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Book Review

The Origins, History, and Future of the Federal Reserve: A Return to Jekyll Island

Michael D. Bordo and William Roberds
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Recently the Federal Reserve reached its one hundred year anniversary. This milestone provided a nice occasion for economists to analyze the Fed's performance in the past century. As a result in the past several years there have been many conferences, special journal issues, and books that have centered on the Fed's centennial and its record. The present book is a collection of essays from a 2010 conference dedicated to that task. The conference marked the centennial of the famous Jekyll Island meeting (1910), a private gathering of U.S government officials and bankers dedicated to the formation of a central bank. It was significant

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because what came out it, the Aldrich Plan, eventually became the body of the Federal Reserve Act. The 2010 conference, which was held in the same location as the 1910 meeting, included many monetary heavyweights, such as Fed chairmen Ben S. Bernanke, Alan Greenspan, and Paul A. Volcker along with Michael D. Bordo, Charles W. Calomiris, Barry Eichengreen, Alan H. Meltzer, Ellis W. Tallman, David C. Wheelock, Eugene N. White, and more. Anyone interested in either monetary economics or macroeconomic history will undoubtedly have heard of these names, as they have been very influential in these fields.

The conference itself included three sessions of papers and a concluding panel. The first session focused on the background of the Federal Reserve and its initial impact. The second session focused on various parts of the Fed's track record in the past 100 years while the third focused on its future. The panel included a video presentation by Paul Volcker and a discussion between Alan Greenspan, Ben Bernanke, and Gerry Corrigan (former president of the Federal Reserve Banks of New York and Minneapolis). Given my own interest and relative (yet meager) expertise, I will concentrate this review on three papers presented in the first two sessions as well as the comments to the papers. The first, "'To Establish a More Effective Supervision of Banking': How the Birth of the Fed Altered Bank Supervision" is by Eugene White and is commented by Warren Weber, the second "The Promise and Performance of the Federal Reserve as Lender of Last Resort 1914–1933" by Michael Bordo and David Wheelock and commented by Ellis Tallman, and the third "Volatile Times and Persistent Conceptual Errors: U.S. Monetary Policy 1914–1951" by Charles Calomiris and commented by Allan Meltzer.

White's paper provides a useful economic history of the National Banking System and the early Federal Reserve System from the generally overlooked angle of bank regulation and supervision. He describes the pre-Fed regulatory apparatus, juxtaposes it with the initial Fed changes, and concludes with a brief analysis of the New Deal overhaul to the financial sector. The theses of the paper, as succinctly put by Weber, are that the National Banking System's flaws were not due to its regulatory framework and that the Federal Reserve System did not substantially improve it. The main defects of the pre-Fed era were the prohibition on branch banking and the

lack of a lender of last resort central bank (to mitigate the "inelasticity" of national bank notes). Although briefly mentioned by White (p. 32), I was glad to see Weber emphasize another important flaw of the National Banking System: the pyramiding of reserves among the different layers of banks.[1] The "pyramiding," which referred to the fact that many of the national banks could keep part of their legal reserves as interest earning deposits in other banks (particularly central reserve city banks in New York), allowed for a greater expansion of credit and an undue concentration of reserves in New York. The New York banks were often heavily invested in call loans in the stock market, so when other banks withdrew money from their New York balances it led to multiple contractions of deposits and could cause financial pressure on the stock market, which possibly led to (or exacerbated an already existing) panic.[2]

Closures of national banks caused by the panics and other events were surprisingly not very costly to the economy. In fact, the costs hold up very well compared to estimates of some of the notable disasters during the Federal Reserve era. White estimates that the total losses from national banks during the period 1865–1913 totaled roughly $44 million, or the equivalent of 0.3–0.6 percent of GDP. Compare this to the 2.4 percent of GDP lost during the 1929–33 contraction, the 3.4 percent of GDP during the Savings and Loan crisis in the 1980s, or the whopping 11.6 percent of GDP from the 2008–09 financial crisis. Interestingly enough, the losses of the National Banking System compare well to the losses of the "free banking era" (1838–60) which totaled 0.01 percent of GDP (p. 30). Given the even laxer regulation and greater approximation (though by no means perfect) of the banking system to a free market, this comparison suggests that an unregulated banking system can do well in minimizing depositor and shareholder losses.

