The Great Debate on Banking Reform

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The story of the origins of the Fed needs revision. The canonical account identified Representative Carter Glass of Virginia as the “father” of the Federal Reserve System, who in collaboration with his legislative assistant H. Parker Willis drafted the Glass-Owen bill that eventually emerged as the Federal Reserve Act. Panic prevention was its main objective, and the real bills doctrine the guide for Fed policymakers. Each of the three propositions is deeply embedded in the literature on the origins of the Fed; each warrants reconsideration. Senator Nelson Aldrich of Rhode Island deserves equal billing with Carter Glass as a cofounder of the Fed. Panic prevention had been achieved in the Aldrich-Vreeland bill (1908). Moreover, the Federal Reserve Act was real bills neutral! Another study of the origins of the Fed should be welcome if these revisions can be supported by the available evidence. Setting the record straight needs no further justification.

The debate on banking reform can for expositional purposes be divided into three separate but slightly overlapping stages between 1894 and 1913. The first stage produced a variety of proposals for an asset-based currency, permitting participating banks to issue currency on the basis of a bank’s general assets. Agreement was reached eventually in 1908 on a measure that made provision for an asset-based currency with commercial paper as the backing for use solely during emergencies. The key words are temporary and emergency. The Aldrich-Vreeland Act remained on the books until 1914, when it expired. By that time more permanent banking reform measures would presumably have been enacted. The act provided for the appointment of a National Monetary Commission for the specific purpose of studying and making concrete recommendations for permanent banking reform. No one had any definite ideas about what the commission might accomplish. Thus ended the first stage of the movement for banking reform.

The second stage opened with the New York Chamber of Commerce’s proposal for a central bank in 1906 and Paul Warburg’s plan for a central
bank in the following year. However, no one in the first half of 1908 thought a central bank would be at the top of the banking reform agenda. Senator Nelson Aldrich had rejected the idea as premature. Asset-based currency proposals monopolized the banking reform debate, but not for much longer. By the end of the summer, as a consequence of the National Monetary Commission’s visit to Europe, Aldrich became a convert to the new viewpoint. The whole complexion of the debate changed. Thereafter, a central bank was the only proposal on the table. The transition from an asset-based currency to a central bank was abrupt and dramatic. Together with a small, elite group of young Wall Street bankers, Senator Aldrich arranged a clandestine meeting at Jekyll Island, Georgia in November 1910 from which emerged an early draft of what later was labeled the Aldrich bill, which called for the creation of a U.S. style central bank even though every effort was made to avoid the label. The Aldrich bill was stillborn, having received no support in the Senate, thus ending the second stage of the movement for banking reform.

The demise of the Aldrich bill initiated the third and final stage of debate on banking reform. Leadership passed from Aldrich to Representative Carter Glass of Virginia. Glass became chairman of the House Banking and Currency Committee and with the sanction of the newly elected President Woodrow Wilson began work immediately preparing a Democrat-sponsored bill with a central bank as its chief focus.

The first two stages I have labeled the Great Debate, for it was during this period that two options were available: an asset-based currency and a central bank. And further progress toward the establishment of a central bank could not proceed until that debate had run its course. Thereafter, the debate was less interesting, for it was mainly concerned with technical details, that is, structural and organizational characteristics of a new central bank.

The Federal Reserve was not the United States’s first experiment in central banking. Both the First and Second Banks of the United States preceded the Fed. But their demise left a traumatic residue that was one of the chief obstacles to the creation of a U.S. central bank. At the beginning of the Great Debate on banking reform in 1894, public opposition to a central bank was a political fact of life. The abandonment of this shibboleth was a precondition for the establishment of a central bank. Senator Aldrich and his associates deserve credit for having removed this obstacle as a deterrent to a favorable reception of the idea of a U.S. style central bank. Aldrich’s victory made it possible for the debate to continue with only one issue in mind—what kind of central bank?

My interest in the Federal Reserve goes back almost forty years. While the Fed was preparing to celebrate its fiftieth anniversary, the Federal
Reserve Board was giving consideration to making their archival records available to qualified scholars. By coincidence, I just happened to have submitted a request to examine their records at about the same time. The Board approved my request, and I was the first outsider to whom the records were made available without restriction. I was able to get on with the task of writing a history of Federal Reserve monetary policy from 1917 to 1933. In the process of writing the book, I repeatedly encountered questions relating to the origins of the Fed, which I set aside for another time. The same questions reappeared while at work on my next two books, on banking panics of the Great Depression and the Gilded Age. Not wanting to postpone the task any longer, I began work on this book.

Until quite recently our chief source of information on the origins of the Fed was H. Parker Willis (1923), who as an associate of Glass was responsible for drafting a bill. For reasons that are not altogether clear, historians have shown little interest in the Fed. But that lack of interest has been dispelled by the recent studies of Livingston (1986) and McCulley (1992), whose works are distinguished by the extensive use of the papers of the leading participants in the banking reform debate, especially that part of the debate that culminated in the Aldrich-Vreeland bill and the Aldrich bill.

The weakness of both the Livingston and McCulley studies is the lack of critical judgment. The reader after working her way through a host of banking reform proposals is given no basis for appraising their economic viability. For example, one learns neither whether the Aldrich-Vreeland bill was an effective panic-preventive measure nor whether there were sound economic reasons for believing an asset-based currency issued by the banks was an effective remedy for banking panics.

Political scientists have discovered the Fed as well. Broz (1997) attributed the origins of the Fed to the desire of New York bankers to make the dollar an international currency and end our dependence on Europe to finance our export trade. Timberlake (1984), Tallman and Moen (2001), and Toma (1997) have also contributed novel explanations of the origins of the Fed. The so-called origins of the Fed problem is a research problem of some significance.

I have undertaken a long, interpretive essay with the intent of revising the conventional explanation for the origins of the Fed. A clearer idea of the origins of the Fed may contribute to understanding Federal Reserve behavior, especially in the earlier years. Whether it does or not, however, is not especially relevant. To repeat, setting the record straight is reason sufficient.

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