The Constitutional Law of Money

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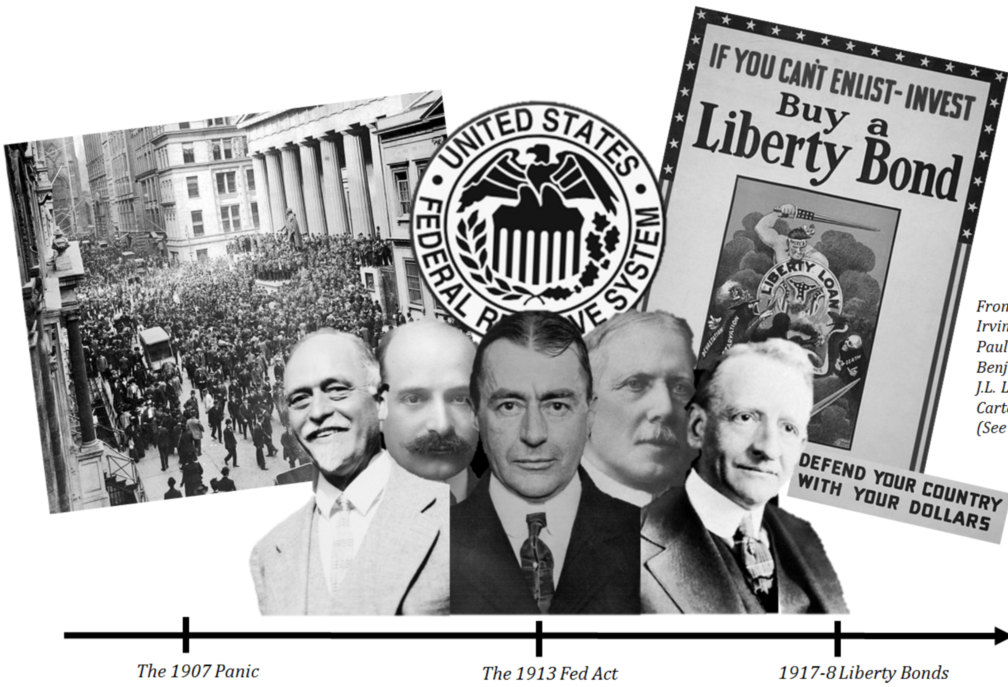
Class 14:
The Fed's Infancy: Born of a Panic, Learning to Walk in War (1907-1917)



From left to right:
Irving Fisher;
Paul Warburg;
Benjamin Strong;
J.L. Laughlin;
Carter Glass
(See Mehrling Reading)

Readings (total: 26 pages)

Part 1: The 1907 Panic

Jon Moen & Ellis Tallman, The Panic of 1907, Federal Reserve History (2015) [URL]

Part 2: The Federal Reserve Act of 1913

Perry Mehrling, Retrospectives: Economists and the Fed: Beginnings, The Journal of Economic Perspectives 16, no. 4 (2002): 207-218 [URL]

Part 3: World War 1 Finance

Kenneth Garbade, Birth of a Market: The US Treasury Securities Market from the Great War to the Great Depression (MIT Press 2012)

Lester Chandler, Benjamin Strong: Central Banker, (Brookings Institute 1958)

For in class reference (will be distributed as handout)

Federal Reserve Act of 1913, Sec. 13 (discounting), 14 (open market operations), 16 (note Issue), 19 (reserve requirements).

Glossary: "Margin Requirements"

The Chandler reading discusses how the "Money Committee," led by Benjamin Strong (first governor of the New York Fed) decided to raise the amount of "margin" required on banks' call loans to New York Stock Exchange brokers.

In simple terms, "margin" refers to the amount of excess collateral that is available to a lender over and above the amount of the loan (today, the term "haircut" would often be used). For example, under a 20% margin requirement, a broker pledging securities collateral trading at a value of $100 can borrow up to $80 against that collateral (=$100–20%*$100). In this way, the raising of margin requirements is analogous to reducing the maximum amount that can be lent to brokers (e.g., with a 30% margin requirement, a broker would only be able to borrow $70 in our previous example).

