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A history of central banking in the United States, 1791–1991

Klatil, Milada, Ph.D.

City University of New York, 1994

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A HISTORY OF CENTRAL BANKING IN THE UNITED STATES

1791-1991

by

Milada Klatil

A dissertation submitted to the Graduate Faculty in Sociology
in partial fulfillment of the requirements for the degree of
Doctor of Philosophy, The City University of New York.

1994

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This manuscript has been read and accepted for the Graduate Faculty in Sociology in satisfaction of the dissertation requirement for the degree of Doctor of Philosophy.

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PREFACE

The purpose of this thesis is to find an answer to the following question: How is it possible that in a modern democratic country such as the United States, a statutory majority of five votes on the semi-private Federal Open Market Committee, comprised of seven members of the Board of Governors of the Federal Reserve System and the presidents of five of the twelve district banks, decides monetary policy which profoundly affects the whole nation.

By modern democratic country I mean a country where the principles of democracy have been extended from the social and political fields into the economic field. The essence of democracy is the informed consent of the governed and full consultation before decisions. Because monetary decisions affecting all the citizens are made with only tangential and easily ignored Congressional and public involvement, it can be said that the Federal Reserve System is an anomaly in modern democracy and a contradiction to an open society. In contrast to monetary policies which are determined largely in secret, fiscal policies are publicly debated and determined in a give-and-take process between the executive and the legislative branches of government. The control over monetary policies exercised by the Federal Reserve can

offset the effects of fiscal policies as determined by a democratic process responsive to collective societal needs.

To find an answer to my question, I investigated the history of banking in the United States. The present central bank's structure and functions were laid by Alexander Hamilton when he created the First Bank of the United States in 1791, notwithstanding Thomas Jefferson's opposition. This study focuses on the assumptions underlying the central bank's policies, the effects of the bank's decisions on social order, and the 200-year debate between the Jeffersonians and the Hamiltonians concerning the banking system and the issuance of currency.

This dissertation covers the years 1791-1991 and has two parts. Part I covers major developments in U.S. banking from 1791 to the end of the 19th century. Part II starts with the creation of the Federal Reserve System in 1913, analyzes the Banking Act of 1935, evaluates the system after fifty years' existence, and discusses the 1991 Congressional proposals for reform of the Federal Reserve System. The final chapter sums up the history of U. S. banking of the past two hundred years and discusses the two conflicting socioeconomic schools of thought which from inception have struggled to dominate U.S. society: the populist school,

starting with Thomas Jefferson, and the technocratic school, starting with Alexander Hamilton.

The power and permanence of the Federal Reserve System can be understood as resting on an interrelation of Max Weber's three ideal types of legitimation. According to Weber, power can be legitimated by legal, traditional, or charismatic rule. The central bankers legitimize their authority over money through laws enacted by Congress, through tradition and through their claim to possess special knowledge, as illustrated in the 1935 and 1964 Congressional hearings. The adjective "Federal" enhances the System's legitimation by associating it with the government that possesses a great deal of legitimacy. The legitimation of the Federal Reserve System rests on tradition--the prescription for central banking was first formulated in 1791 by Alexander Hamilton and incorporated into the present system in 1913. The Federal Reserve System is taken for granted by the public; it is part of an established order. Charisma is a powerful social force in the process of legitimation as illustrated by Paul A. Volcker, chairman of the Board of Governors of the Federal Reserve System from 1979 to 1987. Since the operations of the central bank are only dimly understood and are shrouded in a great deal of mystery, Volcker was revered for his esoteric knowledge of finance and hailed as a "wunderkind" by Congress, the press and colleagues. In the

opinion of some commentators, Volcker's strong leadership reinforced the System's independence from the government, and his monetary policies of high interest rates hastened the fall of President Jimmy Carter.

My study documents the impact of the two fundamentally different and conflicting schools of thought -- the populist and the technocrat -- on national policies. It documents the trend toward technocratic rule and the retreat of the populists from the public scene in the first half of the 20th century. The public discourses and controversies between the two cultures, coexisting in the 18th and 19th centuries up to the beginning of the 20th century, contributed to a general understanding of social issues. After 1913, the populists' diminished influence narrowed the concept of social reality and gave way to the ascendancy of technocratic rationality. In 1925, Franklin Delano Roosevelt called for a return to Jefferson: "Hamilton we have today. . . . Is there a Jefferson on the horizon?" (Abbott 1990, 4) In 1935, the new Banking Act expressed the technocratic orientation of the country by turning control of the money supply over to the Federal Open Market Committee (FOMC), a semi-private group of twelve members with heavy representation of financial and industrial interests. The FOMC administers the single most powerful tool of money supply -- the selling and buying of government securities. It has been

called "the most powerful group of private citizens in America." The centralization of monetary policy in the hands of FOMC in 1935 increased the power of the technocrats and decreased public oversight over money supply policy. It was thus contrary to the intent of the Federal Reserve Act of 1913.

My conclusions are corroborated by Neil Postman, professor of Communication Arts at New York University. In his book Technopoly, Postman juxtaposes two opposing world views -- the technological and the traditional -- which coexisted and competed with each other in the 19th century. With the rise of technopoly, defined as "totalitarian technocracy," the traditional world "disappeared" in the 20th century because "technopoly eliminates alternatives to itself." While Weber foresaw that bureaucracy would replace all traditional forms of social organization in the western world and lead to an "iron cage," Postman's technopoly is the "iron cage" of today's reality. In my analysis, the deviation from Jeffersonian principles of democracy is a consequence of the First World War and the ensuing depression on one hand, and structural shifts in society, changes in societal attitudes and a growing reliance on specialists on the other hand.

My typologies of the populist and technocrat socioeconomic cultures were inspired by Max Weber's concepts of substan-

tive and formal/instrumental rationality and his prediction of a totalitarian technocracy ruled by "specialists without spirit, sensualists without heart." Formal rationality operates in the field of economics, is driven by material interests and is concerned with calculating the most efficient and precise means toward the attainment of goals. It is oriented to short-term goals which are specific, achievable, measurable, and time limited. "It follows from this that instrumentally-oriented action will always favor adaptation to given social conditions, rather than challenge them." (Mommsen 1989, 152) Formal rationality is in conflict with substantive rationality. The latter is oriented toward "non-everyday" values and is not restricted by rational calculations; in contrast to formal rationality, it "is full of ambiguities" and incompletely known facts that cannot be expressed in mathematical terms. Substantive rationality judges the results of economic action "against the scale of value rationality" involving an infinite number of possibilities, among them social justice and equality. It implies "certain criteria of ultimate ends, whether they be ethical, political, utilitarian, hedonistic, feudal (staendisch), egalitarian, or whatever." (Weber 1978, 1:85)

