Legacy Trust

Investment Perspectives

How The Federal Reserve Came into Being, and How the Ghost of Andrew Jackson Almost Kept it From Happening

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Key Takeaways

- Central Banking plays a vital role in helping to smoothen the business cycle by helping prevent liquidity crises
- The United States was one of the last countries to adopt a central system and even then, its structure is quite unique compared to its peers
- Its creation was one of political wrangling, trial-and-error and force of will

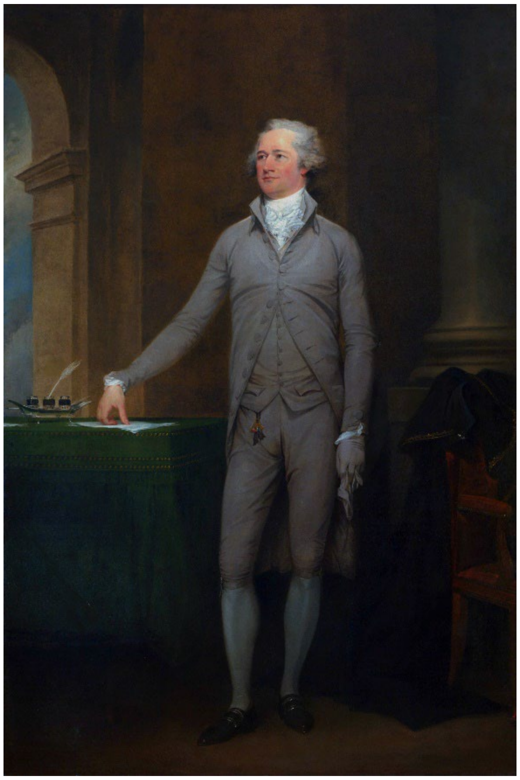
The American Federal Reserve System has been in existence since the Federal Reserve Act of 1913 but prior to that, there was an 80-year protracted struggle to resurrect central banking within the United States. In the intervening period, there was no strong political will to create a stabilizing, centralizing financial system, despite several crises in the decades in between the closing of the Second Bank of the United States and the creation of the Federal Reserve.

It is a frequent feature of the American System that as a nation, we appear incapable of simply replicating and implementing institutional ideas taken from other countries. Most often, we must first deconstruct it, analyze each part, compromise on every possible point of order and then reassemble it - sometimes with very little urgency. Case in point, the United States Federal Reserve. Like so much else in America, the Federal Reserve is much younger than its central bank counterparts in Europe. While the Bank of England boasts its founding back to 1694 and the Banque de France was established in 1800 to help stabilize the country after its own revolution, the Federal Reserve did not come into being until early in the 20th century after a long, protracted struggle that traces back to the very founding of the country.

Today's Federal Reserve might not be recognizable to its founders. There have been several innovations by the Fed since its creation from the Federal Reserve Act of 1913. Originally designed to help smoothen credit cycles and serve as a lender of last resort, the Fed now has additional duties as the result of its dual mandate: maximum employment and price stability. Interestingly, the Federal Reserve isn't even America's first foray into central banking. The Bank of North America was introduced in 1781 following the drafting of the Articles of Confederation, and was later established in 1791 following the ratification of the Constitution. As the brainchild of Alexander Hamilton and other founders, the First Bank of the United States was chartered for 20 years and had only passing similarities to modern central banks. It was "national" in that it had branches across the United States and could lend to the government, similar to its peer the Bank of England. However, unlike today's Federal Reserve, it did not set monetary policy, nor did it hold excess reserves for commercial banks. Its primary purpose was to establish the creditworthiness of the new nation following the Revolutionary War and to help stabilize commerce by promoting a uniform national currency.

The First Bank of the United States faced severe headwinds from the outset. Most notably from Thomas Jefferson and James Madison. Jefferson saw it as a hindrance rather than a spur for national prosperity, whereas Madison viewed the whole idea of a national bank unconstitutional. Their fears were rooted in the notion that such a strong centralized establishment, especially one overseeing something as important as the nation's finances, would inevitably create an imbalance of power away from local autonomy and toward national, concentrated authority, especially when that authority would be focused around New York and Wall Street in particular, Alexander Hamilton's backyard. Hamilton countered that to make the fledgling country into a credible borrower and a player on the international stage, a national bank needed to be established. While he succeeded in establishing the First Bank of the United States, Hamilton was ultimately outmaneuvered and in 1811, when the bank's charter expired, it was not renewed. It took another five years before the Second Bank of the United States was chartered in 1816 for another 20 years.

Coming under heavy scrutiny during its existence, the Second Bank of The United States was viewed in a much worse light than its predecessor as it had failed to prevent a market collapse that caused the Panic of 1819. The inability to prevent collapse, or the policy to simply mop up afterward, was a common criticism of early banking in America, and resurfaced in public debate numerous times following the aforementioned Panic of 1819, but also the Panic of 1837, and subsequent "Panics" in 1857, 1884, 1893, 1896, 1901 and 1907, with 1907 ultimately being the catalyst for the creation of The Fed. However, it should be noted that even after the creation of the Federal Reserve, there was no guarantee that a central bank could function smoothly enough to prevent another collapse, as evidenced by the Stock Market crash of 1929 and the years-long Great Depression that followed.



