



# A History of Central Banking in the United States

“It is a fact well understood that public Banks have found admission and patronage among the principal and most enlightened commercial nations . . . after an experience of centuries, there exists not a question about their utility in the countries in which they have been so long established. Theories of men and business unite in the acknowledgement of it.”

—Alexander Hamilton,  
*Second Report on Public Credit,*  
December 14, 1790

Top to bottom: First Bank of the United States building in Philadelphia, PA; Second Bank of the United States building in Philadelphia, PA; and Marriner S. Eccles Federal Reserve Board Building in Washington, DC.

By Mark Higgins

ON DECEMBER 23, 1913, President Woodrow Wilson signed the Federal Reserve Act into law. Most people believe that this marked the birth of the nation's first central bank, but it was, in fact, the third. The first two, the First and Second Banks of the United States, disappeared when their 20-year charters expired in the early 1800s. The Federal Reserve has endured for more than 100 years and has played a more important role in the expansion of the US economy and stabilization of its financial system.

Despite the importance of central banking, public opinion regarding its utility has fluctuated over time. In the 21st century, skepticism has intensified once again, as evidenced by the popularity of movements such as "End the Fed." Moreover, the very existence of decentralized finance and cryptocurrencies reflects growing distrust of central bankers.

This brief synopsis of the 232-year history of central banking in the United States reveals how a central bank protects the public from financial perils which can only be appreciated when one's knowledge of financial history extends beyond the bounds of the human lifespan. Many financial risks that inspired the return of a US central bank in 1913 have faded from our collective consciousness, rendering Americans vulnerable to the false perception that the Federal Reserve is no longer needed. The lessons from history will remind Americans why the Federal Reserve exists and why its integrity and independence must be maintained.

### Four Functions of a Central Bank

Before reviewing the history of central banking, it is important to first explain the primary functions of a central bank. Using a modern central bank as a reference, these functions include:

**1. Currency Stability**—Everyday, Americans conduct billions of financial transactions denominated in US dollars. The value of a dollar is always accepted at face value, but this was not always the case. In the 1790s, individual banks

issued proprietary bank notes, which customers redeemed for specie (typically gold or silver) that was held in the issuing bank's reserves. Although bank notes were denominated in dollars, they were not necessarily accepted at face value by different banks and businesses. The value of a US dollar, therefore, depended upon the relative strength of the bank issuing bank notes. The result was an unstable currency. A central bank eliminates this problem by issuing bank notes that are accepted universally at face value.

**2. Bank Regulation**—Fractional-reserve banking systems face the perennial risks of insolvency and illiquidity. Preventing reckless banking practices that increase these risks requires the construction of a well-regulated banking system. A central bank is generally regarded as the ideal regulatory authority to enforce such regulations, and thereby ensure that banks employ sound lending practices, maintain adequate reserves and refrain from committing fraud.

**3. Lender of Last Resort**—Fractional-reserve banking systems are structurally vulnerable to financial panics and bank runs. These events can force otherwise healthy banks to renege on their promise to convert bank deposits into cash simply because they lack the liquidity to satisfy large, but temporary, withdrawals. Central banks play a critical role in stopping these crises by serving as a lender of last resort. This entails expanding the supply of currency and providing it to the banking system in exchange for less liquid securities until the crisis subsides.

**4. Monetary Policy**—Finally, a central bank governs the monetary policy of a nation. The stated mandates vary by nation and over time. In 2023, the Federal Reserve's mandate is to balance the competing demands of maximum employment and price stability.

### The Four Eras of US Central Banking, 1791–2023

The evolution of US central banking can be categorized into four distinct eras. It was

not until the signing of the Federal Reserve Act that all four functions of a central bank were present in the United States.

