Transcript

Fed Talk: The Crises That Led to the Fed's Creation: Monetary Policy in American History

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Presentation

Speaker

Owen F. Humpage, economist emeritus, Federal Reserve Bank of Cleveland

Moderator

Chuck Soder, senior media relations specialist, Federal Reserve Bank of Cleveland

Chuck Soder:
Hello everyone. Please find your seats promptly. We are going to get started on time here.
Good afternoon and thank you so much for joining us for today's *Fed Talk*, which by the way is being recorded. My name is **Chuck Soder**, Senior Media Relations Specialist here at the Federal Reserve Bank of Cleveland. If this is your first time joining us, you may wonder what is a *Fed Talk*? Well, it's our speaker series where we dive into economic issues ranging from inflation, to the job market ,to financial literacy. And if you've missed any past sessions, no worries, you can catch them all on our website at clevelandfed.org.

Now, I'm really excited to kick off today's conversation, the crises that led to the Fed's creation, monetary policy in American history. And if you stay to the end, I'm going to tell you something you may not know about The Wizard of Oz. So there's your teaser.

But before we jump in, a few quick housekeeping things. If you are joining us virtually, should Zoom crash on you or if the meeting drops, use the dial-in information from your invitation to rejoin by phone. Also, your microphone and camera will be disabled during the event. However, we want your questions. You can submit them using the Q&A feature on Zoom. And if you're here in person, we have microphones in the aisles. After the presentation, I'll ask Owen a few questions, and then we will open up questions to the room. We'll get to as many as we can. So if you've got questions about how money worked before the Fed, we want to hear them.

And one last thing, the most important thing, the views shared today by myself, and our speaker, are our own and not necessarily those of the Cleveland Fed or the Federal Reserve system.
So let's get started. Today you're going to hear a presentation by **Owen Humpage**, Economist Emeritus here at the Cleveland Fed. Come on up, Owen. And so you know, he's currently working on a book about this exact topic. So I'll turn it over to Owen.

Owen Humpage:
Thank you. You haven't heard me speak yet. You may want that applause back at the end. So hold it off.

The Federal Reserve, as you probably know, is responsible for the nation's monetary policy. And like all economic policies, the overarching goal of monetary policy is to create an environment in which the economy can grow steadily along a path that fully employs labor and capital.

The Fed has two mechanisms in which they can contribute to that overarching goal. The first is by conducting ongoing open market operations, the purchase and sales of assets, notably Treasury securities, and to do that in a way that minimizes the rate of inflation, so that it does not affect household and businesses decisions about consumption and investment.

The second mechanism they have is a lending facility, that they use to inject emergency funds into financial markets when turmoil and uncertainty empower the proper functioning of those markets. When I started here at the Federal Reserve system, I thought monetary policies started with the Federal Reserve, and that is wrong. So today what I'm going to try to do, is walk you through pretty quickly the history of monetary policy in the United States.

So, let's start with the founding of the nation. At the founding, based on a report by Alexander Hamilton, the Secretary of Treasury at the time, Congress passed the Coinage Act of 1792. The Coinage Act put the United States on a bimetallic, or species standard, where only... With silver and gold coins. Under a pure monetary metallic standard, the amount of the two metals extracted from the earth and coined make up the money supply for all the nations that participate in the monetary standard. And it results in inflation rates among all those participants that are basically the same. They can divert a little bit, but not a whole lot.

United States, and other large countries in the 18th and 19th century, never had a pure metallic standard because of banks. What they had then is a mixed metallic standard, consisting of gold and silver coins, and also bank notes, the currency of the day. I'll explain that a little more as I go on. Whereas the pure metallic standard automatically did what it did, with no government involvement and hence no monetary policy, the introduction of banks opened the window for monetary policy. These banks, the banking system altogether, accepted deposits, made loans, and issued these bank notes. They could increase the money supply by this, raise the inflation rate above what you would expect from a pure monetary metallic standard, raise the inflation rate. If they did this, they would eventually find that their exports decreased, their imports increased, and gold flowed out of the economy. Just the opposite, if they contracted the money supply.

So the point here is, they could affect money and the rate of inflation in a near term to interim term, but in the long run, the monetary policy, the metallic policy took over. All right.

These banks also did something else. They introduced risk into the financial system. Well, that's what they did. I just explained that. Yeah. They also introduced risk into the banking system. Before 1863, all of the notes in the economy were issued by state chartered banks. At around 1863, there were 1400 state chartered banks in the United States. They were issuing some over 5000 different kinds of notes, differing in size, differing in what they looked like, differing in their denominations.