In the case of money and capital accounting, the formal perfection in a free-exchange economy inevitably results in deviation from substantive standards of the satisfactory provisions for the economic wants of a population, as well as in deviation from standards of distributive justice and the like. (Barnes 1948, 302-303)

I claim that the rule of the technocrats, grounded in formal/instrumental rationality, permeates the general way of thinking in contemporary U.S. society. My argument is supported, among others, by the theories of social thinkers such as Harold Garfinkel, Vaclav Havel, President of the Czech Republic, and Neil Postman. They claim that by acquiescing we promote and maintain the system we live in, thus we are no longer its victims. For these social thinkers, the new despotism emerges primarily not from government or a specific class, but from the technocratic system itself. By failing to exercise our own volition and our own choices, we strengthen the rule of the technocrats. These social thinkers share a common concern with Weber: how can individuals preserve their freedom and independence in a technocratic society? They place their hope in human nature, which they claim cannot be totally controlled or predicted. For Weber, social change originates in a charismatic leader who will break through the "iron cage" of a totally rationalized bureaucracy by introducing new values, new orientations and new commitments which will then be infused into the mainstream of culture by his followers. For Garfinkel, social change occurs when people refuse to accept and maintain the status quo and its justification. Postman and Havel see social change as the restoration of democratic practices which reject "mechanical petrification." Like Jefferson, they see popular rebellion as a good and necessary event. In

a letter to James Madison of January 30, 1787, Jefferson wrote:

I hold it, that a little rebellion, now and then, is a good thing, and as necessary in the political world as a storm in the physical. . . . It is a medicine necessary for the sound health of government. (Koch and Peden 1972, 413)

When Weber visited the United States in 1904, he noticed the acquisitive nature of American culture and the instrumental foundation of capitalism:

The pursuit of wealth, stripped of its religious and ethical meaning, tends to become associated with purely mundane passions, which often actually give it the character of sport. . . . For of the last stage of this cultural development, it might well be truly said: "Specialists without spirit, sensualists without heart; this nullity imagines that it has attained a level of civilization never before achieved." (Weber 1958, 182)

Weber saw the basic character of capitalism as grounded in formal/instrumental rationality. The same form of rationality also characterizes the Federal Reserve System's technocratic approach to national monetary policy. This approach contrasts with the substantive principles of a rationality of human needs. Following Weber's analysis, the System is rational in terms of formal rationality but irrational in terms of substantive rationality, because it elevates the means to the place of ends. For the technocrats--the followers of Hamilton--the drive to increase material wealth through scientific progress, efficiency, order, and discipline takes precedence over other issues. In contrast the

populists--the followers of Jefferson--emphasize substantive rationality which evaluates economic goals in the light of ethical merits and moral standards. The populists do not separate economic issues from moral issues; for them, economic decisions require not only intellectual capacities but moral qualities as well.

I have traced the two contrasting movements in the American culture through the history of central banking. My documentation of the influence of ideas and beliefs on economic decisions challenges the claim made by the leaders of the Federal Reserve System that their policies are based on objective, value-free judgments.

METHODOLOGY

This dissertation is a culmination of my long-standing interest in central banking in the United States. It is structured in accordance with the six phases of the heuristic methodology and applications presented by Clark Moustakas in Heuristic Research.

1. The initial engagement started twenty years ago when my interest in the Federal Reserve System grew into a desire to find an answer to the question: How is it possible that in a modern democracy, a pre-democratic concept of a central bank prevails? In 1975 I wrote a master's thesis: Banks as Social Institutions, wherein I analyzed the creation of the Federal Reserve System in 1913 and its development through 1964. In 1983, I found it necessary to go deeper and further back into the history of banking in order to more adequately answer my initial question.

2. During the immersion process I read a wide variety of sources and compiled notes. At that stage there was no design and no specific direction except an urge to find the answer to the question of why a pre-democratic concept of central banking still prevails in the United States. The historical approach was a tool that assisted me in finding the answer.

3. The incubation period allowed me to see patterns and relations between events and ideas. By distancing myself from the vast body of literature I had consulted, I was able to recognize and analyze recurring themes.

4. Illumination. At this point I recognized in the present structure and function of the Federal Reserve System an outgrowth of two conflicting philosophies first espoused in this country by Thomas Jefferson and Alexander Hamilton at the time when the First Bank of the United States was being established in 1791. The twentieth-century debates about the power of the central bank and the issuance of currency are a continuation of the 18th century disputes. Inspired by Max Weber's theories of formal and substantive rationality, I abstracted and differentiated the two ideal types of rationality running through U.S. history: the populist and the technocratic. The two ideal types emphasize dominant features, stressing the differences rather than the similarities in each type of rationality. I recognized that wars and financial crises acted as catalysts for Congressional action. I detected a lack of unity and concentrated effort, and an absence of public awareness, as the main obstacles to bank reforms.

5. In the explication phase I looked at the Federal Reserve System from a broader perspective and started to ask

myself: Do we need a higher authority to save us from our boundless desires? The need for an authoritative figure was expressed by several representatives from the financial community at the 1964 Congressional hearings. T.H. Milner, Jr., president of the National Bank of Athens, Athens, Ga., viewed the Federal Reserve as "the father managers of our economy similar to the father of a family" who has to control his wife's and children's never ending demands for money, and "use his best judgment in deciding how the earnings shall be spent, ..." (The Federal Reserve System After Fifty Years, 1964, 3:1707) This view goes against the notion of democratic reliance on the self-imposed discipline of free individuals who can take responsibility for their own actions. A related question was: Who creates social reality? Do we construe it in our everyday lives or are we the players in somebody else's game without the power to shape or influence its structure?

The history of central banking shows the potential political power people possess through the ballot:

The First United States Bank set up by Alexander Hamilton created a powerful class in America but was swept away by the democratic reaction under the leadership of Jefferson. (Chesterton 1919, 102)

In 1835, the Whigs who stood for oligarchy against American tradition and principles "abandoned the Bank's cause on the democratic grounds that the people had spoken against it at

the polls." (McFaul 1972, 76) In 1913, President Wilson won over the opposition of the bankers and financiers because the people were behind him.

6. The final stage of creative synthesis answered the question of how it is possible that in a modern democracy a pre-democratic institution prevails. The history of banking reflects men's thoughts, beliefs, hopes, and fears; it helped me understand the present structure and functions of the central bank. By analyzing the present in the light of the past, I saw how the contending ideas of the populists and the technocrats shaped the political, economic and intellectual style of the country, how the process of centralization put power in the hands of a few men, and how the technocrats won in 1935. This study presents history not as a distant past but as a heritage that lives with us today, and suggests a synthesis of economic, political, cultural and social relations.

