Fiftieth Anniversary of the Federal Reserve System—Immediate Origins of the System

In the decades prior to the establishment of the Federal Reserve System, it became increasingly apparent that the country's financial system failed to meet fully the needs of a growing economy. These shortcomings were most dramatically revealed in fairly frequent "money panics".

New York City was the fulcrum of the banking system operating under the National Bank Act. Many out-of-town banks kept large deposits with New York banks, which in turn employed a large part of these funds in stock market call loans. In most years, seasonal currency withdrawals from the New York banks during the autumn harvest time were met without major difficulty. Occasionally, however, the withdrawals were so great or came at such a time that they triggered a money panic. In the absence of a "lender of last resort", the New York banks, undergoing heavy demands for currency—which constituted their legally required reserves against demand deposits—would restrain withdrawals by their correspondent banks. Failure by out-of-town banks to meet demands for cash would then often follow. With the outflow of currency from New York, moreover, banks would withdraw funds from stock market financing, interest rates would rise to extraordinary levels, and prices of stocks and bonds would drop sharply.

The nation experienced some or all of these conditions in 1873, 1884, 1893, 1901, 1903, and 1907, but each occurrence except the last led to only minor legislative changes. In 1907, the economy was in a recession and stock prices were trending downward over much of the year. As the seasonal demand for currency and credit built up at crop-harvesting time, a large trust company in New York experienced difficulties and suspended operations on October 23. Runs developed on two other New York trust companies, and correspondent banks stepped up their withdrawals of currency from national banks. The net losses of currency from New York banks to the rest of the country increased fourfold over seasonal norms during October and remained at peak levels through November. New York banks strongly discouraged or even rationed currency payments to correspondents, and the usual widespread disruption of payments followed. Call loan rates at one point were reported at 125 per cent per annum, and price declines in the securities markets worsened rapidly.

* The third in a series of historical vignettes appearing during the System's anniversary year.

Eventually, the panic was stemmed. Gold flowed in from abroad, partially reflecting a balance-of-trade improvement and higher interest rates. Treasury deposits of currency in New York banks reduced the pressure on the central money market. Clearing houses served as self-assistance groups for local banks by placing the credit of the group behind each member. Nevertheless, in New York City alone three national banks, eight state banks, and four trust companies, with total deposits and other liabilities of about $110 million, had either failed or temporarily suspended operations.

The panic of 1907 spurred serious study of the basic problem. By May 30, 1908, a means of creating an emergency currency to stem panics had been provided in the Aldrich-Vreeland Act. This act of Congress also established the National Monetary Commission, to consist of nine Senators and nine Representatives, for the purpose of examining the monetary and banking system and reporting on needed changes. The monumental study of this commission (twenty-four volumes of published material) and its recommendations for a central banking system became —in a greatly modified form—the basis for the Federal Reserve Act of 1913 which was "to furnish an elastic currency, to afford means of rediscounting commercial paper, [and] to establish a more effective supervision of banking in the United States".