After 1863, or after the Civil War actually, the only notes in existence circulated by banks were circulated by nationally chartered banks. So these notes were the kind of basic currency you used every day in the economy, people regarded these notes as conveniences or surrogates for the coins, for coins. Coins, to the public, were the real money. The notes were just the convenience.

All of the charters, state charters and national charters, required these banks to redeem their notes anytime anyone walked into the bank and asked for coin instead of the notes. If a bank failed to do that,

that bank could lose its charter and be shut down, even if one person didn't get the coin. That's how important this exchange for notes and coins were. All right.

Consequently, these banks held reserves in their vaults of lawful currency, of lawful money. Before 1863, lawful money consisted only of silver and gold coin. After the Civil War, lawful money consisted of silver and gold coin, and any legal tender notes that the federal government had issued before and after the Civil War.

The banks, so they held these reserves in an amount they though was sufficient to handle any normal day redemptions of notes for coin. People knew this, but if they ever suspected an individual bank couldn't redeem the notes for coin, they would make a run on that bank. That is, they would try to get their notes changed into coin right away. They would try to shift out of their deposits and get out of the bank. They were fearful that they couldn't convert their notes.

Sometimes, this fear became contagious and they would start running on related banks. Then they would start running on other banks that were unrelated in a city, in a state, maybe across the whole country. And we call that a banking panic, and they could have serious economic consequences.
So monetary policy started in the United States in order to accommodate increases in the public's demand for currency. In a panic, monetary policy makers would inject lawful money into the banks, so they could accommodate the demands of their customers without having to contract their loans too much. What they were creating was an inelastic currency. So it would expand when people needed money, it would contract afterwards.

So besides panics, there were seasonal patterns. When farmers had to, had their harvest, they brought in their harvest and shipped it to the markets. They needed extra currency to do this. Monetary policy would expand a bit to accommodate them. And on occasion, something weird would happen. For example, the famous Chicago Fire in 1870s, after that happened, there was a demand for currency in the Chicago area.

So how did this monetary policy, how did it happen? Sorry, I'm getting an old man voice. So the first institution's monetary policy were the First and Second net banks of the United States. The First Bank existed between 1791 and 1811. The Second Bank existed between 1816 and 1836. Each was a private bank. Each had a 20-year charter. The charter was provided by the federal government. They were the only banks at the time that had a federal charter. All other banks had state charters. The federal government owned 20% of each of these banks. The federal government had the right to choose a few directors to these banks. And the federal government had the right to investigate their books on occasion, not regularly.

Like other banks that existed at the time, the First and Second Bank of the United States took deposits from corporations or individuals, made loans, had stockholders that wanted profits, and they operated for profits. Unlike other banks at the time, the state charter banks, the notes of the national bank were legal tender for all transactions with the federal government. That wasn't true of state bank notes.
In addition, the national banks could hold to establish branches throughout the country. State banks couldn't do that. At most, they could establish bank within their own states, and many states precluded that.

The First and Second Bank... Oh, and the other thing I should tell you about the national banks is they held a lot more reserves than the state banks. The First and Second Banks were identical in all respects except two. The Second Bank was much larger than the First Bank, had many more branches. And the Second Bank was established after the monetary chaos that erupted during the War of 1812. So their charter explicitly said they were to maintain a stable currency, which meant they were to engage in monetary policy. Now the Second Bank got its power to conduct monetary policy because of its size, it was the largest corporation in the nation. And because of its relationship with the federal government, the largest transactor in the money market at the time.

Because of its relationship to the federal government, and because of its own transactions, the Second Bank of the United States acquired lots of the bank notes that the regular state banks issued, and held them in the bank. But they would quickly take these other bank notes and redeem them with the various state banks. And when they did that, they pulled reserves out of the state banks, reduced the ability of state banks to make loans, reduce the circulation in the economy, and reduce the circulation. The idea behind this was to stop state banks, which tended to do this at the time, to stop them from overissuing their notes. And by overissuing, I meant not issuing a prudent amount of notes given the amount of reserves they held, or switching that backward, holding a prudent amount of reserves to back the notes that they issued. So by doing this, the Second Bank in the United States prevented them from overissuing notes and fostered a stable money system.