The validation process involved checking the historical evidence against the formulated concepts and moving back from the concepts to the evidence.

This thesis analyzes the influence of ideas and beliefs on political and economic decisions, and shows that ideologies

are not a mere reflection of social conditions but acquire
their independent existence.

SOURCES USED

Both the primary and the secondary sources gave me the information and the insight needed to write the thesis.

The United States government documents include bills, laws, Congressional hearings, Congressional Committee reports, debates on the floor of the Congress as recorded in the Congressional Record, Treasury Department reports, annual reports, bulletins, and publications of the Board of Governors of the Federal Reserve System, along with presidential messages, platforms of political parties, biographies, diaries, and memoirs. The 1964 Congressional testimonies published in The Federal Reserve System After Fifty Years, were especially helpful by providing access to the thoughts, beliefs and wide range of viewpoints of fifty witnesses from the ranks of economists, academicians, central bankers, financiers, public officials, labor representatives and delegates from various organizations.

The archives of Wright Patman, the late Representative from Texas, at the Lyndon B. Johnson Library at the University of Texas in Austin, gave me the privilege of sharing an insider's experience with the Federal Reserve. Patman spent 47 years in the House of Representatives, from 1929 to 1976, and 12 years as chairman of the Committee of Banking and

Currency. His fight for the interest of the common man gained him the reputation of "the last of the great Populists." He kept the Federal Reserve representatives on their toes by probing the Federal Reserve activities and pushing for Congressional oversight.

The Presidential papers of Franklin D. Roosevelt and the diaries of his Secretary of the Treasury, Henry Morgenthau, Jr., in the Franklin D. Roosevelt National Archives, Hyde Park, N.Y., helped me clarify some issues related to the Banking Act of 1935.

For comparison with other central banks, I used the Sessional Papers from the Parliament of Great Britain, the Radcliffe Report, the Bank of England Quarterly Bulletin and the History of the Bank of England by A. Andreades. Information about Canada's central bank was found in the Reports of the Royal Commission on Banking and Finance, the Parliamentary debates and magazine articles. The Central Bank-Government Relations in Major OECD Countries, a study prepared for the Joint Economic Committee of the U.S. Congress in 1991, brought me up to date with developments in the central banks of the major European countries.

The secondary sources that contributed to the formulation of my thesis include books and articles written by historians,

economists, political writers, judges, sociologists, bankers, and philosophers.

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PART I

A HISTORY OF BANKING IN THE UNITED STATES:

1791-1913

**CHAPTER I: THOMAS JEFFERSON, ALEXANDER HAMILTON AND THE
FIRST BANK OF THE UNITED STATES**

Thomas Jefferson and Alexander Hamilton belong to history but their opposing philosophies contending for political dominance profoundly affected the future of the nation and are still with us today.

Jefferson and Hamilton were as different in their views on government and human nature, as they were in their personal backgrounds, temperaments, and experiences. Both Jefferson and Hamilton were Federalists and members of George Washington's Cabinet. Jefferson, a wealthy landowner in Virginia whose philosophy of American democracy is embodied in the Declaration of Independence, became Secretary of State in 1789. In the same year Hamilton, a founder of central banking in the United States, an immigrant of humble origin from the British West Indies, and a self-made man, became Secretary of the Treasury. Their beliefs directed their political and social policies.

The Image of Man and the Form of Government

The political disagreements between Jefferson and Hamilton were based on their different views of human nature.

Jefferson's concept of democracy is imbued with the Chris-

tian belief in the dignity of human beings from which the concept of equal social and political rights for all men is derived. The principles embodied in the Declaration of Independence were not new, as John P. Morgan remarked: "They were consecrated theories, but no government had been previously established for the great purpose of their preservation and enforcement." (Lipscomb 1903, xiii) But to fulfill these promises, government needed to be sustained by its citizens. Jefferson, having faith in people's integrity, made them the guardians of democracy. He acknowledged the predatory disposition of man, but this fact was overshadowed by man's inborn moral sense which guided his actions. Jefferson's man governs himself by obeying his own conscience:

The moral sense, or conscience, is as much a part of man as his leg or arm. It is given to all human beings in a stronger or weaker degree, as force of members is given them in a greater or lesser degree. It may be strengthened by exercise, as may any particular limb of the body . . . the Creator would indeed have been a bungling artist, had he intended man for a social animal without planting in him social dispositions. (Koch 1943, 16, 40)

Jefferson emphasized the moral and humanitarian aspects of life; he saw the promise of wealth and the security of the nation not in its vast natural resources but in "the character of the people, and, above all, both an awareness and a resolute defiance of every form of tyranny over the mind of man." (Foley 1967, Introduction.) He trusted man's "innate sense of justice" and his ability to reason and arrive at a

sound judgment, if given the relevant information. However, Jefferson had backup mechanisms should the inner moral guidance fail. In such a case, outside inducements and controls were necessary: an appeal to self-interest, and finally, punishment.

Jefferson founded just government on the consent of the governed and on the accountability and responsiveness of the representatives to their citizens' needs. Jefferson not only formulated the principles of democracy, but endeavored to realize them by widening political participation through suffrage and education. Since his leading principle of democracy was that the will of the majority should prevail, popular education was a practical shield against the intolerance of the majority. Jefferson did not think that all people could be virtuous or most wise, but he was convinced that more knowledge, along with congenial cultural and economic conditions, would produce men who could be trusted with popular government. Jefferson had a holistic approach to society and interrelated its economic, political, social, and cultural aspects. In the Jeffersonian concept of society, economic and political freedoms were the foundation for intellectual freedom. Jefferson's aim was to create a society where the ideals of equality and justice could be effectively translated into reality and where the inherent potentialities of man could be fulfilled. "The energies of the

nation, as depends on me, shall be reserved for the improvement of the conditions of man, not wasted in his destruction." (Foley 1967, 526)

Jefferson feared the growth of impoverished laboring classes in congested cities; for him, this situation obstructed personal growth and independence:

But Jefferson explicitly denied that the manufacturing life was necessarily worse than the life of the farmers, he meant simply that cities and manufactures were undesirable whenever they did not foster the health of the whole man. (Boorstin 1948, 185)

The economic system conceived by Jefferson was founded on the ethical belief that concentration of wealth should not occur at the expense of the weak. Political and individual freedom, along with the coexistence of equality, was the foundation of democracy that must be enforced and preserved by the government. In order for government, the trustee of society, to continue to be just and honest, the active participation and vigilance of the people was required. The diffusion of power in society and a balanced representation of interests were necessary to counteract the excessive influence of the wealthy and central government's encroachment on individual liberties. "Unless the mass retains sufficient control over those entrusted with the powers of the government, these will be perverted to their own oppression." (Foley 1967, 385) Jefferson was aware that a democratic rule could degenerate into oppression in the absence

of public watchfulness, but he had confidence in the power of the people to safeguard democracy.

