LESSON TWO:

HISTORY OF MONEY AND BANKING IN THE U.S.

LESSON OVERVIEW:

The historical footage in *The Fed Today* video introduced students to the origins of money and banking in the U.S. This lesson expands on the video content with activities that help students analyze the impact of important events in the history of money and banking. Students learn about the first paper money issued by the Continental Congress to finance the American Revolution. They evaluate early attempts at central banking, the Free Banking Era, bank panics, and the establishment of the Federal Reserve System. Small groups of students will complete a timeline that identifies ten important money and banking events leading up to the establishment of the Federal Reserve System. Having placed the events correctly on the timeline, students will describe their economic impact.

STUDENT OBJECTIVES:

Students will:

- Analyze historical events leading up to the establishment of the Federal Reserve System.
- Identify reasons for the lack of confidence in the U.S. banking system early in the nation's history.
- Evaluate the economic impact of important events in the history of money and banking in the U.S.

TIME NEEDED:

One-two 50-minute class periods

MATERIALS:

- Background: *Significant Events in the History of U.S. Money and Banking*
- Classroom Visual: *Ten Important Events in the History of Money and Banking in the United States*
- Student Handout: *U.S. Banking and the Federal Reserve Timeline*
- Answer Key: *U.S. Banking and the Federal Reserve Timeline*
- Access to the FED101 website: http://www.federalreserveeducation.org/fed101/history/ to learn more about the history of money and banking. On-line quiz available. (Optional)

TEACHER PREPARATION:

1. Review Background: *Significant Events in the History of U.S. Money and Banking.*
2. Prepare copies of Background as handouts for classrooms that need more historical knowledge to complete the timeline.
3. Review classroom visual and handouts.
4. Create group sets of Classroom Visual: *Ten Important Events in the History of Money and Banking in the U.S.*
5. Create group sets of Student Handout: *U.S. Banking and the Federal Reserve timeline.*
6. Review history section on the FED101 website: http://www.federalreserveeducation.org/fed101/history/ for additional on-line activities about the history of money and banking. (Optional)

ACTIVITY:

Constructing a Money and Banking Timeline

PROCEDURES:

1. Have students recall some of the early historical events described in *The Fed Today* video. Ask students to analyze reasons why people during the 1800s did not have much confidence in the money and banking system. Remind students of all the various notes that were issued by states, banks, and even private companies. Students may also recall from the video that banks did not always have enough money to pay depositors, and they had to close down.
2. Explain that in this lesson they will analyze the impact of some important events in the history of money and banking. This analysis begins with currency printed to finance the American Revolution.
3. Project the Classroom Visual: *Ten Important Events in the History of Money and Banking in the United States.* Explain to students that these events are not listed in chronological order, and that they will soon be placing them in the appropriate spaces on a historical timeline. Emphasize to students that not all historians agree on the importance of these ten events, but the establishment of the Federal Reserve System is certainly one of the most notable. Hand out and/or review the Background information, then discuss the ten events and their economic significance with the class.
4. Divide students into small groups. Give each group a copy of the *Ten Important Events in the History of Money and Banking in the U.S.* and a copy of the *U.S. Banking and the Federal Reserve Timeline.*
5. Explain to students that each group will need to enter the correct events for each of the ten historical time periods in the blank box sections of the timeline. Students will then complete the information required in the "Impact" boxes based on earlier class discussion.
6. Ask the groups to report back on specific events, including their analysis of those events' impact on the economy. (An answer key is provided in this lesson for checking student responses).
7. **Teacher Summary:** Explain to students that although not all historians will agree on the most important events in the history of money and banking, the establishment of the Federal Reserve System is certainly one of the most important. Ask for student participation to summarize the following:
   - During many periods in the 1800s, people lacked confidence in money and the banking system in the U.S.
   - Before the issuance of paper money was effectively regulated, people preferred to use gold and silver coins.
   - Establishing a central bank in the U.S. was a controversial issue because many people were afraid of giving too much financial power to a central government authority.

EXTENDING THE LESSON:

Have students visit the FED101 website at http://www.federalreserveeducation.org/fed101/history/.
Students can learn more about the history of central banking, link to other historical sites, and take an on-line quiz.

DISCUSSION POINT:

Myth:

The Federal Reserve Act was passed illegally under a cloak of secrecy and was started by an elite group of private bankers.

REALITY:

The Federal Reserve System was created by the Federal Reserve Act and signed into law by President Woodrow Wilson on December 23, 1913. Although the Act was passed in the final days of the legislative session, it had been debated for some time in earlier versions. Because the regional Federal Reserve Banks are privately owned, and most of their directors are chosen by their stockholders, it is common to hear that control of the Fed is in the hands of elite bankers. However, individuals do not own stock in Federal Reserve Banks. Only banks that are members of the System hold the stock. Ownership and membership are synonymous.