If for some reason the Second Bank in the United States thought there was not enough money in the economy, what they would do is hold back on redeeming these notes and accumulate them in their vault, thereby allowing banks to continue to make loans. Yeah. So then the banks could hold onto the reserves and continue what they were doing. So that forbearance limited their effect on the state banks. In addition, the Second Bank was so large that it realized it could affect the money supply and conditions in money markets through its own lending operations. If it wanted to increase the money supply, the Second Bank would lower its interest rate, increase its loans, and the money supply would generally increase. If it felt it needed to contract the money supply, it would do just the opposite.
The First Bank had all these same things as the Second Bank. They could do the same kinds of operations, but they didn't seem to do that. When Alexander Hamilton appointed the First Bank, he didn't envision it as an instrument of monetary policy. He saw it as an important addition to the federal government because it held deposits. Because through its branches, it could distribute government funds through its branches all over the economy, and the same way, collect revenue for the federal government.

Also, and more importantly, the banks of the United States could make quick, inexpensive loans to the federal government and to the state and local governments.

Well, when both the First and Second Banks of the United States were shut down, and they were shut down, they didn't get their charters renewed. And they didn't get these charters renewed because the state banks, and the states that chartered these state banks, complained to Congress that the banks, First Bank and the Second Bank of the United States, engaged in unfair competition. And in fact, they did. They held a lot of deposits on the federal government, which the state banks didn't have. It allowed them to lend a lot. They had a currency that was legal tender with the government. The state banks didn't have that. And they could have branches throughout the nation. The state banks couldn't do that. So they complained to Congress and Congress eventually agreed with them. And they were shut down. That left only the Treasury left to conduct monetary policy.

So when Hamilton and Congress started thinking about how they would structure the Treasury, they realized that the amount that, because the federal government was large relative to the money market, that the receipts and expenditures of the federal government would have a strong influence on the money market. And they particularly worried about the fact that if the government had a large budget surplus, that they would pull reserves out of the banking system. The banking system wouldn't be able to make as many loans. The money stock would start to diminish. People didn't have currency, and it could be a detriment to economic activity in the nation.

So what Hamilton decided, and the others, was it was very important for any surplus that the Treasury [inaudible 00:20:08] in a private bank, because then the bank could lend out those funds when the Treasury didn't need them, hence the First and Second Banks of the United States.
So the Treasury didn't get too involved with monetary policy until during the Civil War and especially after the Civil War. And I'm going to tell you how they did it. They did engage in monetary policies in the 1870s, in the 1880s, and in the 1890s. So I'm going to start with the 1890s because it explains what they did, but it also explains why they failed.

In 1890, United States entered a recession. Not a big recession, but a recession. And they also had a banking panic. So the federal government, with having a pretty good surplus at the time, entered the market, bought bonds, Civil War bonds that were still out in the market, bought them from the market, or from people who had them when they were maturing, and injected funds when they bought these markets. They were basically engaging in open market operations.

So they did a bunch of these when the recession first started in late 1890s. They stood back, watched, see what happened. And then they did another bunch in the early, 1891, when the recession was still going on.

In addition to these open market type operations, they decided to prepay the interest on a lot of outstanding bonds that weren't maturing and they weren't going to buy. So through these two mechanisms, they shifted reserves out of the surplus held in Treasury vaults, and into the commercial banks, allowing them to extend loans to service their customers. And in fact, it seems to me reading this, that they actually mitigated the recession a little bit and certainly mitigated the extent of the banking panic.

Okay. So by 1900, the federal government was having a surplus again. Things were fine. And they were engaging in a whole lot of monetary policymaking through the early 1900s using the same mechanisms. The other mechanism they might use on occasion is to Treasury deposits into central banks as Hamilton originally suggested. They didn't like doing that because then Treasury secretaries were accused of favoritism.

All right. Okay. So that brings us up to the establishment of the Federal Reserve system. Now, what struck me as odd is that the Federal Reserve system was put in the same kind of box that the First and Second Banks of the United States was put into, along with the Treasury. What do I mean by that? When the Federal Reserve Act was written, it didn't include inflation as an objective of the Federal Reserve, because the idea was that the gold standard would continue, and the gold standard would ultimately determine the amount of reserves in the system, and it would ultimately determine the inflation rate. The Federal Reserve was instead established to provide an elastic currency, just like the banks of the United States did, and just like the Treasury did.

It was a little different though. Any bank that became a member of the Federal Reserve system had to hold their reserves as deposits in the Federal Reserve. All right.