While Jefferson had faith in democracy and the will of the majority, Hamilton distrusted the common man and feared democracy would lead to a dictatorship of the "ungovernable mob." Hamilton believed that the common man is unfit to govern himself and others because of his stupidity, indolence, and selfishness. He saw the greedy, brutal side of man as an inherent fact of life that could not be perfected by education or improved social conditions. James T. Adams quoted Hamilton in a conversation: "Your People, Sir, your People is a great beast." (Adams 1932, part 2:xii) Hamilton classified the vices of men by social status and preferred the vices of the wealthy because they could be channeled into industrial production with desirable economic consequences: "Their vices are probably more favorable to the prosperity of the State than those of the indigent. . . ." (Adams 1932, 39) Claude G. Bowers, a New York politician, found some justification for Hamilton's distrust of popular government "in the illiteracy of the time, . . . the exaggerated notions of freedom, . . . and the levity with which so many looked on financial obligations." (Bowers 1927, vi) Bowers praised Hamilton's "genius," his powerful logic, oratory and writing skills, his grasp of facts and his knowledge of governmental matters.

Hamilton's pessimistic view of human nature led him to conclude that people in general were incapable of democratic self-government and in need of an elite to do the job for them. Having contempt for the common man and his opinions, Hamilton turned to the rich and the wellborn for advice and support. Whereas Jefferson advocated an equal distribution of power between state and federal governments in tune with a broad variety of interests, Hamilton favored a strong central government under the leadership of the President, and advocated total subordination or even abolition of the states. Reportedly, as Secretary of the Treasury, Hamilton conceived himself as a "Prime Minister" and his dictatorial manners offended Jefferson. Hamilton foresaw a powerful industrial nation through the mutually beneficial linkage of government and commerce interests. Since Hamilton did not believe in the perfectibility of man and in the redeeming influence of education and congenial social structures, he opposed expenditures for public projects as wasteful:

This distrust of the people, contempt for democracy, and reliance on strong government supported by wealth, and, if need be, sustained by standing armies, were carried by him into the Constitutional Convention and there proclaimed with all the tremendous force of his personality. (Bowers 1927, 29)

According to Bowers, Hamilton was a monarchist who never lost faith "in his own plan" for an aristocratic republic or gained "confidence in the Constitution which was adopted."

Hamilton was influenced by Adam Smith's The Wealth of Nations. According to Robert E. Keleher, Adam Smith was popular not only with Hamilton but with many American statesmen and leaders, including Thomas Jefferson and Benjamin Franklin. The Wealth of Nations is considered "perhaps one of the most important supply-side book of all times." (Keleher 1932, 7) Like the supply-side economists, Hamilton measured the wealth of a nation solely by its economic growth and production.

Adam Smith's influence on Hamilton is evident in his "Report on Manufactures":

There is scarcely any thing of greater moment in the economy of a nation than the proper division of labor. The separation of occupations causes each to be carried to a much greater perfection than it could possibly acquire if they were blended. This arises principally from three circumstances.

1st. The greater skill and dexterity naturally resulting from a constant and undivided application to a single object.

2d. The economy of time, . . .

3d. An extension of the use of machinery.

In consequence of it, all the different processes for spinning cotton are performed by means of machines which are put in motion by water, and attended chiefly by women and children; and by a smaller number of persons, in the whole, than are requisite in the ordinary mode of spinning. And it is an advantage of great moment that the operations of this mill continue, with convenience, during the night as well as through the day. . . . To this invention is to be attributed, essentially, the immense progress which has been so suddenly made in Great Britain. (Hamilton 1791, 85-86)

The main concern of both Hamilton and Smith was the creation of capital through increased productivity attained by division of labor and unceasing work. The inhuman working conditions were accepted as an unavoidable necessity. Smith also realized the dehumanizing effects of monotony and harsh labor on the workers; however, he thought it could be softened by education.

Jefferson branded Hamilton as an "Anglomaniac" who slavishly imitated English institutions, and yet, he admired his abilities:

His mind was really powerful, but chained by native partialities to everything English . . . and made them his model in everything; without considering that what might be wise and good for a nation essentially commercial . . . might not be so for one essentially agricultural, and insulated by nature from the abusive governments of the old world. (Foley 1967, 1:396)

In a letter to Edward Carrington of May 26, 1792, Hamilton attacked Jefferson and Madison for their "womanish attachment to France and womanish resentment against Great Britain." (Fried 1968, 37) A group of supporters of the First Bank of the United States, thereafter referred to as BUS I, scorned Jefferson as "a maniac" for his opposition to the Bank. While Jefferson sympathized with the principles of the French Revolution, Hamilton abhorred them; while Hamilton admired conquerors like Napoleon and looked toward England and its commercial culture for guidance, Jefferson was inspired by "humanitarianism, growing out of primitive

Christian morality, English and American Quakerism, and the European enlightenment generally." (Boorstin 1948, 179)

The First Bank of the United States: 1791

Hamilton was keenly aware of the nation's need for capital and stable currency as prerequisites for the growth of commerce and industry. After the revolutionary war there were just a few banks in the country and very little experience in banking. There was no uniform currency since each bank was issuing its own notes. Hamilton turned to the Bank of England for guidance and resolved to create a powerful, stable financial institution, serving as "an engine of paper credit" and "furnishing a substitute for the metals" under the patronage of the government. When England was in distress to fund the war against France, the Parliament in 1694 granted a charter to "The Governor and Company of the Bank of England," a group of private shareholders, for the purpose of raising a capital of one million and two hundred thousand sterling pounds and lending it to the government for financing the war against France. In return, the government paid an interest of 8% to the Bank. Thus the Bank of England was not created by law as a central bank but became one gradually, through its close connection with the government. Originally chartered for twelve years, the Bank survived as a private corporation and as a fiscal agent of the government till 1946 when it was nationalized.

