

HISTORY *of* Central Banking



FROM 1791 TO THE 21ST CENTURY

THE FEDERAL RESERVE SYSTEM

Central Banking at a Glance

1791-1811

Congress establishes first Bank of the United States in 1791

- Nation's first central bank
- Helps unify country's economy
- Faces major opposition
- Has eight branches
- 20-year charter not renewed



1816-1836

Congress establishes second Bank of the United States in 1816, which serves the same functions as the First Bank

- Finances debt from War of 1812
- Bank President Nicholas Biddle and U.S. President Andrew Jackson at odds over Second Bank
- 20-year charter not renewed
- Central banking not revived for more than 75 years



1913

Federal Reserve System established

- Nation's third central bank
- Banking Panic of 1907 raises issue of need for central bank
- Congress passes Federal Reserve Act, December 23, 1913
- Like predecessors, Fed has 20-year charter, but McFadden Act of 1927 gives Fed permanence



1930s

Nation faces grave economic woes; Great Depression leads to bank and business failures

- Congress passes laws to change financial system
 - Glass-Steagall Act passed
 - FDIC established
 - SEC established
- New laws help to restore faith in safety of banks and stocks



1940s - 1950s

Nation weathers WWII

- Congress passes Employment Act of 1946, which defines goals of economic policy
- Treasury-Fed Accord reached in 1951; acknowledges Fed's independence in setting monetary policy



1960s - 1970s

Consumer protection laws take prominence beginning in late 1960s; high inflation and high unemployment plague nation in 1970s

- Congress passes Truth in Lending Act in 1968
- Community Reinvestment Act passed in 1977
- Humphrey-Hawkins Act of 1978 requires Fed to submit report to Congress on monetary policy twice each year

1980s - 1990s

Deregulation of the banking industry takes hold

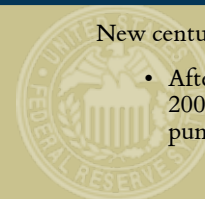
- Congress changes the way the Fed provides services
- Consumers turn to electronic methods of payment, such as credit and debit cards
- Glass-Steagall Act of 1933 reversed in 1999. Banks can now combine with financial services firms in financial holding companies



2000 & Beyond

New century means changes and challenges

- After the terrorist attacks on September 11, 2001, the Fed maintains financial stability by pumping liquidity into the U.S. economy
- Enacted in 2003, Check 21 allows a paper check to be converted to an electronic image, further changing the U.S. payment system
- The Fed takes extraordinary steps to respond to the financial crisis of 2008, lowering short-term interest rates to near zero and establishing special lending programs



THE FIRST BANK OF THE UNITED STATES 1791-1811

The history of central banking in the United States begins almost with the founding of the country.

Once America won its independence, Congress was faced with the task of paying off the new nation's war debts.

Alexander Hamilton, the first Secretary of the Treasury, urged Congress to also assume the war debts of the individual states and then create a national bank to help refinance all these debts. Hamilton's proposal faced major opposition. Critics said that Hamilton's bank was unconstitutional, would be a monopoly, and would reduce the power of the states. Although Hamilton won, the bank's charter was limited to 20 years.


The first Bank of the United States, also called the First Bank, was not a central bank in the modern sense, especially since the country had few banks. Nevertheless, with branches in eight port cities, its large size and broad geographic presence gave it influence over the economy, particularly as changes

in its lending policies influenced state banks' lending practices.

Like other banks, the First Bank made business loans, accepted deposits, and issued notes that circulated as currency and were convertible into gold or silver.

Unlike state banks' notes, however, First Bank notes were valid for payment of federal taxes.

The First Bank served as the federal government's fiscal agent, receiving its revenues, holding its deposits, and making its payments. Its stock was publicly traded and held by both foreign and domestic investors.



The First Bank
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The First Bank helped transform the country into a more unified national economy, but many Americans continued to oppose the bank. Some people still thought that a national bank was unconstitutional; others thought that it exerted too much power over the nation's economy. When the bank's charter came up for renewal in 1811, it was rejected by a single vote in each house in Congress.

THE SECOND BANK OF THE UNITED STATES 1816-1836

After the War of 1812, the state banking system was in turmoil. Congress tried to restore order and finance debts from the war by establishing a second Bank of the United States. Like the First Bank, it was given a 20-year charter.

Despite a rocky start, the Second Bank under Philadelphian Nicholas Biddle became quite effective in managing the nation's finances. But Biddle was a better banker than politician. He underestimated the opposition of state banks and frontiersmen, who said that the Second Bank helped only the East's commercial classes.