So now, the Federal Reserve has a pool of reserves. This pool is bigger than what the first and Second Banks of the United States had. And, it's more stable than the pool of reserves that the Treasury had. The Federal Reserve, in times when money was needed, would lend this money out through its lending facility. They would charge the banks that came in, had to be member banks that came in and wanted to borrow. They would charge them an interest rate, that was kind of high so the banks didn't abuse the privilege, and make them present collateral.

The gold standard also affected the amount of lending that the Federal Reserve could undertake. The Federal Reserve had to have, hold reserves of gold at a specific level. If the amount of gold that the Federal Reserve held increased, they could lend out more. If the amount of gold that the Federal Reserve held was close to or below that level, they couldn't lend out very much money.
So basically, what the Federal Reserve is shifting a pool of reserves from its deposits to banks again, just like the other two. So what happened after that? Well, before the Federal Reserve got going in the end of 1914 was World War I. World War I pushed all the countries off the gold standard. Try as they might during the 1920s, and some got back on it. They had difficulties. And then the Great Depression started. Everyone was off the gold standard again.

Money then was fiat, not backed by gold. You couldn't take a dollar bill into a Federal Reserve Bank and ask for gold. They wouldn't give it to you. And, we were no longer on the gold standard. So what this meant was that a country could engage in monetary policy that was independent of all the other countries. Under the gold standard, as I tried to explain, the gold standard ruled the roost, and distributed reserves and money to all the countries that were on it. And they had to have inflation rates that were similar, not exactly the same, but similar over the long run. That no longer existed. If there was huge depression in the United States, we could create as much reserves as we wanted.

And the second, well, that's basically the second point. Because we are on a fiat standard now, the Federal Reserve could actually create reserves or destroy reserves. And that allowed it to conduct a monetary policy like we have today. And I contend, and this is the bottom line of this whole talk, that those are the two hallmarks of modern monetary policy. Independence from a gold standard, the ability to create and destroy reserves.

And I will stop there with 15 seconds to go, and try to answer any questions, except spelling. I'm not answering spelling questions because some people from my grade school are here and they know I can't spell. So I'll just leave this here.

Chuck Soder:
All right, Owen, thank you so much for giving that very informative talk. So I want to let you know we're going to be taking questions from the crowd shortly. So be thinking of them. Brew those in your mind. But I've got a few questions for Owen that I'm going to ask first.

And actually I think I'm going to build off of, kind of where you ended a little bit on the creation of the Federal Reserve. I've given a few Fed 101 talks and we talk a lot about the Bank Panic of 1907, which involved many bank runs as sort of the straw that broke the camel's back to get support going for the creating of the Federal Reserve. But it sounds like 1800s, there was just a lot of bank panics, a lot of bank runs. And I'm hoping you can talk about, just how bad was it? We don't really have a good sense of that.

Owen Humpage:
Well, if you compare the 19th century with the 20th century, I think you can make an argument that there were a lot of recessions in the 20th century. But it was well known, even before 1907, that the number of panics in the United States during the 19th century was larger than most other well-developed countries like England, France and Germany. And that played into the idea of, they needed to make some sort of monetary reforms, and monetary reforms started... The recession in 1893 was so bad that, shortly after that, monetary reform became an issue in the United States. And it's existed then, into the 20th century.

Chuck Soder:

Gotcha, gotcha. And you mentioned a bit about the need for an elastic currency as well. So, it's sort of the stopping of the bank runs, and maybe these two issues kind of go hand in hand, the bank runs and the need for additional currency when supply ran short during the harvests, and during some of those other calamities.

Owen Humpage:
Yeah. So to offset the bank runs, whatever the monetary authority was at the time, they would move bank reserve. They would try to shift bank reserves out of their vaults and into the banks. This would allow the banks to continue to meet their customer's demand.
And most importantly, what happened in a banking run, if the bank couldn't make... They had to accommodate all their customers, but they also needed to make loans in order to keep commerce going and preventing the recession becoming extremely bad. So the idea was to put the, the monetary authority would inject these reserves into the banking system. They could accommodate their customers without cutting back so much on their loans. Sometimes it worked pretty good, sometimes not very good. And I-

Chuck Soder:
Continue. Don't Let me cut you off.

Owen Humpage:
I mean, 1893 was a really bad recession. 1873 was the previously really bad recession. And there are lots of little recessions and bank panics in between that.

Chuck Soder:
Gotcha. So going back into the 1800s a bit, before we got up here, you told me a story about, that links Ohio and the Second Bank of the United States.

Owen Humpage:
Yes.