The First Bank of the United States was chartered by Congress on February 25, 1791, under An Act to Incorporate the Suscribers to the Bank of the United States, for the duration of twenty years. Hamilton saw the national bank as a prerequisite to national safety and prosperity: "There is no other that can give to government that extensive and systematic credit which the defect of our revenues makes indispensably necessary to its operations." (Adams 1932, 165)

BUS I started with a capital of ten million dollars and opened in Philadelphia. Four-fifths of the capital was subscribed by private corporations and one-fifth by the United States government. In return, the Bank loaned the same amount, two million dollars, to the government to be reimbursed at annual installments. The government paid 6% interest on the loan and received a 4% dividend. The two million dollar loan to the bank was money transferred from a European account. Hamilton explained his design of borrowing with one hand what he lent with the other. The chief objective of engaging public debt in the formation of the national bank's capital was "to enlarge the specie fund of the bank, and to enable it to give a more early extension to its operations." (Hamilton 1790, 77) The two million dollars of public money provided not only a safe collateral for the Bank's extended loans, but enlarged its profits and

furnished the shareholders with income from the dividends. Hamilton used public money to stimulate the efforts of industry and bypassed demands of "public necessity" that would "most probably be a canker, that would continually corrode the vitals of the credit of the bank." (Hendrickson 1981, 290)

The immediate beneficiaries of Hamilton's plan were therefore the security holding contributors who were quite generally merchants, traders, shippers and manufacturers. (Beard 1943, 122)

Jefferson was critical of Hamilton's plan:

First to lend them two millions, and then borrow them back again, cannot change the nature of the latter act, which will still be a payment, and not a loan, call it by whatever name you please. (Krooss 1969, 27)

According to Krooss, when the government sold its shares in 1802 it paid a total of \$1,200,000 in interest on the loan of two millions and realized a profit of half a million on the appreciated stock.

To secure the cooperation and the expertise of merchants, as a precaution against bad loans and to insulate BUS I from government politics, Hamilton placed the Bank under the private management of twenty five directors elected by shareholders, of whom seven constituted the board. The President of the United States appointed three persons to represent the government.

The directors themselves, being, for the most part, selected from the class of traders, are to be expected to possess individually an accurate knowledge of the characters and situations of those who come within that description. (Hamilton 1990, 60)

By law, the Treasury Department of the U.S. was to be furnished "from time to time" with statements on the condition of the bank. According to John J. Knox, no such reports were ever made to the Treasury, although the Bank was the depository of government funds.

In addition to being a depository of public money, BUS I acted as a fiscal agent of the government: it collected taxes, paid government obligations, assisted the Treasury with loans, and oversaw foreign exchange operations of the Treasury Department. No interest was paid by the Bank and its branches on the surplus government deposits in their safekeeping. Keeping public money, free of interest, in the Bank instead of locking it in the Treasury augmented the capital in the hands of the stockholders who used it for the advancement of commerce and industry. BUS I also assisted state banks with funds in emergencies and forced them not to overextend their operations. In this way, the national bank exercised an indirect control over the state banks.

The BUS I was given the authority to issue notes and create money by making loans amounting to five times its capital in gold and silver. The ratio of 1:5 is equivalent to the 20%

reserve requirement; currently the statutory requirement fluctuates between 10% and 20%.

In this arrangement proposed by Secretary Hamilton and enacted by Congress, three major desiderata were established: one was a permissible expansion of bank credit in a ratio to specie . . .; the second was acquisition by the Bank of adequate specie; and the third was eligibility of the federal government's bonds as a substitute for specie in satisfaction of three-fourths of the amount due from subscribers, other than government, to the Bank's capital. (Hammond 1957, 133)

Hamilton distrusted the elected representatives of the people who, in order to maintain their popularity, would rather print money than levy taxes:

The emitting of paper money by the authority of Government is wisely prohibited to the individual States by the national constitution; and the spirit of that prohibition ought not to be disregarded by the Government of the United States. . . the wisdom of the Government will be shown in never trusting itself with the use of so seducing and dangerous an expedition. . . in great and trying emergencies, there is almost a moral certainty of its becoming mischievous. The stamping of paper is an operation so much easier than the laying of taxes. (Hamilton 1790, 64-65)

Hamilton's conviction that government cannot be entrusted with the power of issuing paper money was shared by the British economist David Ricardo (1772-1823) in his plan for a National Bank:

But I propose to place this trust in the hands of Commissioners, not removable from their official situation but by a vote of one or both Houses of Parliament. I propose also to prevent all intercourse between these Commissioners and ministers, by forbidding every species of money transaction between them. (Ricardo 1824, 13)

Hamilton's plan for BUS I, when first introduced in Congress in 1789, encountered opposition on constitutional and moral grounds. Jefferson and Edmund Randolph, the Attorney General, challenged the constitutional right of Congress to create a privileged national bank, thus depriving state banks of government deposits, crucial to their successful operations. They objected to the federal usurpation of state rights and argued that the power of incorporation was not "expressly" given to Congress and therefore was "reserved" to the states. Hamilton interpreted the Constitution more broadly and referred to the "implied" and the "sovereign" powers of the federal government. Jefferson strongly objected to Hamilton's farming out power over money to a private institution. He saw dangerous political consequences in the creation of a monopolistic bank and a "moneyed aristocracy." "I deem no government safe which is under the vassalage of any self-constituted authorities, or any other authority than that of the nation." (Jefferson 1982, 117)

Jefferson feared that the Bank, in close alliance with its branches, could dictate its own terms and upset the government's stability. By distributing government deposits throughout all state banks, Jefferson wanted to avoid both concentration of wealth and "demands of irresponsible power."

The opposition to BUS I was defeated by a majority in the Congress and President Washington, who had full confidence in Hamilton, signed the bill into law in February, 1791. The debates over the constitutionality and special privileges of BUS I were the prelude to the 19th century "bank war."

Jefferson was against Hamilton's financial system for the present and the future. He feared that once the system was established, we would never get rid of it. His prediction proved to be right. Jefferson was not against a strong central bank, but against a monetary system in the hands of private individuals who would run it for private profit. He objected to Hamilton's giveaway of public money, which had been raised in Europe, to BUS I "to extend the speculation and increase the profits of the institution." (Foley 1967, 1:397) Those funds, Jefferson argued, should have been used to liquidate the American debt there, instead of perpetuating it and passing it on to the next generation. Jefferson further accused Hamilton of creating a tool of power by making a "puzzle" of the financial system which excluded "popular understanding and inquiry" aimed at the "corruption of the Legislature." (Foley 1967, 1:398) According to Jefferson, the deliberate "fogging" of the issue was intended to prevent the President and the Congress from understanding and controlling the system. We see here a foreshadowing of the technocratic justification of rule by experts, which

removes monetary policy from public scrutiny. While Hamilton considered national debt a "national blessing," Jefferson feared that a perpetual debt promoted by the rulers would be a threat to national independence:

We must make our election between economy and liberty, or profusion and servitude . . . This exactly marks the difference between Colonel Hamilton's views and mine, that I would wish the debt paid tomorrow; he wishes it never to be paid, but always to be a thing wherewith to corrupt and manage the Legislature. (Foley 1967, 1:231)

Jefferson and his supporters organized a political movement to oppose "aristocracy" and the special privileges granted to the national bank. They feared this control of concentrated money power and its aspirations would be above the law and the will of the people. This organization -- first called the Republican, then the Democratic-Republican, and finally the Democratic Party -- is the ancestor of the modern Democratic Party.

