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Federal Reserve

America's central bank, called into being by the Federal Reserve Act, which President Woodrow Wilson signed (using four gold pens) on Dec. 23, 1913.

The act projected an institution to "provide for the establishment of the Federal Reserve banks, 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, and for other purposes."

It's unlikely that the founders of the Federal Reserve would recognize their own handiwork if they could somehow inspect it from wherever it is the progenitors of central banks go after they die. Perusing the Fed's Web site, they would read that the first purpose of the institution they conceived is to conduct "the nation's monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices."

In 1913, the concept of a "macro economy" was yet unarticulated. Neither had the idea of "monetary policy" been hatched. As the gold standard was still in place, the principal duty of a central bank was to exchange currency for gold and gold for currency at the statutory rate (a dollar was defined as a little less than one-twentieth of an ounce of gold).

"Full employment"? Not until 1921 did the Department of Labor make its first official survey of national employment conditions. "Stable prices"? Here the founders—notably Rep. Carter Glass, a Democrat from Virginia, the chief legislative sponsor of the Fed—would nod in recognition, for there was popular grumbling in 1913 about the high cost of living. But the idea that the central bank, by means of discretionary purchases of massive volumes of government securities and federally guaranteed mortgages, should target a certain rate of inflation would be incomprehensible. Still more daft to the founders would be the vision of a Federal Reserve note uncollateralized either by gold or by self-liquidating commercial paper. In debate in the House of Representatives, Glass snorted in derision at the charge that the Federal Reserve would produce "fiat currency."

The authors of the Federal Reserve Act envisioned an institution that would function passively. It would not print money but rather make it "elastic" by expanding and contracting the supply of currency according to the needs of trade. It would forestall panics by centralizing the nation's gold reserve and by lending to banks in times of financial stress, though only to solvent banks presenting good collateral. Manipulating interest rates and conducting open market operations in order to steer the American economy was not the approach Glass had in mind.

But the founders never really got the central bank (or rather, as they insisted, the decentralized central bank) of their imagining. The classical gold standard perished in World War I. Under Benjamin Strong, the Federal Reserve Bank of New York, then as now the flagship bank of the Federal Reserve System, took up open market operations to smooth out bumps in the business cycle in the 1920s. Gone was the original doctrine of central-bank passivity. Came the Depression and more of the founders' ideas went by the wayside. The coming of federal deposit insurance in 1933 marked the beginning of the long-running trend to socialize banking risk.

H. Parker Willis, Glass's right-hand man and first secretary of the Federal Reserve Board, let the evolved Fed have it with both barrels in his 1936 book, "The Theory and Practice of Central Banking." Central banks. . . ," wrote Willis, "will do wisely to lay aside their inexpert ventures in half-baked monetary theory, meretricious statistical measures of trade and hasty grinding of the axes of speculative interests with their suggestion that by so doing they are achieving some sort of vague 'stabilization' that will, in the long run, be for the greater good."

Well-wrought words but futile: "Stabilization" has become the modern central-banking watchword. Thus, the Fed has been Johnny-on-the-spot following financial disturbances ranging from the 1987 stock-market crash to the 1994 peso devaluation to the 1998 Long-Term Capital Management crisis. It has, of course, intervened in unprecedented ways in the debacle of 2007-09. On Jan. 2, 2008, the sum of the Fed's earning assets, known as Reserve Bank credit, footed to $891.7 billion. By Oct. 22, 2008, the sum had more than doubled to $1,803.3 billion. A balance sheet that was 95 years in growing to not quite $900 billion was only 294 days in doubling. It did so in the joint causes of stabilizing the overleveraged American economy and of defending the solvency of the banks and other financial institutions judged too big to fail.

In 1991, the Truth in Savings Act was passed to enlist the Fed in the cause of protecting thrifty Americans against deceitful financial advertising. But after decades of aggressive financial market interventions, savers now earn interest rates hardly worth being deceitful about.

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