Opponents of the bank found a powerful ally when Andrew Jackson became President in 1829. Debate came to a head in the election of 1832 when Jackson vetoed a bill for an early recharter of the bank that was supported by his opponent, Henry Clay. Jackson won the election and transferred the federal government's funds to state banks. After the Second Bank's charter ran out in 1836, central banking wasn't revived for more than 75 years.

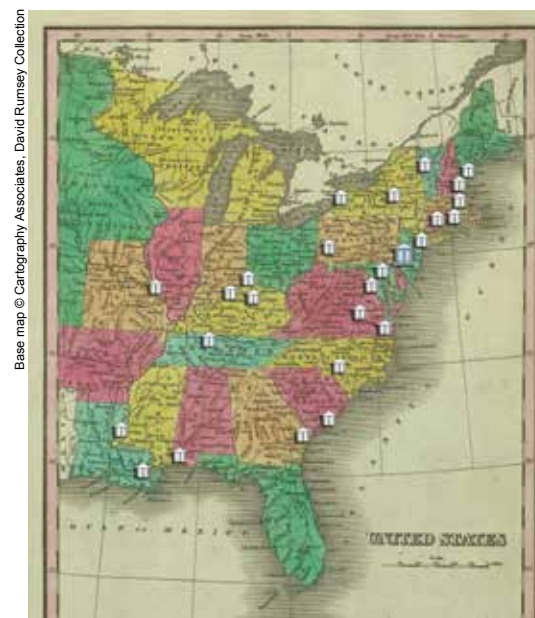
Despite a rocky start, the Second Bank was quite effective in managing the nation's finances.

The second Bank of the United States, like the First Bank, was not a central bank in the modern sense. It did not conduct monetary policy as we know it today, and it did not supervise or regulate other banks. However, because the bank was very large — it had 25 branches throughout the country by 1830

— changes in its lending policies influenced the lending practices of state banks.

The Second Bank's primary functions were the same as the First Bank's. It was the federal government's fiscal agent, receiving its revenues, holding its deposits, and making its payments. It made business loans, accepted deposits, and issued bank notes that circu-

lated as currency and could be converted to gold or silver. However, the number of state banks was growing rapidly, and competition between state banks and the Second Bank contributed to its downfall.



THE THIRD CENTRAL BANK: THE FEDERAL RESERVE SYSTEM

The Federal Reserve System was not initially thought of as a central bank. Indeed, much of the legislative debate in 1913 about establishing the Fed was about whether the Federal Reserve would be one central bank or a collection of regional Reserve Banks. Initially, the Fed operated as a system of Reserve Banks, with a substantial amount of decentralized decision-making. In the 1920s, for instance, some Reserve Banks sold Treasury securities at times when other Reserve Banks were buying Treasury securities.

To improve the coordination of such open market purchases and sales of securities, the Reserve Banks eventually formed the Open Market Committee in the 1920s. This was the predecessor of the FOMC (Federal Open Market Committee), which was established by congressional action in the Banking Act of 1933. The FOMC conducts monetary policy as we know it today. In 1935, Congress put all seven members of the Federal Reserve Board of Governors on the FOMC and limited the Reserve Banks to only five voting members at any one time.

Unlike the First and Second Banks, the Federal Reserve was not designed to make business loans or accept

deposits from the general public. Instead it is a “bankers’ bank,” holding deposits and making loans to depository financial institutions. Like the First and Second Banks, however, the Fed issues notes that circulate as currency. Also, just as its predecessors had branches, the Fed has 12 Reserve Banks plus branches throughout the country.

The Fed is the federal government’s fiscal agent, receiving its revenues, holding its deposits, and making its payments.

Like the nation’s two previous central banks, the Fed is the federal government’s fiscal agent, receiving its revenues, holding its deposits, and making its payments. Originally, the third central bank also had only a 20-year charter from Congress. But the McFadden Act of 1927 gave it permanence. So, unlike its predecessors, the Fed has lasted beyond its initial charter period.

National banks and those state-chartered banks that choose to be members of the Federal Reserve System receive nontradable stock in their District Reserve Bank, in contrast to the publicly owned and traded stock of the First or Second Bank. By law, the stock earns a fixed 6 percent dividend. Stockholders elect six of the nine members of a Reserve Bank’s board of directors, while the remaining three (including the chairman of each board) are appointed by the Federal Reserve’s Board of Governors.

THE GREAT DEPRESSION

The stock market crashed in 1929. Over the next several years, thousands of banks and businesses failed. By 1933, one in four Americans was out of work. After Franklin Roosevelt's election in 1932, the federal government moved quickly to implement his "New Deal."