Background

SIGNIFICANT EVENTS IN THE HISTORY OF U.S. MONEY & BANKING

(Taken from FED101 at http://www.federalreserveeducation.org/fed101/history/)

1775-1791: U.S. Currency in the Beginning

To finance the American Revolution, the Continental Congress printed the new nation's first paper money. Known as "Continentals," the fiat currency notes were issued in a large quantity and that led to inflation,which,although mild at first,rapidly accelerated as the war progressed. Eventually people lost faith in the notes, and the phrase "Not worth a Continental" came to mean "utterly worthless."

1791-1811: First Attempt at Central Banking

At the urging of Treasury Secretary Alexander Hamilton,in 1791 Congress established the First Bank of the United States, headquartered in Philadelphia. It was the largest corporation in the country and was dominated by big banking and money interests. Many agrarian-minded Americans, uncomfortable with the idea of a large and powerful central bank, opposed it. By 1811 when the bank's 20-year charter expired, Congress refused, by one vote, to renew it.

1816-1836: A Second Try Fails

By 1816 the political climate was again in favor of a central bank; by a narrow margin,Congress agreed to charter the Second Bank of the United States. But when Andrew Jackson, a central bank foe, was elected president in 1828,he vowed to kill it. His attack on its banker-controlled power touched a popular nerve with Americans, and when the Second Bank's charter expired in 1836,it was not renewed.

1836-1865: The Free Banking Era

State-chartered banks and unchartered "free banks" took hold during this period, issuing their own notes, redeemable in gold or specie. Banks also began offering demand deposits to enhance commerce. In response to a rising volume of check transactions, the New York Clearinghouse Association was established in 1853 to provide a way for the city's banks to exchange checks and settle accounts.

1863: National Banking Act

During the Civil War the National Bank Act of 1863 was passed.This created national banks, which issued circulating notes that had to be backed by U.S. government securities. An amendment to the Act required taxation on state bank notes but not on national bank notes, effectively creating a uniform currency for the nation. Despite taxation on their notes, state banks continued to flourish because of the growing popularity of demand deposits, which had taken hold during the Free Banking Era.

1873-1907: Financial Panics Prevail

Although the National Bank Act of 1863 established some measure of currency stability for the growing nation, bank runs and financial panics continued to plague the economy. In 1893 a banking panic triggered the worst depression the United States had ever seen,and the economy stabilized only after the intervention of financial mogul J.P. Morgan.It was clear that the nation's banking and financial system needed serious attention.

1907: A Very Bad Year

In 1907 a bout of speculation on Wall Street ended in failure, triggering a particularly severe banking panic. J.P. Morgan was again called upon to avert disaster. By this time most Americans wanted reform of the banking system, but the structure of that reform was cause for deep division among the country's citizens. Conservatives and powerful "money trusts" in the big Eastern cities were vehemently opposed by "progressives." But there was a growing consensus among all Americans that a central banking authority was needed to ensure a healthy banking system and provide for an elastic currency.

1908-1912: The Stage is Set for a Decentralized Central Bank

The Aldrich-Vreeland Act of 1908, passed as an immediate response to the panic of 1907, provided for emergency currency issues during crises. It also established the National Monetary Commission to search for a long-term solution to the nation's banking and financial problems. Under the leadership of Sen. Nelson Aldrich, the commission developed a banker-controlled plan. William Jennings Bryan and other progressives fiercely attacked the plan; they wanted a central bank under public, not banker, control. The 1912 election of Democrat Woodrow Wilson killed the Republican Aldrich plan, but the stage was set for the emergence of a decentralized central bank.

1912: Woodrow Wilson as Financial Reformer

Though not personally knowledgeable about banking and financial issues, Woodrow Wilson solicited expert advice from Virginia Rep. Carter Glass, soon to become the chairman of the House Committee on Banking and Finance, and from the Committee's expert adviser, H. Parker Willis, formerly a professor of economics at Washington and Lee University. Throughout most of 1912 Glass and Willis labored over a central bank proposal, and by December 1912 they presented Wilson with what would become, with some modifications, the Federal Reserve Act.

1913: The Federal Reserve System is Born

From December 1912 to December 1913 the Glass-Willis proposal was hotly debated, molded and reshaped. By December 23, 1913, when President Woodrow Wilson signed the Federal Reserve Act into law, it stood as a classic example of compromise—a decentralized central bank that balanced the competing interests of private banks and populist sentiment.