### 1. The First and Second Bank Era



**"Credit is an entire thing. Every part of it has the nicest sympathy with every other part. Wound one limb and the whole tree shrinks and decays."**

—Alexander Hamilton, January 1795

The United States ratified the Constitution in 1788, but the financial system remained in disarray. Both the federal and state governments had amassed a mountain of unserviceable war debt, and many veterans were not even fully paid for their service. In 1790, the nation's first Treasury Secretary, Alexander Hamilton, devised a three-pronged strategy to restore the nation's creditworthiness. First, all state and federal debts were consolidated and backed by the full faith and credit of the United States. Second, Congress established new tariffs to provide revenue to service the debt. Finally, Congress approved a 20-year charter for the nation's first central bank, the First Bank of the United States.

The First Bank's powers were more limited in comparison to those afforded to the Federal Reserve. The primary objective was stabilizing the currency, as constant fluctuations in the value of bank notes issued by state-chartered banks created unnecessary frictions and risks in trade. Bank notes issued by the First Bank maintained a uniform value, which was bolstered by its eight bank branches, sizeable reserves and stable deposit base. It also served as the nation's fiscal agent and provided commercial banking services to individuals.

The First Bank played an important role in facilitating strong and stable economic growth in the United States from 1791 to 1811, yet many politicians failed to appreciate its value. Fierce opposition from the Democratic-Republican party led Congress to reject a bill to renew the charter in 1811. Over the next five years, the United States experienced persistently

high inflation and struggled to raise debt to fund the War of 1812. Realizing that a central bank was essential, Congress approved a 20-year charter for the establishment of the Second Bank of the United States in 1816. President Nicholas Biddle took over as the Bank's president after the Panic of 1819, and the Second Bank once again stabilized the nation's currency.

## 2. The Wildcat Banking Era



**"The bank, Mr. Van Buren, is trying to kill me, but I will kill it."**

—President Andrew Jackson, July 1832

In the run-up to the 1832 election, President Andrew Jackson expressed hostility toward the Second Bank. His animosity stemmed from his populist leanings, as well as his personal financial history. In the early 1800s, Jackson was nearly bankrupted after he accepted a promissory note for the sale of his property, and the buyer defaulted. This made him skeptical of any currency other than gold and silver coin. Sensing that President Jackson posed a threat to the Second Bank, Biddle submitted an early request to Congress to renew the Second Bank charter in January 1832. Biddle believed that this would force Jackson to either back down from his threats or openly voice his opposition and lose the election as a result. But Biddle miscalculated. Despite gaining approval in both Houses of Congress, President Jackson vetoed the bill.

Contrary to Biddle's expectations, the veto strengthened Jackson's populist appeal, and he easily won a second presidential term. After taking office, Jackson terminated the Second Bank's contract as the government's fiscal agent and removed the government's deposits. He then distributed the funds to state banks across the country. The Second Bank's charter officially expired in 1836, but without the government's deposits its power was dramatically reduced by the end of 1833.

The distribution of the government's deposits initially stimulated the US economy, as it increased the reserves of state banks, which could then lend more liberally. This, in turn, drove higher asset prices, especially in real estate in the Midwestern and Western states. It was only a matter of time, however, before prices rose to

unsustainable levels. Jackson then made matters worse by issuing the *Specie Circular* in July 1836, which forbade the use of bank notes for the purchase of public lands. This triggered a sharp rise in withdrawals of gold and silver from banks, forcing many to suspend conversion of bank notes.

Financial conditions worsened after Jackson left office, triggering a financial crisis known as the Panic of 1837. In that year alone, several hundred banks failed, and the failure rate worsened in the 1840s. Americans referred to the early 1840s as the "Hard Times," and the US economy contracted to depths previously unseen. Similar to the Great Depression that occurred nearly 100 years later, bread lines, soup kitchens and violent uprisings were common in major American cities throughout the early 1840s.