But the Federal Reserve's role during this time was neither well defined nor well executed. Despite numerous runs on banks that led President Franklin Roosevelt to declare a "bank holiday" in 1933, the Fed didn't adequately perform its function as the lender of last resort. Also, despite the

New laws helped restore faith in banks and stocks.

decade's high unemployment, the Fed did little to expand money or credit.

The market's crash and the financial system's prolonged crisis led Congress to pass several laws that substantially changed the financial system and the Federal Reserve.

For example, Congress passed the Glass-Steagall Act of 1933, which separated banking and securities firms. Congress imposed further separation between banking and com-

merce by prohibiting banks

from being owned by nonfinancial companies. Furthermore, the Fed was given authority to supervise multibank holding companies and to remove bank officers. The Fed also received authority to restrict interest payments on bank deposits.

Congress also passed the Banking Act of 1933, which established the Federal Deposit Insurance Corporation to insure consumers' bank deposits. The Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC). This law, together with the Securities Act of 1933, was designed to restore investor confidence in U.S. capital markets. Congress also gave the Federal Reserve Board more central authority in the Banking Act of 1935, which determined that the FOMC should include the seven-member Board of Governors as well as the Reserve Bank presidents.



Many Americans lost their entire savings when more than 6,500 banks failed between 1929 and 1933.



During the Depression many Americans were unemployed and looking for jobs.

POST-WORLD WAR II & THE EMPLOYMENT ACT OF 1946

After World War II, the Treasury wanted the Federal Reserve to continue its wartime practice of helping the Treasury issue large amounts of federal debt at low interest rates. The Fed went along for several more years by buying Treasury securities — an action that expands money and credit — whenever interest rates began to rise above very low levels. But this meant that monetary policy couldn't raise interest rates to combat inflationary pressures.

At the start of the 1950s, tension between the Fed and the Treasury increased over this issue.

Fed policymakers and some congressional leaders took the position that monetary policy must be independent of the Treasury's financing plans. With war breaking out in Korea, President Truman's Treasury wanted interest rates to remain low.

The issue came to a head in early 1951, when the Federal Reserve acted independently of the Treasury's plan to issue debt. Ultimately, a statement

was issued — called the Treasury-Fed Accord — that acknowledged the Fed's independence in conducting monetary policy.

Influenced by the Great Depression and changes in economic thinking about government's role, Congress passed the Employment Act of 1946, which defined the goals of economic policy: to “promote maximum employment, production, and purchasing power.” These goals were meant to guide the fiscal policies of the President and Congress, as well as the monetary policy of the Federal

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Reserve. When the federal government debated changes in fiscal policy during the 1950s, such as spending on the new interstate highway system or new taxes, these policy goals were taken into consideration.



REVISITING ECONOMIC POLICY GOALS

In the 1970s, a decade that experienced both high inflation and high unemployment, two legislators spearheaded a reconsideration of the nation's economic policy goals. Senator Hubert H. Humphrey and Congressman Augustus Hawkins believed the President's administration and the Federal Reserve should coordinate their plans for fiscal and monetary policies to bring the unemployment rate and inflation down to the low levels reached in earlier decades.

President Jimmy Carter signed the Full Employment and Balanced Growth Act into law in 1978. Also known as the Humphrey-Hawkins Act, this legislation required the

President to submit a report to Congress that explains the President's economic goals and when they will be achieved.

It also required the Federal

Reserve to provide Congress with a semi-annual report

on the Fed's objectives and plans for monetary policy. Twice each year, the Fed Chairman's "Humphrey-Hawkins testimony" is closely watched for signals of changes in monetary policy.

Although Congress has since allowed many of the original act's provisions to lapse, the Fed

Chairman's semi-annual testimony was retained. It's still popularly known as the Humphrey-Hawkins testimony.

The Humphrey-Hawkins Act required the Fed to provide Congress with a semi-annual report on the Fed's objectives and plans for monetary policy.



Hubert H. Humphrey

CONSUMER PROTECTION LEGISLATION

For most of its history, the Fed's involvement in the protection of consumers largely involved ensuring that banks were safe and sound. That changed in 1968 when Congress passed the Truth in Lending Act (TILA) to inform consumers about the cost of credit and to protect them against inaccurate and unfair credit billing and credit card practices. As a result, the Fed published Regulation Z, which comprehensively specifies the protections for consumer credit products, including residential mortgages, credit cards, home equity lines of credit, and private education loans.

