com/pages/h1052.html> Even before the creation of the Federal Reserve, banks were used by the public just as we use them today. Deposits were made into savings accounts. Loans were taken out to mortgage a home or finance a new business. Banknotes were issued and spent when the public borrowed from the banks. Borrowers spent these banknotes just as paper money is spent today. These bank notes were valued as money since they were backed by the promise that they would be exchanged on demand for either gold or silver. There was the occasionally belief on behalf of the public that banks would not be able to, or outright refuse to honor their banknotes. This fear, if held by enough of a community, could lead to a run on the banks. In a single day, demands for exchange of banknotes for gold and silver would be made by a majority of the people if there was doubt concerning the ability of a bank to redeem its notes. This problem would be compounded when this fear spread to other banks. Runs on a single bank would escalate and spread from one bank to another causing financial panic (<http://www.dallasfed.org>). Another problem prior to the establishment of the Federal Reserve System was the inelasticity of bank credit and the supply of money. Small banks placed their excess reserves in large central reserve banks. Whenever a bank's depositors wanted their funds, the smaller

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