Conclusion

In the 18th and 19th century banking and control over public money were the central issues in political discussions. Two powerful ideologies of Thomas Jefferson and Alexander Hamilton were expressed in two conflicting visions of the organization of the state. Should the new nation be a monarchy or a democracy? Should public money be used for the expansion of private enterprise or should it be used for public purposes? The diversity of opinions between Jefferson and Hamilton grew out of a different understanding of human

nature, the relationship between external control and self-control, between the political sphere and the private sphere, and the meaning of public interest. In a letter to H. Lee, 1824, Jefferson captured the difference between himself and Hamilton when he described the difference between the Republicans and the Federalists:

Men by their constitution are naturally divided into two parties. 1. Those who fear and distrust the people, and wish to draw all powers from them into the hands of the higher classes. 2ndly those who identify themselves with the people, have confidence in them, cherish and consider them as the most honest and safe, although not the most wise depository of the public interests. . . . Call them therefore liberals and serviles, Jacobins and Ultras, Whigs and Tories, republicans and federalists, they are the same parties still and pursue the same object. (Jefferson 1982, 65)

In 1832, Alexis de Tocqueville visited America and made a similar observation about the Federalists and the Republican or Democratic party. Under the "apparent unanimity" he noticed "profound differences of opinion" and antagonism between the interests of the rich and the interests of the poor:

The deeper we penetrate into the inmost thought of these parties, the more we perceive that the object of the one is to limit, and that of the other to extend, the authority of the people. . . . But beneath this artificial enthusiasm, and these obsequious attentions to the preponderating power, it is easy to perceive that the rich have a hearty dislike of the democratic institutions of their country. The people form a power which they at once fear and despise. If the maladministration of the democracy ever brings about a revolutionary crisis, and monarchical institutions ever become practicable in the United States, the truth of what I advance will become obvious. (De Tocqueville 1863, 1:226-227, 229)

Tocqueville could not decide whether aristocracy or democracy governs the best. "But it is certain that democracy annoys one part of the community, and that aristocracy oppresses another." (De Tocqueville 1863, 1:241)

The disputes as to who should control money, whether Congress or an independent monetary authority, has continued to this day. Hamilton's argument that BUS I had to be insulated from politics because the legislators could not be entrusted with money is continued to this day by the advocates of an independent central bank.

Hamilton's financial system and philosophy have survived and the Jeffersonian voices have subsided. Hamilton is the architect of the present monetary system based on debt. The fractional reserves enable the banks to create new money from loans and expand capital. Yet, Hamilton cautioned against excessive debt and set the reserve requirements at 20% of deposits which the banks had to hold as reserves. Today, the statutory percentage of reserves fluctuates between 10% and 20%. The issuance of money and its control are out of the reach of the legislators, and Congress has to ask banks for money when revenues fall short of expenditures. The interest payments on public debt tend to increase the government's dependence on loans and reach into the pocket of every taxpayer and every state and local chest.

The interest payments on public debt are an indirect regressive tax insofar as a transfer of a large proportion of revenues is made to the bond holders. Ultimately, this state of affairs contributes to economic inequality in American society.

Hamilton's principles and his basic design for the BUS I operating system continue in the present central bank, the Federal Reserve System. Like BUS I, the Fed is isolated from the people and the legislators, it enjoys the privileges of issuing and creating paper money, is the fiscal agent of the government, collects taxes, pays government obligations, assists the Treasury with loans and oversees foreign exchange operations. Like BUS I, the Federal Reserve pays no interest on the surplus government deposits in its safe-keeping.

Although Hamilton placed the Bank under private management, and out of the reach of the legislators, he was in control of national finances as the Secretary of the Treasury and advocated a strong Presidential power. Contrary to Hamilton's designated role for the Treasury and the Executive, the present core policy-making body of the Federal Reserve System, the Federal Open Market Committee, is a semi-private group of twelve men; the power to conduct monetary policy has been delegated to this group. Because of

the Federal Reserve's adamant insistence on independence from elected representatives, their decisions are made behind closed doors and presented to the President and the Treasury as facts. In accordance with Hamilton's central bank structure, the voice of the people's representatives is excluded from the Fed's policies. While the banks and big corporations are represented by the twelve Federal Reserve bank presidents, of whom five have the right of vote, the representatives of government, labor, consumers and small business are absent.

The Jeffersonian era has been interpreted and reconstructed alongside economic, political, social, psychological and philosophical lines. I will mention three authors who tried to recapture the leading ideas of the Jeffersonian philosophy.

Professor Charles A. Beard interprets the contest between Hamilton and Jefferson as the conflict between the spokesmen of capitalistic and agrarian interests:

His [Jefferson's] democracy was founded upon an economic system of small land-owning farmers -- upon that wide distribution of property which was possible only where land was cheap and plentiful. It did not embrace a working class. (Beard 1943, 421-422)

Beard highlights the practical and tactical side of Jefferson's political philosophy. Jefferson was a realist, not a doctrinaire. When he became President, he saw the

advantages of securing the support and cooperation of the financial interests, but differentiated his approach from Hamilton's whose aim was to promote "the interests themselves" and those of "the Federalist party." Jefferson, as the representative of the people, intended "to engage the individuals who belong to them in support of the reformed order of things or at least an acquiescence under it."

(Beard 1943, 445)

Daniel Boorstin, a historian, sees the early American conflict, which we still experience in our own time, as "the discord between the active and the contemplative sides of man's nature . . . between man as maker and man as thinker."