Chuck Soder:
Can you tell that story to the audience?

Owen Humpage:
Okay. This is basically a fun fact. So here's the issue. So in 1800... In 1818, the state of Maryland decided they were going to tax the Bank of the United States branch that was in Baltimore. And they were going to charge them, I think it was $15,000 a year. The US Bank in Baltimore refused to pay the tax.

And it went to the Supreme Court when John Marshall was the Chief Justice. And it was McCulloch versus Maryland. And McCulloch was an officer of the Baltimore branch of that bank. So the Supreme Court ruled that, indeed the Bank of the United States was constitutional, and they ruled that the state could not tax them. And I think, and there's a lawyer in the crowd, can get the nod if I'm wrong. I think the basic argument was the ability to tax is the ability to destroy, and therefore the state couldn't destroy an instrument of the federal government.

Okay, so that's the background for all this. I think it was February 1819, the State of Ohio decides they're going to tax the Bank of United States branch in Chillicothe. Now, Chillicothe at one time was the capital of Ohio, but in 1819 it was not. Columbus was. Okay.

So of course the Bank of the United States, “No, we’re not paying the tax.” And I think that tax was $50,000, a lot. And at the same time, we also had a branch in Cincinnati. Now why Ohio had two branches? I have no idea. But anyway, so back to Chillicothe. So the auditor of the state gets a posse together and tells the posse to go in that branch and take the money. So they go in the branch, hop over the counter. He actually said this in his thing allowing them to do this. “You can hop over the counter.”

They went behind the branch, the counter. They took out $120,000, and they took it back, I’m assuming, to Columbus, which was the capital. Well, the courts started going through the court system and the court system, citing McCulloch versus Maryland, said, “You can’t do that.”
So the courts sent some guys down to Columbus to try to recover the money, and they recovered a lot of it. And I think the auditor of state ended up in jail for a short period of time, but they got most of it back. It eventually went to the Supreme Court. The Supreme Court just reiterated what McCulloch versus Maryland did. And that’s the fun fact.

But there’s one other fun fact in all this. McCulloch, the officer for the Bank of the United States in Baltimore, a week after the court decision, he’s arrested for embezzlement and fraud. Somehow, I couldn’t figure out exactly what it was all about, but it involved the stock of the Bank of the United States.

Chuck Soder:
And we think our news cycle can get crazy sometimes.

Owen Humpage:
Yeah.

Chuck Soder:
Okay. And actually, one more thing I want to ask, and if you guys have questions and want to start moving toward the microphones in the room, please do so. You touched on physical cash in the 1800s. And I want to spell it out a little more clearly.

That period before the Civil War when banks were literally printing what we would call or think of as paper money, they were basically IOUs. As you can see on the images, they had the names of the banks on them. They didn’t look anything like today’s dollar bills. Thousands of these were out in the wild circulating. And the way I understand it, not all of them were worth as much as the face value and things like that.

But around the Civil War, that stopped. And you and I discussed this briefly, and I kind of thought of it as the government taxing bank printed money, but I might be a little off there. But how’d the government put a stop to this, and why?

Owen Humpage:
All right. Okay. So all these banks issued these notes. And if you were in a town like Cleveland, say in 1840s or ‘50s, and you got these bank notes, they were generally on, notes on banks right around you. And if you wanted to redeem them, if you thought some bank wasn’t very good, you can redeem them. But generally, in your general location, the banks, the notes always traded at their face value. But as you moved farther and farther away from the bank that issued the note, to redeem them became expensive. So they didn’t trade at their face value. They were discounted. And the discount was bigger if there was any information out there about the bank that issued them that wasn’t good. And at the time, they would publish these little things that listed all the banks that they knew about and the value of

their notes. They'd routinely do this, and they had brokers that would redeem them. All right. But they were discounted. Okay.

So now shift up to the late 1850s and early Civil War. The Secretary of the Treasury at the time was Salmon, named after a fish. God, now I forgot his last name because I was making fun of him. Yeah, Salmon Chase. Thank you. All right.

So, now remember at this time, the railroad had already reached the Mississippi River, and I think they had ways to get it on the other side. I'm not sure. Anyway, so if you traveled, say, from New York out to St. Louis, what kind of notes would you take? You could take gold coin, but that's really heavy, and silver coin is even heavier. And it's dangerous to carry a big amount of that around. If you didn't have notes from a well-established bank in New York City, you were basically, to use the technical term, screwed. All right. So you'd have to get notes.