Above: Alexander Hamilton, First Secretary of the Treasury

Banking oftentimes has as much to do with psychology as it does with math and that means even sound financial decisions can be undone by human error. The collapse of 1819 and the subsequent recession caused many Americans to lose faith in the bank. There were constant questions regarding who the national bank served and to what ends it served them. The national bank's rechartering became a major wedge issue in the 1832 election as Andrew Jackson and his associates waged an all-out assault on The Second Bank of The United States in a political battle that became known as The Bank War. Jackson and his supporters argued that the Second Bank had failed to help the common man and had only served to enrich the financiers and merchants in the northeast. Jackson easily secured re-election by carrying the then-western part of the country. Immediately after his second inauguration in 1833, he began the swift process of kneecapping the national bank's power. By the time its charter expired in 1836, the bank had transitioned to a private corporation and a complete nonentity.

Even in the years following President Jackson's death in 1845, there was no political will to reverse course despite several severe financial crises exacerbated by a lack of credit including the financially-crippling Civil War and costly Reconstruction. There simply were few who had the clout to dare speak openly about resuscitating the American central bank. Instead, a sense of rugged financial individualism settled in over the country, as it drifted from credit crisis to credit crisis for decades.

At the turn of the 20th century, as the country shifted squarely from a rural, agrarian society to an urban, industrial nation, there was also an influx of people from "The Old World." One such individual was Paul Warburg. Born in 1868 in Hamburg, Germany to the prominent Warburg family, Paul was an investment banker who came to America in 1902. He did not have to wait long to see just how quickly cracks could form in the American banking infrastructure. Only five years into his arrival, the Panic of 1907 struck.

That financial calamity was the result of an attempt by an unscrupulous group of financiers who borrowed money in an attempt to corner the market on copper. When their scheme failed and they could not pay back their losses, clients of the Mercantile National Bank, one of the banks related to the scheme, became extremely worried and began lining up to withdraw their funds. When it became known that the president of Mercantile National Bank had been in league with the president of another financial institution, the Knickerbocker Trust, clients at the Knickerbocker began to feel nervous and made their way to get their money out as fast as they could. The run was on. In a span of three days, the Knickerbocker Trust paid out $8 million (approximately $250 million in 2023 terms) before suspending operations.

In a country lacking a centralized banking structure, there were no official lenders of last resort. JP Morgan determined after a review of their books that the Knickerbocker lacked the ability to remain solvent and no lifeline was extended and The Knickerbocker was shuttered. The ensuing catastrophe laid bare the true unviability of the current system. With no other lender to step in, and a national crisis of confidence at his feet, Morgan, along with other financiers propped up not only the city's trusts but also the New York Stock Exchange by providing much-needed liquidity in the form of collateralized loans. Even still, the damage had been done. Across the country, banks could no longer issue loans as they had exhausted their reserves paying out depositors whatever cash they could. It was not uncommon for banks, business owners and consumers to resort to issuing IOUs, oftentimes for significantly more than the actual amount they needed to borrow. The stock market plummeted 40 percent.

Top: Political cartoon of Andrew Jackson "Slaying the many headed Monster" (1836)
Bottom: Portrait of Investment Banker & Central Bank Advocate Paul Warburg, (CA 1910)

Warburg looked on in horror as the Panic of 1907 engulfed his adopted homeland. In the aftermath, he penned a letter to the New York Times, declaring only "a modern central bank" could have averted such a large-scale disaster. Before 1907, a declaration like that would have been met with skepticism by men like Nelson W. Aldrich, an elder Republican statesman in the U.S. Senate. Prior to 1907, Aldrich had no reason to reflect on changes to the financial system. However, in its aftermath, he had begun to take a harder look at reform, if for no other reason than it would be politically untenable for his party to run in 1908 without a proposal on how to repair a clearly broken system. That year, Aldrich would lead a delegation across the Atlantic to observe and hopefully learn from Europe's central banks.

In Europe, Aldrich was able to see with stark clarity how impactful a central bank could be. Especially in England, Aldrich was amazed at how little reserves the commercial banks carried. The same was true for the Bank of England. Trust in the central bank was enough. The mere belief that the bank would be able to stay open helped keep it open. It was the complete opposite in America. Where England had little gold but a lot of faith, America had a lot of gold but little faith.

Upon his return to America, Aldrich got to work on banking reform. Following the Republican victory in 1908, Aldrich sensed the time was right for a major overhaul of the country's banking system. However, he also seemed to sense the window could close at any moment. The Progressive mood, the promotion of women's suffrage, of equal rights and of "trust busting" was spreading across the country. Reforms were happening across all aspects of society. Why not banking too? Unfortunately, while Aldrich saw himself as the champion of financial renovation, he was often portrayed (some would argue very fairly) as being in league with big business throughout his senatorial career. While his message of banking reform was made in earnest, Aldrich was not considered to be the right messenger.