To ensure that lenders do not discriminate against borrowers on the basis of race, color, religion, national origin, sex or marital status, age, receipt of public assistance, or exercise of federal rights, Congress passed the Equal Credit Opportunity Act (ECOA) in 1974. In 1977, Congress enacted the Community Reinvestment Act (CRA), which encourages banks to meet the credit needs of the entire communities in which they are located and requires the Fed and other banking regulators to review banks' lending patterns.

In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. This legislation significantly changed the Fed's role in consumer protection. The Dodd-Frank Act created the Consumer Financial Protection Bureau (CFPB), which examines banks, savings and loan associa-

tions, and credit unions with assets greater than \$10 billion to ensure compliance with federal consumer protection laws. The CFPB also examines certain nonbank providers of financial services, including payday lenders, private education loan providers, mortgage lenders and brokers, and providers of foreclosure relief services. The power to

issue regulations for the various consumer protection laws, which had been the responsibility of the Fed and other federal agencies, has been transferred to the CFPB. However, the Fed continues to have a role in consumer protection by examining certain state-chartered banks with assets less than \$10 billion to ensure they are complying with federal consumer protection laws, and it continues to issue regulations in the few instances in which rulemaking power was not transferred to the CFPB, such as for the CRA.

The Fed
continues to
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enforcing the
CRA.



DEREGULATION OF THE FINANCIAL SYSTEM

Since the 1970s, financial market innovations and competition have spurred state legislatures, Congress, and federal bank regulators to ease Depression-era restrictions on banks. Both banks and their holding companies were gradually allowed to increase their range of financial products, pay market interest rates on most deposits, and expand across state lines.

This trend toward deregulation culminated in 1999 when Congress reversed the Glass-Steagall Act separating banks from securities firms and insurance companies. Now banks can combine with these financial services firms in “financial holding companies.”

Since the Federal Reserve is charged with implementing many of Congress’s banking laws, financial deregulation has affected how the Fed oversees banks, bank holding companies, and financial holding companies.

Congress deregulated banking in three key ways:

INTEREST RATE DEREGULATION: The Depository Institutions Deregulation and Monetary Control Act (1980) phased out restrictions on banks’ ability to pay interest on deposits.

GEOGRAPHIC DEREGULATION: The Riegle-Neal Interstate Banking and Branching Efficiency Act (1994) provided a framework that permitted interstate banking and branching as of 1997 but allowed states some flexibility in its implementation.

PRODUCT DEREGULATION: The Financial Modernization Act (1999), also called the Gramm-Leach-Bliley Act, repealed the prohibition against combining commercial banking, investment banking, and many insurance activities in the same organization.

In the Depository Institutions Deregulation and Monetary Control Act, Congress also changed the way the Fed provides services. Instead of the Fed’s providing discount window loans, check clearing, and other payment services only to its member banks, Congress required the Fed to offer these services, at a price, to all depository institutions. In turn, all depository institutions above a certain size are required to hold money in reserve accounts with the Fed.

In 1980,
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services.



CENTRAL BANKING ENTERS THE 21ST CENTURY

The most striking change in American central banking over the past 200 years is the prominence to which it has risen. Unlike its predecessors, the Fed is acknowledged to be the nation's central bank. It is insulated from partisan political pressure, but it is clearly accountable to Congress, which has defined the Fed's monetary policy goals: to promote price stability and maximum sustainable economic growth and employment.

The Fed's regional structure ensures that the views of a broad spectrum of people from across the nation are brought to bear on these important policy decisions.

In recent years, the Fed has also responded to the challenges presented by the many changes in the financial services industry, which had led the Federal Reserve to undergo a considerable number of adjustments as well.

For example, the Check Clearing for the 21st Century Act, which was passed in 2003 and went into effect in 2004, promoted the greater use of electronic processing of check images, rather than the return of an actual check. This legislation led to a

major reduction in the number of paper checks processed throughout the industry. As a result, the Federal Reserve started to shrink its check-processing footprint from 45

sites in 2003

to only two sites in 2010.

In 2010, the Federal Reserve moved all remaining paper

check processing to the Federal Reserve Bank of Cleveland and all electronic check processing to the Federal Reserve Bank of Atlanta. In December 2012, the volume of paper check processing continued to drop, and this function was also transferred to the Atlanta Fed.

The modern-day Fed reflects the lessons of history and the demands of a rapidly changing economic and financial system.



As the Fed moves to processing checks electronically, it will need fewer high-speed check sorters such as this one.

The modern-day Fed reflects not only the lessons of history but also the demands of a rapidly changing economic and financial system. Thus, central banking in the United States has evolved and adapted over the last two centuries and has moved into the 21st century with a sense both of history and of the challenges that lie ahead.

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