So Chase became governor of Ohio. And when he became governor of Ohio, he was pushing to have a national currency, issued by the federal government, I believe.

All right, so the Civil War comes along. In the Civil War, we go off the gold standard. Chase sets up the national banking system. He makes the national banks, if they want to issue notes, they have to buy Treasury bonds to back the notes. So the idea here was to get bigger demand for Treasury bonds that they're selling during the war.

That's one explanation for the notes, but I actually think Chase wanted a national currency, and other people wanted a national currency. So we got the national bank notes for those two reasons. They needed a national currency, and Chase needed money to finance the war. Thank you.

Chuck Soder:
Thanks, Owen. Okay. I need to see some people lining up with their questions. And we also have questions from the online audience. Emily, you want to start with something there?

Emily Kalina:
Yes. I'm monitoring the online questions. And so here's one that came up. How volatile were pre-Fed prices?

Owen Humpage:
Great question. I was afraid the first question would be: is that guy real for real? Anyway, so if you look, at home for my work, I have a chart of the US price level, and I have a chart of the British price level. So the United States had a huge inflation during the Civil War. And it took from that time until 1896, the prices came down from the 1865 down to about 1896. There was a little period in the 1880s when it was kind of flat, but then it came down again.

Then it turned around, because in 1896, gold was discovered and ways to get more gold out of ore were discovered, and the money started, more funds started coming in the United States. And then the price level marched back up to almost the period, to where it was in 1870. And it was a little bit volatile in the United States along that path.

Britain followed a similar path, but it started later. So it went down for a while and then came back up. But what struck me about the British price level, it was actually very volatile. At least I thought so. So they were volatile.

The gold standard doesn't guarantee that you'll have a stable price level. What it guarantees is two things: that governments won't screw around with a price level in the long run, and the other thing it guarantees is that the exchange rate will be very stable, and exchange rates under the gold standard were very stable and encouraged international trade and transactions.

Chuck Soder:
And to build off of that, I get the sense that there were more deflationary periods where prices would be dropping during the 1800s.

Owen Humpage:
From 1865 up to about the 1880s, there was a deflationary period, then a period when it was kind of stable, and then another deflationary period to 1896.

Chuck Soder:
Gotcha. Okay. We'll go in the room to this gentleman.

Speaker 4:
Thank you. We're not on the gold standard right now, and I don't believe we ever will be again. So the question is, does that big pile of gold down at Fort Knox in Kentucky, does that serve any monetary purpose? Or if not, what should we do with that immense amount of gold?

Owen Humpage:
I really don't know. I though Goldfinger got it, but I guess that's not true. Yeah. So I actually went to the Federal Reserve Bank of New York one time, and I saw their gold holdings. And they hold a lot of gold for other nations and they have it deep down underground. And what they-

Chuck Soder:
Don't give them any information that's going to help them get access.

Owen Humpage:
But if France wants gold, sells gold to Germany, they take some bars and they move it to the German bin. But I really don't know what... They won't go back on a gold standard, I'm pretty sure.

Chuck Soder:
We'll go to another fellow in the room.

Speaker 5:
Can you speak a bit about the creation of the FDIC?

Owen Humpage:
Actually, no, I can't.

Chuck Soder:
Yeah. That's... We're the Federal Reserve, so...

Owen Humpage:
I'm sorry. There was a lady I worked with here for many years and she went to the FDIC, but I haven't seen her in decades.

Chuck Soder:
Let's go online for one. And you are obviously welcome to still join us at the microphones in the room.

Emily Kalina:
Okay. This came directly from online. I'm fascinated by the decision to not renew the first two 20-year federal bank mandates. And to what extent this was merely politically driven versus a belief that the model could not work?

Owen Humpage:
The model seemed to work. I mean, you have to put yourself back in the early 1800s, but the model worked pretty well, it seemed.

When the First Bank was going to be terminated, people would write memorials, that's what they called them. And they would say, "Well, the First Bank made the monetary money markets very stable." And the Second Bank, same thing. People said it was very stable. So, of course, this was political because they went through Congress arguing about the unfair competition.

The other thing though, if you read about the First and Second National Banks, you'll see two arguments routinely made when they want to get rid of these institutions. The first argument, and these are basically political and they're both specious. The first argument they kept making was, it's not constitutional. Andrew Jackson, when he wanted to get rid of the Second Bank of the United States, said that in his inauguration. And then he did everything he can repeating that over and over again. "It was not constitutional."