This is not to say that White thought the panics that occurred during the period had no major economic consequences. On the contrary, White argues that they had severe macroeconomic effects and that the pre-Fed era had greater volatility in various economic aggregates and shorter expansions, although the lengths of recessions were

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[1] This point was also described in greater depth in the second essay by Bordo and Wheelock (pp. 64–66).

[2] For more, see Klein (1982, 180–182).

similar. Without getting into too much of a discussion on various modern GDP/Industrial production estimates of macroeconomic performance in the pre-Fed era, it can be argued that the evidence White provides is from too small a sample (the late 1880s onwards, which includes the particularly rough 1890s). A legitimate argument can be made that the macroeconomic volatility and frequency and duration of recessions in the entire pre-Fed era (e.g. after the Civil War) has been overstated, and that the Federal Reserve has not noticeably improved economic performance.[3]

The prohibition on branch banking caused by federal and state legislation led to an uneconomical amount of small single "unit" banks that were often undiversified in their loan portfolios and artificially propped up from an absence of competition, making them very susceptible to business failures and panics. This, along with the lack of a central bank, is what distinguished the U.S banking system from other European countries. White also mentions the Canadian banking system during this time, which allowed branch banking but did not have a central bank until 1935 and did not suffer from bank runs and panics. This leads White to cogently suggest that Congress' first reform should have been to allow for branch banking and then worry about the need for a lender of last resort. The comparison also suggests that perhaps a government-instituted lender of last resort was not needed at all.

After discussing some of the changes brought by the Federal Reserve with regard to moral hazard and regulation (such as the discount window), White concludes by describing the New Deal regulatory overhaul in the early 1930s. White argues that these changes were largely harmful, and "the New Deal swept aside [the] successful regime and imposed a radically different one that sharply increased moral hazard and risk taking" (p. 45). The reforms were driven mainly by small unit bankers and investment bankers and replaced the competitive market environment with a "loosely organized government cartel" that had many regulations on entry and pricing (p. 46). Many of these regulations gave quasi-monopoly grants to banks and hampered economic performance.

[3] For more, see Selgin, Lastrapes, and White (2012). However also see Miron (2012) who challenges their conclusions.

White notes that it took decades for all of the consequences of the regulations to be shown, such as the moral hazard spurred on by the Federal Deposit Insurance Corporation (FDIC). White briefly describes the increased moral hazard brought by the FDIC through its termination of the "double liability" policy, an old National Banking System regulation that was imposed on shareholders in order to protect depositors (pp. 24–25). A more general and widespread inducement to moral hazard, however, was the main feature of the FDIC itself that insured depositors up to a certain amount against bank failure. With such a guarantee, depositors are less likely to monitor banks because they know the government will cover some of their deposits if the bank fails.

Bordo and Wheelock's paper also provides an analysis of the National Banking era but concentrates more on the performance of the Federal Reserve during its initial years (1914–33). They talk about the rationale behind the founding of the Fed, which was to serve as an effective lender of last resort to the banking system, and enumerate reasons why they were unable to do so as envisioned by the creators of the system, particularly during 1929–33. These include the conventional reasons such as the system's decentralized structure, its harmful allegiance to keeping the U.S dollar on the gold standard and its execution of the "Riefler-Burgess" doctrine but also its inability to recreate the essential features found in other European central banks and defects in the discount window apparatus (p. 83).

Bordo and Wheelock document the steps taken in the drive for a U.S central bank, such as describing the National Monetary Commission, the Warburg plan, the famous meeting at Jekyll Island, the Aldrich bill which was based off of that meeting, and the eventual Federal Reserve legislation. They properly state at the beginning that "the Federal Reserve Act of 1913 resembled the Aldrich bill in many respects" and later that "the act almost completely replicated the key monetary and international policy provisions of the Warburg plan and the Aldrich bill" (pp. 60, 71). However, they also write that the Federal Reserve Act and the Aldrich bill differed largely in terms of organizational structure. This seems to buttress the argument found in the introduction to the book by Michael Bordo and William Roberds:

> Over years, the clandestine nature of the meeting has often been criticized as allowing undue Wall Street influence over the founding of the U.S. central bank. However, the meeting itself was just one step in the process that led to the creation of the Federal Reserve, and many details of Aldrich's original design were changed in the legislation that was eventually passed (p. 2).