1914: Open for Business

Before the new central bank could begin operations, the Reserve Bank Organizing Committee, comprised of Treasury Secretary William McAdoo, Secretary of Agriculture David Houston, and Comptroller of the Currency John Skelton Williams, had the arduous task of building a working institution around the bare bones of the new law. But by Nov. 16, 1914, the 12 cities chosen as sites for regional Reserve Banks were open for business, just as hostilities in Europe erupted into World War I.

1914-1919: Fed Policy during the War

When World War I broke out in mid-1914, U.S. banks continued to operate normally, thanks to emergency currency issued under the Aldrich-Vreeland Act of 1908. But the greater impact in the United States came from the Reserve Banks' ability to discount banker's acceptances. Through this mechanism, the United States aided the flow of trade goods to Europe, indirectly helping to finance the war until 1917, when the United States officially declared war on Germany and financing our own war effort became paramount.

1920s: The Beginning of Open Market Operations

Following World War I, Benjamin Strong, head of the New York Fed from 1914 to his death in 1928, recognized that gold no longer served as the central factor in controlling credit. Strong's aggressive action to stem a recession in 1923 through a large purchase of government securities gave strong evidence of the power of open market operations to influence the availability of credit in the banking system. During the 1920s the Fed began using open market operations as a monetary policy tool. During his tenure, Strong also elevated the stature of the Fed by promoting relations with other central banks, especially the Bank of England.

1929-1933: The Market Crash and the Great Depression

During the 1920s Virginia Rep. Carter Glass warned that stock market speculation would lead to dire consequences. In October 1929 his predictions were realized when the stock market crashed, and the nation fell into the worst depression in its history. From 1930 to 1933 nearly 10,000 banks failed, and by March 6, 1933, newly inaugurated President Franklin Delano Roosevelt declared a bank holiday that lasted four days, while government officials grappled with ways to remedy the nation's economic woes. Many people blamed the Fed for failing to stem speculative lending that led to the crash, and some also argued that inadequate understanding of monetary economics kept the Fed from pursuing policies that could have lessened the depth of the Depression.

1933: The Depression's Aftermath

In reaction to the Great Depression, Congress passed the Banking Act of 1933, better known as the Glass-Steagall Act, calling for the separation of commercial and investment banking and requiring use of government securities as collateral for Federal Reserve notes. The Act also established the Federal Deposit Insurance Corporation (FDIC), placed open market operations under the Fed, and prohibited interstate banking. This prohibition had profound future implications, as holding companies became a prevalent structure for banks to do business across state lines.

1935: More Changes to Come

The Banking Act of 1935 called for further changes in the Fed's structure, including the creation of the Federal Open Market Committee (FOMC) as a separate legal entity, removal of the Treasury Secretary and the Comptroller of the Currency from the Fed's governing board, and the establishment of members' terms at 14 years. Following World War II, the Employment Act added the goal of promoting maximum employment to the list of the Fed's responsibilities. In 1956 the Bank Holding Company Act named the Fed as the regulator for bank holding companies, and in 1978 the Humphrey-Hawkins Act required the Fed chairman to report to Congress twice annually on monetary policy goals and objectives.

1951: The Treasury Accord

From its founding in 1913 to the years up to and following World War II, the Fed largely supported the Treasury's fiscal policy goals. When the Korean War broke out in 1951, Fed chairman William McChesney Martin again faced pressure from the Treasury to maintain low interest rates to help provide funds for the war effort. Martin, however, worked closely with the Treasury to break the long-standing practice of supporting government bond interest rates. Since then, the Fed has remained staunchly independent in its use of open market operations to support its monetary policy goals.

1970s-1980s: Inflation and Disinflation

The 1970s saw inflation skyrocket as producer and consumer prices rose, oil prices soared, and the federal deficit more than doubled. By August 1979, when Paul Volcker was sworn in as Fed chairman, drastic action was needed to break inflation's stranglehold on the U.S. economy. Volcker's leadership as Fed chairman during the 1980s, though painful in the short term, was successful overall in bringing double-digit inflation under control.

1980: Setting the Stage for Financial Modernization

The Monetary Control Act of 1980 required the Fed to price its financial services competitively against private sector providers and to establish reserve requirements for all eligible financial institutions. The Act marks the beginning of a period of modern banking industry reforms. Following its passage, interstate banking proliferated, and banks began offering interest-paying accounts and instruments to attract customers from brokerage firms. Barriers to insurance activities, however, proved more difficult to circumvent. Nonetheless, momentum for change was steady, and by 1999 the Gramm-Leach-Bliley Act was passed, in essence overturning the Glass-Steagall Act of 1933 and allowing banks to offer a menu of financial services, including investment banking and insurance sales.