Everything that happened from the beginning of the First National Bank to the ending of the Second National Bank said it was Constitutional. And here's why. When one of these banks wanted to open a new branch, they had to get permission from Congress, it turned out. Congress approved the branch. Must be constitutional.

The Congress actually wanted the First Bank of the United States to open branches in Washington and in New Orleans after Louisiana Purchase. The bank didn't want to do that, but they did it. McCulloch versus Maryland. The Supreme Court said it was constitutional.

Madison, who was against the First National Bank, was all for the Second National Bank. So that constitutional argument you'll see in every book you read about these banks is specious.
And the other one is this. They complained that they were foreign owned. Well, indeed, foreigners owned a lot of stock in the national banks. The banks of the United States, it was a good investment. The British owned a lot of the First Bank, right at a time when we were having discussions with Britain about their seizing guys off our boats.

But here's the bottom line of that. Foreigners who owned stock couldn't elect directors, and they had no role in the decision-making process of the banks they held stocks in.

So both of those arguments are specious. And that's why I didn't bring them up in my discussion.

Chuck Soder:
All right the gentleman over here.

Owen Humpage:
Thanks for waiting.

Speaker 6:

Yes. Thank you. Being a historian, you're being a historian. Maybe you could put some clarity on this. You talked about recessions and inflation in the 19th century and the 20th century. Even the 21st century, we have ups and downs. And I guess how would you explain to the average American now we're better off with the Federal Reserve or not? How would our lives be better with it, or without it? I hope that makes sense.

Chuck Soder:
And I guess I would ask Owen to frame it in the historical lens that he is known for.

Owen Humpage:
Oh, maybe I could stand on my head too.

Chuck Soder:
Well, I mean, you talked earlier about that we don't have an elastic currency.

Owen Humpage:
Are we better off with a Federal Reserve Bank?

Speaker 6:
Yeah. Can you explain how we're better off, as opposed to not having a Federal Reserve?

Owen Humpage:
All right, here's my argument. There are 12 Districts. There are a number of things that go on now that didn't exist in the last century. We have 12 Districts. Each District focuses on the economy.
So point one, GDP, inflation rates, all the information we get, that lags. GDP comes out at the end of the quarter and it's revised the next two months. Inflation comes a little after the month it pertains to. But the Federal Reserve, through the Districts, engages with all people in the District and they often get information that gives them a clue of what's going to happen ahead of time. So that's one thing I think the Federal Reserve does that didn't exist before.

The second thing that we do is, each of the Federal Reserve banks have their own research staff, and they have different opinions about things in the economy, especially how monetary policy works, how stuff happens, whether we should intervene in the foreign exchange markets or not. And this creates a kind of competitive argument between the banks that wouldn't exist if it was monolithic, like in the 19th century. There's a lot of that going on. Widely different opinions. Yeah.

Chuck Soder:
And that addresses the regional side of the... I'll give you a teaser at the end. There'll be more to learn about the regional structure of the Fed. But just going back to the original reason for the founding, to me, from our conversations, the prevalence of bank runs was a huge problem.

Owen Humpage:
Oh yeah, sure.

Chuck Soder:
And then the inelasticity of the currency, there just sometimes wasn't enough to go around, which created a lot of problems. I mean, you've addressed that in your talk, so maybe that's relevant.

Owen Humpage:
Yeah. So we have a more elastic currency I would say, but some of the bottom stuff you could legitimately raise an issue. I mean, we still have recessions. We still have problems with inflation and

deflation. So why is this different? Well, I think it actually works much better, despite its flaws, than anything that existed in the 19th century.

Chuck Soder:
So if anybody else has questions, though, we definitely want to stay in the history realm because that's what I'm authorized to talk about here today. We have another fellow coming up. We'll get a question here and then we'll check online.

Speaker 7:
In the 1920s, Federal Reserve built 12 regional headquarters buildings, and each of these buildings featured a big, monumental main banking floor. And these were built presumably for face-to-face banking interactions. And who were the customers that traveled to the regional headquarters to do business at the Federal Reserve Banks, and how and why did that come to end? When did that come to an end?

Owen Humpage:
Great question. When I first started here, that's in November of 1973, that situation still existed. And one of the first things they did when I got here, it wasn't my responsibility at all, they made me learn to fill out a form for a person to buy a Treasury security. They sold these securities in the main lobby of this bank. And they did that because the interest rates on Treasury securities went through the roof the year before, and mobs of people came into the bank trying to buy these securities. And so they were afraid that another mob might come in. All right.