(Boorstin 1948, 3-4) This dichotomy corresponds to Max Weber's distinction between "ideal" and "material" interests or between substantive value orientation and the formal/instrumental attitudes which determine man's actions. Boorstin's purpose has been to revise the concepts of our intellectual heritage:

To get inside the Jeffersonian world of ideas -- to see the relations among their concepts of God, nature, equality, tolerance, education and government. . . and hence toward strengthening the philosophical foundations of a moral society in our day. (Boorstin 1948, xi-xii)

Boorstin agrees with Beard's emphasis on Jefferson's pragmatic nature:

The pragmatic temper of his political philosophy weakened all bulwarks against power. Jefferson's personal contribution to American political institutions (despite his insistence on preserving rights and fragmenting power) was his model of a strong Presidency. Once in power, Jefferson could not but recognize that his negative concept of government was imaginary. (Boorstin 1948, 200)

While we will never live in Jefferson's day,

the Jeffersonian tradition has played and should continue to play a vital and valuable role in American history: it has provided our principal check on the demands of irresponsible power. (Boorstin, xi)

Adrienne Koch, professor of history at the University of California, Berkeley, analyzes Jefferson's social and moral thinking. Koch maintains that Jefferson's political thinking cannot be separated from the other components of his philosophy: ideology, ethics, the law of nature and nations, government and political economy. Jefferson made

an effort to formulate a moral pattern, for both public and private affairs, joining the basic art of living well and living wisely to the special art of good government. (Koch 1943, 2)

**CHAPTER II: THE INTERREGNUM AND THE SECOND BANK OF THE
UNITED STATES**

The political climate at the beginning of the 19th century differed substantially from the climate at the end of the 18th century. The father of the First Bank of the United States and its most eloquent and influential spokesman, Alexander Hamilton, died in 1804 in a duel with Aaron Burr. The Federalists were defeated by the Anti-Federalists, and the Democratic Republican Party gave Jefferson his victory in 1801. The powerful class created by Hamilton was swept away by the democratic reaction under Jefferson's presidency. In 1809 James Madison, Jefferson's disciple, became President. The Federalists' control over government and their support of the national bank were weakened. The sentiment against Britain was strong in the United States because of British interference with American commerce and British general contempt for the American people. The Federalists were discredited because they were pro-British, and the national bank was called a British bank because 70% of the stock belonged to British subjects. The resentment culminated in the War of 1812.

The population of the United States, its composition and the country's economy were changing rapidly. Between 1790 and 1820 the population grew from 3,900,000 to 9,600,000 and the

original thirteen states grew into twenty three. A flux of European immigrants, eager to improve their economic conditions, came to the country. The number of banks grew from three in the 1790's, to 246 in 1816. The significance of this growth lay not just in the number of banks but in the vast expansion of the volume of money, since banks not only received money, they also created it. "For each dollar paid in by the stockholders, the bank lent two, three, four or five." (Hammond 1957, 146) This growth of new money was in response to the credit demand by the new, growing industry. It was a turbulent time and the beginning, in the United States, of the industrial revolution.

The Interregnum: 1811-1816

In March 1811, the twenty-year charter of the First Bank of the United States was to expire. On January 6, 1809, the stockholders of the Bank submitted a petition to the Senate and the House of Representatives soliciting recharter.

The Secretary of the Treasury, Albert Gallatin, reviewed the Bank's performance and recommended its renewal. In his report of March 2, 1809, Gallatin credited BUS I with wise and skillful management and with service advantageous to the government, but proposed some amendments. The most important proposal was that the Bank should pay interest on Government deposits in excess of three million dollars.

Through this measure Gallatin hoped to accumulate a pool of funds in the Treasury for national emergencies. "Discontinuance of the Bank meant for the Treasury a reorganization of procedures followed for twenty years and the devising of new agencies and arrangements." (Hammond 1957, 223)

After a lapse of twenty years, Congress resumed debates on the constitutionality of the Bank and the sovereignty of the states vis-à-vis the federal government.

In Clarke and Hall's Legislative History of the Bank of the United States, some thirty nine speeches on renewal of the charter are recorded. . . and thirty five of these dealt with constitutionality. (Hammond 1957, 214)

The debates were lengthy and lively but did not solve the problem; it reappeared again in the twentieth century.

The national bank as a depository of government funds and a regulator of currency was opposed by "the more aggressive business and state bank interests." (Hammond 1957, 220) The supporters of the national bank argued that the Bank was "constitutional" because "necessary" for the proper functioning of the government. The opponents argued that the Bank was not only unconstitutional but a dangerous encroachment on the sovereignty of the states. They challenged the "necessity" of the Bank by arguing that the state banks were well capable of meeting the government's needs.

On January 16, 1811, Representative William Burwell of Virginia questioned the assumption that because a national bank is necessary to the operation of government it is, therefore, constitutional. The national bank may be convenient but this convenience is purchased at "exorbitant and invidious privileges to a particular class in the community." Burwell distinguished between service and control:

But, sir, admit for a moment that the bank may be formed to collect the revenue; ought it not to be exclusively used for that object? Whence the power to make it an instrument of commerce? Why invest it with a capital, immense in amount, and sovereign in its control over the external and internal commerce of the country? (Krooss 1969, 372)

Burwell feared that "the close and intimate connexion between the government and the bank; the dependence of the former for loans and the latter for public deposits" would increase the power of government and especially the power of the President.

Senator William Crawford of Georgia, an agrarian and a Jeffersonian, favored the recharter of the national bank. "The banking system has been too long and too deeply rooted, to be frowned out of existence by Congress." (Krooss 1969, 350) Crawford extended the discussion to the constitutionality of the state bank-notes by pointing out that the Constitution of the United States prohibited the states from coining money and issuing bills of credit. He reasoned that states, having no such rights, cannot delegate these rights

to banks. Crawford accused the states of "avarice" and of attempting to legislate for Congress "by usurpation."

Senator Robert Taylor of Virginia, also an agrarian and a Jeffersonian, opposed the recharter and regretted Crawford's derogatory remarks. Taylor defended the sovereignty of the states and the intentions of the State of Virginia as

the purest and most honorable motives from the conviction that the power of granting charter of incorporation was not conferred to Congress by the Constitution, but reserved to the States respectively. (Clarke and Hall 1832, 347)

The above debates demonstrate a conflict in Jefferson's Party, and Hammond ascribed this rift to the industrial revolution:

The rifts between the agrarian world and the business world, and between the North and South, were as sharp as ever, but the attitude of each toward government had altered. The debates on renewal of the charter show business sheering toward close association with the separate state governments, and the agrarians sheering toward a closer association with the federal government.

But this mutual interchange of policies between the two groups was not complete and clear-cut. The Republican party -- Jefferson's party -- was no longer overwhelmingly agrarian. It now comprised both a business wing and an agrarian wing. The business wing was against the Bank; the agrarian wing was divided for and against it. (Hammond 1957, 219-220)

The proposition for recharter lost in both Houses: by the tie-breaking vote cast by the President of the Senate, and by a majority of one vote in the House of Representatives. Due to the narrow margin of defeat, Hammond concluded that

"neither group of the Bank's enemies could have killed it alone." Another factor in the defeat was the Bank management's lack of concern and their political ineptitude.

The First Bank of the United States went out of business in March of 1811. In the liquidation process, Secretary Gallatin transferred the government deposits from BUS I to the state banks. Stephen Girard of Philadelphia bought most of the Bank's assets and started the Girard Bank which was converted to a national bank in 1865.