Background:

The Federal Reserve Act of 1913 is a dramatic event that has reconfigured the relationship between the banking system, capital markets and public finance. The immediate backdrop for the creation of the Fed was the Panic of 1907 and the severe economic contraction it brought. To many reformers, the panic was the result of a series of long-standing structural weaknesses in the U.S. monetary system. These weaknesses included the pyramiding of bank reserves in the large New York banks, the employment of these reserves in "call loans" to New York Stock Exchange (NYSE) brokers and the absence of a lender of last resort that could expand the monetary base to avert crisis.

The 1913 Federal Reserve Act attempted to address all these structural weaknesses. The Federal Reserve System was to replace the New York banks as the pinnacle of the payments system (Sec 19 of the FRA). Instead of using its liabilities to fund call loans to

NYSE brokers, the Fed was meant to invest primarily in "commercial paper". As provided in Sec. 13 of the FRA, commercial paper represents short-term borrowing by the real economy (commerce agriculture and industry) as opposed to speculative borrowing to purchase long-term securities. The Fed could provide liquidity to its member banks by "rediscounting" their commercial paper and expanding the monetary base (Sec. 13 of the FRA).

Barely three years had passed since the Federal Reserve banks opened their offices when the U.S. entry into World War I unsettled the careful design of the 1913 Act. Instead of rediscounting short-term commercial paper, the Fed soon acquired a pivotal role in the Treasury's massive program of war finance. From an initial public debt of only $1 billion, $17 billion in Liberty Bonds were raised from the public in a little over a year. As one economic historian recently noted "This was a time when $17 billion was an almost unthinkably large number. An equal share of gross domestic product today would amount to $6.3 trillion."[1] Once the Great War was over, the liquidity channeled by the Fed to the public securities market would ironically find its way back into the call loan market so dreaded by the framers of the Fed Act.

Discussion Questions:

1. What is the analogy Moen & Tallman draw between the Panic of 1907 and the Financial Crisis of 2007-2009? What role does the payments system play in their analogy? In what sense do the historical trust companies resemble modern "shadow banks"?

2. According to Mehrling, what was the "real bills doctrine" and what was its political significance for the passage of the Federal Reserve Act? What type of credit was that doctrine meant to favor?

3. What are the main distinctions Mehrling draws between the monetary reform visions of J.L. Laughlin, Irving Fisher and Paul Warburg? How do these distinctions map onto Mehrling's discussion of the "banking principle" and the "currency principle"?

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[1] See Richard Stuch, Liberty Bonds, Federal Reserve History (2015) [URL].

4. According to the Mehrling and Chandler readings, what is the significance of the Fed's open market operations with treasury securities as they developed after World War 1? Which reformer's vision does this development most closely represent and why? What departure does this mark from earlier thinking at the Fed?

5. According to Garbade, in what ways did the Federal Reserve facilitate the Treasury's floatation of Liberty Bonds during the war? In what ways did the Fed refuse to support the Treasury?

6. According to the New York Fed (Garbade, p. 141):

   > "[The sales of Government securities] always exceeded in volume the savings available at the time, and therefore, could only be absorbed through recourse to bank loans [to purchasers of the bonds] for a considerable part of each issue. In fact, 'borrow and buy' was one of the slogans common to all of the later loan campaigns."

   What is the role of bank lending in enabling the marketing of new securities? Can endogenous money theory help us articulate this role?

7. In p. 132 of the Chandler reading the author laments:

   > "How different might have been monetary policies in the late 1920's if the prevailing philosophy had been different, and the federal reserve had resurrected the wartime technique of controlling margin requirements in order to restrict loans on stocks without restricting credit for domestic business and international loans"

   What is the relationship between Chandler's remarks and the new reality of Fed rediscounting of government securities following World War 1?