The Creation of the Federal Reserve

Roger Lowenstein's "America's Bank" is a riveting read, but ignores the compelling arguments of the central bank's early opponents.

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The ink from the golden pen that President Woodrow Wilson used to sign the Federal Reserve Act of 1913 was barely dry when histories of the Fed started appearing. Early accounts were by men who had a hand in the legislation and wanted to secure their share of credit for it. More than a century later, the story of the Fed's origins can be told without the self-serving triumphalism that marred those efforts.

Roger Lowenstein, a former Wall Street Journal reporter and author of several best sellers, including *Buffett: The Making of an American Capitalist*, has no ax to grind, and his history of the Fed's origins makes for a riveting read. Alas, the version of the story in*America's Bank* suffers from another form of triumphalism that also won't bear scrutiny.

As Lowenstein tells it, the challenge of establishing a U.S. central bank was not unlike the contemporaneous building of the Panama Canal: a triumph over seemingly insuperable odds. Although a Democratic Congress crafted the final legislation, and a Democratic president signed it, most Democrats were as opposed to the idea of a U.S. central bank as their counterparts had been 80 years earlier, when President Andrew Jackson signed the death warrant of the Second Bank of the United States.

By the early 1900s, there was widespread suspicion that the new plan had been devised by powerful Wall Street bankers for the sake of strengthening the "Money Trust," the target of a much-publicized investigation just launched by Congress. Large chunks of the plan were borrowed from earlier legislation sponsored by Nelson Aldrich, the notoriously pro–Wall Street Republican senator and former head of the Senate Finance Committee.

Lowenstein's account elevates Aldrich from the shadowy role often assigned him to that of the story's progressive hero. A less-likely progressive than this consummate crony capitalist can hardly be imagined. Far from having been in the vanguard of monetary reform, Aldrich had for decades stood firmly opposed to every reform proposal that came his committee's way.

That changed with the financial Panic of 1907, which led to Aldrich being charged with coming up with a plan for ending panics, once and for all. According to Lowenstein, the new assignment marked a sea change, not just in Aldrich's thinking, but in his character, turning him from a self-serving defender of the monetary status quo to a public-spirited proponent of desperately needed reform.

The Aldrich-transformation narrative is far less plausible than an alternative view: Circumstances changed, but Aldrich's spots didn't. In the wake of the great panic, he and his cronies could no longer hope to block reform, so they decided to shape it instead.

Thus, the secret meeting in 1910 on Jekyll Island off the coast of Georgia, at which Aldrich and several Wall Street bankers came up with the so-called Aldrich Plan, which shaped the Federal Reserve Act in crucial ways. The plan was the Money Trust's best hope for preserving business as usual.

Were there other options? There were, though *America's Bank* gives them short shrift. Instead of calling for any sort of central bank, other proposed reforms put forward at the time took aim at the root causes of U.S. financial instability. The chief cause was a regulation that made the supply of currency notoriously "inelastic." Dating from the Civil War, the law allowed national banks to issue currency only if they backed it with government bonds. Originally targeted at facilitating war finance, the requirement raised havoc afterward as the requisite bonds became scarce, preventing banks from meeting spikes in the demand for paper currency, like those of the harvest season. Numerous plans called for the repeal of the harmful restriction.

Another source of financial instability consisted of rules that supported "unit" banking, which prevented banks from having branches. Unit banking made it difficult for banks to geographically diversify their assets and liabilities, forcing them to rely on correspondent banks as a way to do business in other markets.

Branch banking would have made panics less likely by allowing banks to do business in markets of their choice, without sacrificing control of their reserves. In fact, almost a century would pass before banks in the U.S. finally secured unlimited branching privileges.

The proposed reforms drew inspiration from Canada, where branch banking and an elastic currency had been in place for decades. With no central bank in Canada, U.S.-style financial crises were unheard of. Reformers introduced a score of bills in the U.S. Congress, which were killed off by Aldrich and his cronies, whose banks thrived on the correspondent-banking business.

If it isn't necessary to depict Aldrich as having turned somewhat miraculously from slimeball to saint, why does Lowenstein resort to this interpretation? The problem lies with the author's "presentism," the fallacy of assuming that present circumstances are an ideal against which to judge the past. Since a central bank was clearly the "modern" solution, Lowenstein can't imagine why any true progressive would have hesitated to embrace the idea.

From there, it is but a small step to the conclusion that all of those who favored a central bank did so because they were progressive thinkers. Critics of Aldrich's scheme, or of the Federal Reserve Act it helped shape, are dismissed as "parochials," haunted by "the ghost of Andrew Jackson."

The presentist perspective does not hold up. By 1913, only a score of nations had central banks, most of which arose only after battles between their champions and their opponents, with prominent economists on both sides. Nor, in the U.S. itself, were Democrats alone in rejecting the idea of a U.S. central bank. Many Republicans also doubted that such a bank would prove a reliable solution to U.S. monetary ills.

Just days before passage of the Federal Reserve Act, the brilliant Republican Senator Elihu Root expressed his doubts to Congress in remarks as prescient as they were blistering. “The Federal Reserve,” he insisted “does not provide an elastic currency. It provides an expansive currency, not an elastic one.” The temptation to expand the currency, Root warned, might cause the Fed to encourage the very cycles it was supposed to prevent.

Today, there can be no denying that, if the Fed was indeed “a highly worthy achievement,” it has fallen tragically short of its champions’ hopes, and not just because of the Great Depression. The record of financial and economic instability since World War II is *not*clearly superior to that for 1870-1913, the admittedly unstable decades before the Fed’s creation. Had the proposed reforms prevailed, the record since 1913 might have been much better.

Instead of pushing his inquiry further and allowing that the Fed’s opponents may have been on to something, the author of *America’s Bank* dismisses them as history’s losers. Of course they were losers—in the sense that their proposals were not implemented. But there is more to being one of history’s heroes than merely helping history get to wherever it happens to be going.

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