1990s: The Longest Economic Expansion

Two months after Alan Greenspan took office as Fed chairman, the stock market plummeted—on October 19, 1987. In response, he ordered the Fed to issue a one-sentence statement before the start of trading on October 20: "The Federal Reserve, consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system." Since then, the Fed has used monetary policy on a number of occasions—including the credit crunch of the early 1990s and the Russian default on government bonds—to keep potential financial problems from adversely affecting the real economy. Greenspan's tenure has been marked by generally declining inflation and the longest peacetime economic expansion in our country's history.

2000 & Beyond

The Federal Reserve faces many new challenges in the financial services industry: deregulation, technological advances in the payments system, and the move to a global economy.

Classroom Visual

Ten Important Events in the History of Money and Banking in the U.S.

1. **The Federal Reserve Act was passed** by Congress, orchestrated by President Woodrow Wilson, and established a much needed U.S. central bank.
2. **The Monetary Control Act marked the beginning of a period of modern banking industry reforms.** Following its passage, interstate banking proliferated,and banks began offering interest-paying accounts and instruments to attract customers from brokerage firms. By 1999 the Gramm-Leach-Bliley Act was passed, in essence overturning the Glass-Steagall Act of 1933 and allowing banks to offer a menu of financial services, including investment banking and insurance sales.
3. This was a time period that saw rapid **increases in inflation, skyrocketing oil prices,** and the doubling of the federal deficit.
4. The Great Depression resulted in the failure of nearly 10,000 banks during this four-year period. **A "bank holiday" was declared by Franklin Delano Roosevelt** to avoid bank runs.
5. President Andrew Jackson led the effort opposing the Second Bank of the United States. **The charter for the Second Bank of the U.S. expired.**
6. **The Free Banking Era** allowed many state-chartered, city, and private businesses to issue their own paper money.
7. During the Civil War **the National Bank Act of 1863 was passed,** creating a system of national banks whose currencies were backed by U.S. government securities.This Act allowed banks to issue a reliable and uniform currency for the nation.An amendment to the Act required taxation on state bank notes but not on national bank notes.
8. **Intervention by J.P. Morgan, a private citizen and banker, kept a severe bank panic from becoming a national disaster.** This lead to a consensus in support of a central banking authority.
9. **The Continental Congress issued Continental Currency** to help finance the American Revolution.
10. **U.S. Congress established the First Bank of the United States** with a 20-year charter as the nation's first central bank.

Student Handout

U.S. Banking and the Federal Reserve Timeline

Event		Impact on U.S. Economy
	1775-1779	
	1791-1811	
	1836	
	1836-1865	
	1863	
	1907	
	1913	
	1929-1933	
	1970-1980s	
	1980	

Answer Key

U.S. Banking and the Federal Reserve Timeline

Event		*Impact on U.S. Economy*
The Continental Congress issued Continental Currency.	*1775-1779*	Printed in excess, Continental notes created inflation, decreasing public confidence in paper money.
U.S. Congress established the First Bank of the United States.	*1791-1811*	This was the first attempt at creating a central bank in the U.S., beginning a controversy that would continue into the next century.
The charter for the Second Bank of the U.S. expired.	*1836*	Without a central bank, there were no federal regulations on the banking industry.
The Free Banking Era.	*1836-1865*	With no national currency, state-chartered banks and unchartered "free banks" issued their own notes.
The National Bank Act of 1863 was passed.	*1863*	The Act provided more reliable money and a stable banking industry by effectively creating a uniform currency for the nation.
Intervention by J.P. Morgan, a private citizen and banker, kept a severe bank panic from becoming a national disaster.	*1907*	The Bank Panic of 1907 rekindled the debate about creating a central bank, leading to the passage of the Federal Reserve Act in 1913.
Federal Reserve Act is passed.	*1913*	The Federal Reserve established a true central bank unlike the First and Second Banks of the United States.
A "bank holiday" was declared by President Franklin Delano Roosevelt.	*1929-1933*	Reduced bank panics.
Increases in inflation, skyrocketing oil prices.	*1970-1980s*	The Federal Reserve's credibility increased when Paul Volcker's leadership as Fed chairman was successful overall in bringing double-digit inflation under control.
The Monetary Control Act marks the beginning of a period of modern banking industry reforms.	*1980*	The act marks the beginning of a period of modern banking industry reforms. Following its passage, interstate banking proliferated, and banks began offering interest-paying accounts and competing with mutual funds and brokerage firms.