So they sold securities over the counter. I don't know what kind. I think they sold all different kinds. People would come into the bank occasionally. They would have bags of money that got burnt because their house burnt down. We would convert that into new currencies if they had more than 50% of the bill.

So people could come in for currency transactions. They'd come in, they want the new quarters or something, all sorts of things. And other things I just might not know about. But you're right, they did face-to-face operations with general public.

Chuck Soder:
Any more online that you-

Emily Kalina:
Sure. We have a question that came in that is asking: where did the Treasury get the money to deposit the money in the various state chartered banks in the 19th century, since there was no federal income tax?

Owen Humpage:
So they had taxes. Most of the money, and throughout most of the 19th century, I think before the Civil War for sure, more than 50% of the money came through custom duties. We'd import stuff. The guys importing would have to pay custom duties. Those custom duties, incidentally, would go directly into the Treasury.

We also had taxes. And the interesting thing about taxes, some of the general taxes that we had, specific taxes, so some guy would collect these taxes, different guys throughout the countries, they would put them in a bank initially, and then Treasury would draw it out of the bank.

And when we issued debt, the money from the debt would go into a bank initially. The bank that generally brokered the debt, and then the Treasury would pull it out. So from taxes and if we borrowed, that's where they would get that money.

Chuck Soder:
And we have time for one more question and we have one more man standing in the room here. All right. Perfect.

Speaker 8:
Awesome. First, thank you for your time and your insights. I was curious if you could provide a historical overview on the Federal Reserve's approach when it comes to public communication, given there may be a change in the future with Fed dots and projections. So would love your thoughts there.

Chuck Soder:
Well...

Owen Humpage:
This guy is an expert on that.

Chuck Soder:
Yeah. Well, expert to the point where I know what to say, which is what I cannot say. If you've viewed any of Kevin Warsh's recent statements, he's mentioned that there is a committee that's been formed to study how the Fed communicates, which includes some of the things you mentioned. And this year the committee's hoping to make its recommendations, which then the Federal Open Market Committee, which is the group that votes on the federal funds interest rate, then they will consider those recommendations. So we will see what comes out of those committees.

Owen Humpage:
Can I add something?

Chuck Soder:
And you can, as long as you don't go any further than I've gone.

Owen Humpage:
All right. So, if you're interested in economic history, there's lots of stuff that the Fed publishes that would help you. So if you're interested in Fed history, Google Fed history. And it's run out of the Richmond Fed, I believe, or the Chicago Fed. I'm not sure if they switched it, but it has lots of stuff, written for the general public, about Fed history.

And then, the various Federal Reserve banks publish stuff. Often they will have some historical stuff in it. Some of the best economic history is in their reviews, articles.

Chuck Soder:
Yeah. We even have researchers on staff who still study history to help us understand the present, which is what Owen has done for his career. And we got a guy named Ned Prescott does a lot of that here. So yeah, keep reading, keep learning. And now thank you for your question.

And I'm going to wrap us up. Owen, thank you so much for your time and this discussion. I know I really enjoyed it. Before we wrap up though, a few things. First, we'd love to hear your thoughts. If you're online, there's a survey link in the chat. It'll also pop up in your browser after the program ends.

And keep an eye for a follow-up email, all of you, which will have info about today's program and that will also have the survey link. So if you here in person want to fill out the survey, please do. It helps us a lot. Your feedback helps us figure out how to make sessions like this better.

If you want to watch this program, or listen to any of our past *Fed Talk* programs, go to clevelandfed.org/fedtalk. If you're a podcast person, search your favorite podcast platform for the phrase, "*Fed Talk*."

You can get all of them in audio form. And also September 14th, you'll see on the screen we're going to have, it's not quite a part two to this, but it kind of is. Owen's going to be back. We're going to talk a little bit more about the creation of the regional banks, the Fed's regional structure. So you're going to hear about why there's a Federal Reserve Bank here in Cleveland, and why there are Feds scattered across the nation, and why that still matters today.

So please, please check it out. Also, I promised I'd tell you something about The Wizard of Oz. Some historians have argued that the original book is an allegory, representing the debate over whether to add silver to the money supply, silver, gold.

If you're here in person, you may have gotten one of our pamphlets. If you didn't get a pamphlet, be sure to grab one from the tables outside before you go.

And with that, I think we are done. So thank you for spending time with us. Have a great rest of your day. And for those of you who signed up for a tour, you'll find your tour group right over here. Thank you.