## 3. The National Banking Era



**"We only ask you to examine the history of the times, during the existence of the two Banks [First and Second Banks of the United States], and compare those times with the miserable present."**

—President Abraham Lincoln, 1843

The US economy slowly recovered in the mid-1840s but only reached escape velocity after the discovery of gold at Sutter's Mill in 1848. The gold strengthened the balance sheets of the federal government and banking system by adding \$50 million in reserves from 1848-1849, and a total of \$555 million in reserves over the course of the next decade. The expansion was interrupted, however, with the outbreak of the Civil War in 1861. Soon thereafter, currency instability was problematic again. Union troops needed to purchase equipment and services across state lines, and stabilizing the currency was essential to ensure operational efficiency.

The United States did not reintroduce a central bank, but it did pass three laws that resurrected several of its functions. The Legal Tender Act of 1862, the National Currency Act of 1863 and the National Banking Act of 1864 formed what is now referred to as the National Banking System. Nationally chartered banks were authorized to issue bank notes backed by Treasury securities, which stabilized the value of the currency.

The laws also established national banking regulations for the first time, which were enforced by the Office of the Comptroller of the Currency (OCC). Finally, the United States issued "greenbacks," which were the nation's first fiat currency, as they were not initially convertible to a fixed amount of gold or silver. The National Banking Acts proved absolutely critical during the Civil War and for several decades thereafter. However, the expansion of the US economy at the turn of the 20th century soon rendered them inadequate.

## 4. The Federal Reserve Era



**"This is the place to stop the trouble, then."**

—J. Pierpont Morgan, October 22, 1907

On April 18, 1906, residents of San Francisco were jolted awake by a massive earthquake. Within days, a large percentage of the city was either leveled by the quake or destroyed by fire. The earthquake also triggered a financial chain reaction that slowly made its way to New York City. By October 1907, the combination of bank withdrawals to fund reconstruction in San Francisco and the typical pressure of the agricultural financing cycle rendered New York City banks and trusts highly vulnerable to panic.

In mid-October, the panic arrived when an amateur stock operator, Otto Heinze, attempted to corner the stock of United Copper. After his scheme failed, Heinze defaulted on his loans, forcing several brokerage firms into bankruptcy. With liquidity tight, the failure of the brokerage firms triggered an all-out run on the banking system. If not for the heroic effort of J. Pierpont Morgan to rally support from the largest national banks and trust companies, the entire financial system would have collapsed.

The Panic of 1907 inspired several key reforms, but it took six years before Congress and President Woodrow Wilson concluded that re-establishing a central bank was essential. Frustrated by the delays, Senator Nelson W. Aldrich lamented, "Something has got to be done. We may not always have Pierpont Morgan with us to meet a banking crisis."

The opposition eventually relented, and Wilson signed the Federal Reserve

Act into law on December 23, 1913. In November 1914, the system was up and running, and for the first time in history, the United States had a fully functional central bank. Currency stability was maintained by the issuance of Federal Reserve notes. Bank regulation was strengthened by the Fed's new powers to examine and demand adjustments to banking practices. The Federal Reserve became the first US central bank to have the power to serve as a lender of last resort. Finally, the Fed gained the power to manage monetary policy by engaging in open market operations to adjust prevailing interest rates.

### Wisdom from Failure



**“Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton [Friedman] and Anna [Schwartz]: Regarding the Great Depression. You’re right, we did it. We’re very sorry. But thanks to you, we won’t do it again.”**

—Ben Bernanke, *Former Chairman of the Federal Reserve, November 8, 2002*



**“...the Federal Reserve System had the power to abort the inflation at its incipient stage 15 years ago or at any later point, and it has the power to end it today... It did not do so because the Federal Reserve was itself caught up in the philosophic and political currents that were transforming American life and culture.”**

—Arthur Burns, *Former Chairman of the Federal Reserve, September 30, 1979*

Since its establishment in 1913, the Federal Reserve has prevented many financial shocks from spiraling into devastating financial crises. But the Federal Reserve has also made many mistakes. Most had consequences that were containable, but two failures stand out. The first was the Great Depression in the 1930s, and the second was the Great Inflation in the 1970s. With respect to the first error, the Fed's actions in the early 1930s did not cause the Great Depression, but they did cause it to deepen unnecessarily. The biggest mistake was standing by idly while the banking system collapsed after several waves of bank runs.