The purported "differences" in the central bank systems would seem to allow for a convenient agnosticism of the special interest banking involvement in the legislation. From a historical perspective as well as to answer the ever important question of "cui bono?" or "who benefits?" from a piece of legislation, what matters is that private bankers wanted to form a central bank to benefit themselves and that their main plan formed the basis for the Federal Reserve System (Rothbard, 1984, pp. 89–103).[4]

Bordo and Wheelock also take the standard interpretation of Federal Reserve monetary policy during the 1920s. They largely follow Friedman and Schwartz (1993) and say the Fed's performance largely avoided the problems found in the National Banking System and that economic activity and the price level were stable. Movements in Federal Reserve credit were a matter of seasonal accommodation and more or less automatic (p. 76). The interpretation provided by Friedman and Schwartz, as well as later monetary historians, argues that the Fed's policy can be seen as deflationary and neutral to the economy. This view might be misleading overall because it can be argued that the Fed's policy during this era should be viewed as inflationary and disruptive. Movements in member bank reserves, which were mostly responsible for the increase in the money supply, experienced three sharp jolts upwards in 1922, 1924, and 1927 and were caused by heavy purchases of government securities and acceptances from the Federal Reserve. Changes in Federal Reserve credit outstanding is an inaccurate measurement of Fed policy, because it includes the uncontrolled factor of bills repaid into the system.[5] One could also argue that the apparent stability of economic

[4] For a study that argues that the organization drive for the Fed and its public benefits was made possible through additional private benefits (particularly international) concentrated to New York bankers, see Broz (1997).

[5] For more, see Rothbard (2008, pp. 85–167) and Newman (forthcoming).

indicators was merely an illusion and that the Fed's expansionary policies promoted an economic boom that eventually burst at the end of the decade.[6]

Another problematic interpretation of their 1920s analysis appears when they discuss the defects of the discount window. They say that one of its weaknesses was that member banks were reluctant to borrow (p. 84). Despite the Fed's attempts to dissuade banks from borrowing and "reminding" them that they were reluctant to lend, banks did often borrow continuously from the Federal Reserve. I was glad to see Tallman challenge them on this point and mention that member banks were able to effectively borrow from the Federal Reserve (pp. 104–105). Data found in White's paper also show that many banks in the 1920s did borrow for profit for significant periods of time (p. 43).

Calomiris also reviews the early years of the Federal Reserve (1914–51), but from a broader viewpoint and not specifically on the lender of last resort policies as described in the previous essay. The bulk of the paper looks at five key issues concerning the late 1920s and 1930s that monetary economists have analyzed in recent decades. They are: the Fed's involvement in the 1929 October stock market crash, the apparent conflict between remaining on the gold standard and expanding the money supply from 1929–33, Friedman and Schwartz' classification of banking panics, the liquidity trap question in the 1930s, and the connection between the Fed's increase in reserve requirements in the mid-1930s and the subsequent recession from 1937–38. While all of Calomiris' discussion is very insightful, I will concentrate on his points made in the first, third, and fifth topics of interest.

Calomiris notes that in the stock market boom and bust, stocks more than doubled in value amidst an explosion in technological innovation that occurred throughout the 1920s. Opinions on the cause of the rise in stock prices were mixed (including contemporary research) as some thought that the high prices were based off of expectations of past revenue growth and were sustainable, while others thought they were symptoms of an unsustainable bubble that was not grounded in fundamentals. The Fed initially tried to

[6] On the "business cycle" consequences, see below.

deal with this through a policy of "moral suasion," or attempting to restrict loans to banks that would be made for speculative purposes while maintaining credit for legitimate activity. This policy was abandoned in favor of one of outright contraction at the end of the decade. Calomiris notes that there is evidence on both sides for whether a bubble in stocks existed, but seems to slightly hint that the growth in the market was sustainable (pp. 187–188, 203).