In November 1910 Aldrich assembled a group he believed had the financial wherewithal to help bring about the necessary changes to the American financial system. Under the auspices of a duck hunting excursion, the group, which included Paul Warburg as well as several other prominent financiers and even an Assistant Secretary of the U.S. Treasury, was spirited away to the secluded and exclusive Jekyl Island Club in Georgia. It was here, away from public view, that over the course of the following week the outline of what was to become The Federal Reserve began to take shape.

The structure of the organization, then known as "The Reserve Association of The United States" was to be a uniquely American answer to a universal question. It would not be a single, centralized bank, but instead a compilation of several regional banks, with regional board members being voted on by each member bank. While larger banks would have more shares, each bank would be given a single vote so that no single bank or even a group of large banks could dominate the proceedings. It was designed to be "a Bankers Bank" but also meant to serve the public good. Therefore, dividends paid to member banks were capped at 5%. As Roger Lowenstein (whose book "America's Bank" has been the guiding source for this piece) put it, "While bankers were in control, they could not expect more than a reasonable return."

Above: The Jekyl Island Clubhouse

Upon their departure from Jekyl Island, all the men in attendance were sworn to secrecy at what they had done. Andrew Jackson's ghost still haunted the halls of Washington, DC and any whisper of a central bank would be snuffed out immediately. It would be three more years and major changes to the American political landscape, but the Aldrich Plan, fashioned in Jekyl Island would eventually serve as the foundation for the Federal Reserve Act of 1913.

While The Aldrich Plan was the forerunner for the Act, following the 1912 election and a sweep of Democrat victories, it would not be Aldrich's mantle to carry any longer. Despite the fervor of his conversion to central banking, Aldrich was mistrusted both by progressive members of his own party as well as by every Democrat he came across. The plan was attacked not on its merits but on the reputation of its architect. William Jennings Bryan, a presidential also-ran, refused to endorse his party's nominee (and eventual president) Woodrow Wilson unless Wilson denounced the Aldrich plan. Wilson, however, was a savvy political operator, and he accepted entreaties from members of the banking class. Privately, he was very keen for some form of banking reform, but publicly, as a leading member of the Party of Andrew Jackson, he had to tread lightly.

The president of National City Bank and Jekyl Island conspirator, Frank Vanderlip, was no doubt frustrated at Wilson's lack of public support for the Reserve Association and had told the candidate as much. Wilson's reply was that while Vanderlip may understand banking, "[You don't] understand politics. It does not make any difference what I think ought to be done. I've first got to be elected."

The duty of directing the bill through the legislature would ultimately fall to the most unlikely of participants, Carter Glass. Born in 1858, Glass was the son of a Confederate major whose career began not in politics but in his father's pre-war business of newspapers. The same year that Paul Warburg made his way to America, Glass was elected to the U.S. House of Representatives and in 1913 became chairman on the Committee of Banking and Currency. Glass was a state's rights advocate to the end, but also understood that America would always be weaker without a strong financial base. Borrowing heavily from the Aldrich Plan, Glass and his cohort Parker Willis, with assistance from James Laughlin, devised a banking plan that was generally acceptable to president elect-Wilson.

In their plan, there would be upwards of twenty regional reserve banks with commercial banks holding shares in their nearest regional reserve bank. All that was missing, according to Wilson, was a "capstone" that would provide for further, national oversight. The idea proposed by Glass and Willis, that the Reserve Banks would report to the comptroller of the currency, was insufficient. It was this capstone that would allow for federal oversight while keeping most of the decision-making at the local levels.

Despite his career-long protestation against such a bill, after careful consideration and compromise, including reducing the number of regional banks from twenty to twelve and including more governmental oversight, William Jennings Bryan, the man known as The Great Commoner and current Secretary of State, put his stamp of approval on the bill. It passed swiftly in the House, 285-85. Bryan shepherded the bill through the House while Wilson shepherded Bryan. The Senate was a separate matter. Frank Vanderlip, at the eleventh hour, had the gall to believe that he could create, navigate and implement his own version of a central banking bill. He had even written to President Wilson on the topic, stating that he felt his new bill was "quite along the lines of your own thoughts, as I understand them." However, Wilson's reply stated in no uncertain terms that Vanderlip did not, in fact, understand Wilson's thoughts:

"I am at a loss to understand how you can have come to think of the bank plan which you proposed to the [committee] yesterday as 'being along the lines of my own thought.' It is so far from being along the lines of my thought in this matter that it would be quite useless for me to discuss it with you…"

Woodrow Wilson's reply to Frank Vanderlip's request to discuss Vanderlip's plan for a Central Bank.

After another few months of wrangling and reconciliation, on December 20, 1913, the Senate voted 54-34, with 6 Republicans joining all the Democrats to pass the bill. 80 years after Andrew Jackson had led central banking in America to an untimely demise, Woodrow Wilson and the Democrats, on the back of a pro-business Republican Senator's work, managed to resurrect the central banking system in America. And while there have been fits and starts still to this day, the work of creating a stabilizing financial infrastructure was finally realized, and with it, America would be able to take its place amongst the other Titans of the modern world.

Right: Painting by Wilbur G Kurtz depicting the signing the Federal Reserve Act with many of the key players including Woodrow Wilson (seated) and Carter Glass (3rd from right)