Confidence in the banking system was restored after President Franklin D. Roosevelt declared a national bank holiday (see article, page 18) and then slowly reopened banks in March 1933. The most important lesson from the Great Depression was that preserving the integrity of the banking system—even when bank executives are unworthy of support—is critical to preventing catastrophic depressions. This lesson was applied during the Global Financial Crisis in 2008 and 2009, and it explains why the US unemployment rate topped out at 10% in 2009 rather than 25% like it did during the Great Depression.

The Fed's second greatest failure occurred in the late 1960s and 1970s. Under pressure from politicians, and impaired by an inaccurate understanding of the Phillips curve and natural rate of unemployment, the Fed allowed inflation to remain at elevated levels for too long. Once higher inflation expectations became entrenched in the American psyche, stagflation set in and Americans suffered from both high inflation and high unemployment. Chairman Paul Volcker ended the scourge of stagflation by enacting draconian monetary policies which caused a brutal recession from 1981 to 1982. The key lesson from this experience was that taming inflation early and aggressively is essential to economic prosperity.

The lessons from the Great Depression and Great Inflation proved critical over the past three years. First, in March 2020, the Fed acted quickly to provide liquidity to the financial system after a large portion of the economy suddenly shut down during the first year of the COVID-19 pandemic. This enabled the United States to avoid a repetition of the Great Depression. Then, in early 2022, the Fed began tightening monetary policy aggressively to end post-COVID-19 inflation. This effort remains in progress, but lessons from the painful experience of the 1970s will likely prevent the Federal Reserve from ending the tightening cycle prematurely and inviting a repetition of the Great Inflation.

### What Lies Ahead?

In his recent book, *21st Century Monetary Policy*, Former Federal Reserve Chairman Ben Bernanke presents multiple challenges that central bankers must overcome in the decades to come. Some are technical, such as managing monetary policy amid

secular stagnation and a low natural rate of interest. But one challenge that is easily understandable is the growing threat to the Fed's independence. Such threats come from both extremes of the political spectrum. Examples have included presidential attempts to influence FOMC decisions, proposed legislation to “audit” Fed monetary policy decisions and even legislation to restrict the Fed's lender of last resort powers.

The United States has an exceptional economic track record, but one weakness is the tendency of politicians to yield to pressure to knock down walls without checking first to see if they are load bearing. History demonstrates that the presence of an independent central bank is essential to US economic prosperity. That does not mean the Fed is infallible. Over the past 108 years, the Fed has made many errors, with the most notable ones contributing to the Great Depression and Great Inflation. Fortunately, the Federal Reserve has learned from these errors and adjusted its tactics accordingly. Despite the imperfections of the Federal Reserve System, it continues to play a critical role in the economic success and financial stability of the United States. 💰

*Mark Higgins, CFA, CFP® is a seasoned investment advisor with more than a dozen years of experience serving large institutional investors, such as endowments, foundations, public pension plans, and corporate operating reserves. He is also an avid financial historian and is publishing a book on the full history of the US financial system with Greenleaf Book Group in 2023.*

### Sources

- Bernanke, Ben. *21st Century Monetary Policy*. New York: W.W. Norton & Company. 2022.
- Chernow, Ron. *The House of Morgan*. New York: Grove Press. 1990.
- Hamilton, Alexander. *Final Version: First Report on the Provision Necessary for Establishing Public Credit*. December 13, 1790. <https://founders.archives.gov/documents/Hamilton/01-07-02-0227-0003>
- Stedman, Edmund. *The New York Stock Exchange: Volume I*. Stock Exchange Historical Company: New York. 1905.