While understandably not being mentioned in the essay, Austrian business cycle theory (ABCT) sheds important light on the stock market bubble question in the late 1920s. In a nutshell, this theory says expansionary monetary policy by a central bank leads to a boom in intensive capital goods industries that is unsustainable and inevitably turns into a bust. The rapid expansion in the stock market was simply a reflection of the higher-order boom as stocks are titles to capital goods. And the growth in these capital goods industries was not based on fundamentals, as their profitability was artificially exaggerated by the increase in bank credit created by Fed policy. The October stock market crash and subsequent downturn was not caused by tight monetary policy in the late 1920s, but was a lagged adjustment to the downturn in those industries which began earlier in the middle of 1929.[7] And the downturn in those industries was caused by the end of the boom that the Fed engineered throughout the 1920s. Rather than pinpointing the Federal Reserve's mismanagement of monetary policy starting in the late 1920s, ABCT pushes the timeframe back to the early 1920s.[8]

With regard to the third issue, Calomiris challenges the view taken by Friedman and Schwartz (1993) that the bank failures which gripped the country in the early 1930s were nationwide panics driven mainly by illiquidity (positive equity but not having enough reserves to meet depositor withdrawals) and not insolvency problems (negative equity). According to Friedman and Schwartz, there were four major banking panics during this period: one in late 1930, two in 1931, and one from late 1932 to early 1933. Calomiris presents evidence which suggests that these panics were not purely exogenous instances of illiquidity issues and were more regional in

[7] This is not to say that ABCT explains the severity of the 1929–33 downturn.

[8] For more on ABCT and its relationship to the 1920s, see Rothbard (2008).

nature (except for the last one). He notes that the bank failures were a continuation of previous bank failures in troubled agricultural regions in the prior decade, as roughly half of the 15,000 bank disappearances between 1920–33 came from before 1930, and there were high numbers of bank failures that occurred outside the panics (pp. 192–197). Perhaps the most succinct statement of the issue can be found earlier in the essay when Calomiris writes that "the high bank failures of the early 1930s are best seen as a continuation of the rural bank failures that had begun in the 1920s" (p. 180). Calomiris concludes by saying "it is probably not correct to argue, then, that the Fed failed to detect avoidable national liquidity crises and prevent waves of bank failures in 1930 and 1931" (p.196).[9] This insolvency analysis nicely fits in with what was argued by Vedder and Galloway (1997, pp. 112–127), who state that the rigid wage policy promoted by the Hoover administration led to a profit squeeze that reduced the value of bank portfolios and caused worried customers to withdrawal deposits.

Lastly, Calomiris argues that the Federal Reserve's increase in reserve requirements from 1936–37 did not have a contractionary effect on the economy and did not contribute to the recession of 1937–38, contrary to the views of Friedman and Schwartz (1993). Calomiris writes that one must look elsewhere for an explanation of the recession and suggests two explanations: the gold sterilization or contractionary fiscal policies taken at this time. Another explanation also deserves mentioning, namely the fact that the pro-union 1935 National Labor Relations Act (the "Wagner Act") was upheld as constitutional by the Supreme Court in 1937, leading to an enormous jump in wages that caused a rapid increase in unemployment and decline in business activity.[10]

Overall, despite some of my criticisms, the essays in the book are extremely well researched and important. They are all sources of a wealth of information about U.S economic history and they cite an impressive amount of both old and contemporary research

[9] It must be stressed though that Calomiris did not think there were any illiquidity problems or that the Fed did the right policy in the early 1930s, on the contrary, he argues that the Fed should have vigorously expanded to prevent the money supply from failing.

[10] For more, see Salerno (2010, 437-38).

to buttress their arguments. They provide up to date commentary on key macroeconomic and monetary policy questions in contemporary research, and deserve to be read by anyone interested in these fields. Readers will find that the writers' arguments and the cited sources can be used for future research and will want to be well acquainted with the papers.

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