When the state banks became the depositories of public funds, the Treasury felt the void of one central place to transact government finance:

The Treasury now had no one responsible place to turn to for quick loans, but must negotiate here, there, and everywhere, encountering varying dispositions and abilities. (Hammond 1957, 229)

The state banks, which the opponents of the recharter believed would meet the nation's currency needs and the fiscal requirements of the government, failed to meet expectations. The war of 1812 compounded the problem by encouraging reckless banking. The small banks had inadequate capital; their main profit consisted in the issuance of notes. When they could not meet the demands for war loans they started issuing irredeemable notes. Forced by a shortage of gold and silver, all the banks south of New England suspended specie

payments at the end of 1814. Nearly one hundred of these banks were depositories of government funds.

In 1814 the Treasury had nearly nine million in the suspended banks. In the absence of any control on the issuance of notes the banks expanded the printing of them. According to Secretary Crawford the volume grew from \$28 million in 1811 to \$110 million in 1815. The loans to the Government amounted to over \$35 million. . . . The root of the evil lay in the attempt of Government to carry on an expensive war by means of bank loans and the notes of state corporations over which it had no control, thereby converting an irredeemable paper issued by irresponsible institutions into a national currency by assisting in its circulation and encouraging its extension. (Knox 1900, 49)

John Jay Knox, an American banker who was a Deputy Comptroller of the Currency from 1867 to 1872 and a Comptroller till 1884 when he returned to the banking practice, blamed the government and the banks equally for the social disorder of the post war period.

The state banks had abused their note issuing privileges and foisted worthless paper upon the trusting public. The Secretary of the Treasury, Alexander Dallas, summed up the situation:

The multiplication of state banks in the several states has so increased the quantity of paper currency that it would be difficult to calculate its amount and still more difficult to ascertain its value . . . there exists, at this time, no adequate circulation medium common to the citizens of the United States. The money transactions of private life are at a stand, and the fiscal operations of the Government labor with extreme inconvenience. (Knox 1900, 49)

The Second Bank of the United States: 1816

In January 1814, a petition signed by 150 New Yorkers was submitted to Congress asking for the incorporation of a new national bank.

In October 1814, the Secretary of the Treasury Alexander Dallas, a Jeffersonian Democrat, recommended the incorporation of the national bank not only to promote the general welfare, but as being "necessary and proper for carrying into execution some of the most important powers constitutionally vested in the Government." (Knox 1900, 49) The Secretary of War needed money and had difficulty obtaining it. In his report, Dallas stated

that nearly \$2,000,000 of Treasury obligations were past due and unpaid in Philadelphia, New York, and Boston, and the Treasury had no funds in New England for payment of interest on the debt held there. . . . In short, it was difficult to conceive a situation more critical and perilous than that of the government at this moment without money, without credit, and destitute of the means of defending the country. (Hammond 1957, 229-230)

Various propositions for the establishment of the national bank were introduced. Under the urgency of the situation, Congressional discussion concentrated on expediency rather than justice, or democratic principles of equity. Whereas in 1811 constitutionality was the center of the Congressional discussions and 35 speeches out of 39 dealt with it, four years later "only two discourses" concentrated on constitutionality. (Hammond 1957, 234) Some of the Representatives

who in 1811 had opposed the recharter of BUS I spoke in favor of it in view of the fact that the state banking system was incapable to meet the country's needs and to provide sufficient capital in case of war. The national bank now seemed to be not only "necessary" but "indispensable."

In the Congressional debates on January 2, 1815, Daniel Webster, Representative from Massachusetts, led the Federalists' opposition not only against recharter but against the propositions in the 1814 bill. This bill was designed to "pull the Treasury out of the hole" by proposing a bank capital composed of \$5 million in specie and \$45 million in public money, of which \$25 million represented public debt, \$10 million Treasury notes, and \$15 million were to be created for the purpose of stock subscription by the Government. Webster urged his colleagues to consider long-term remedies and abstention from short-term solutions necessitated by the moment.

James Madison vetoed the 1814 bill on January 20, 1815, on the grounds of insufficient capital in case of war, and for giving too much consideration to the Bank and too little to the public interest:

When it is considered that the proposed establishment will enjoy a monopoly of the profits of a national bank, for a period of twenty years; that the monopolized profits will be continually growing with the

progress of the national population and wealth; . . . it is reasonable as it is requisite, that the Government, in return for these extraordinary concessions to the bank, should have a greater security for attaining the public objects of the institution, than is presented in the bill, and particularly for every practicable accommodation, both in the temporary advances necessary to anticipate the taxes, and in those more durable loans which are equally necessary to diminish the resort to taxes. (Krooss 1969, 1:403)

Nearly one year later, on December 5, 1815, in his State of the Union Message, Madison recognized the necessity of a national bank and stressed the indispensability of a uniform national currency. Since the state banks could not provide it, the national bank would

merit consideration; and if neither of these expedients be deemed effectual, it may become necessary to ascertain the terms upon which the notes of the Government shall be issued, upon motives of general expediency, as a common medium of circulation. (Clarke 1832, 609)

In February 1816, a bill was introduced incorporating Mr. Dallas' revisions. In the ensuing debates, Representative John C. Calhoun of South Carolina, a Jeffersonian with Hamiltonian inclinations, dismissed constitutionality as "a useless consumption of time" and the discussion on the Bank's conduciveness to public liberty and prosperity as "purely speculative." The only question Calhoun proposed to deal with was a practical question: how to remedy the evil and "whether it was in the power of Congress, by establishing a National Bank, to remove those disorders." Calhoun compared the general disorders between 1812 and 1816 to

the conditions of the Revolutionary war, in which every State issued bills of credit . . . of various values. . . . The right of making money -- an attribute of sovereign power, a sacred and important right -- was exercised by two hundred and sixty banks, scattered over the United States, not responsible to any power whatever for their issues of paper. (Clarke and Hall 1832, 414)

Calhoun recognized that the government had a responsibility and a duty to control the issuance of money since experience showed that self-interest had taken precedence over the common interest; to believe otherwise would be to believe the impossible. The interests of banks were:

Gain, gain, nothing but gain; and they would not willingly relinquish their gain from the present state of things, which was profitable to them, acting as they did without restraint, and without hazard. (Clarke and Hall 1832, 417)

Since the banks were incapable of self restraint, Congress had to resume its power of creating and regulating the currency as empowered by the Constitution. To remedy the situation, Calhoun recommended that the banks return to specie payments and that the national bank be reconstructed. He saw the national bank as an appropriate means through which the government could restore the social order, and believed that the local banks could also be made to see the advantage of compliance:

A National Bank would enable the Government to resort to measures which would make it unprofitable to banks to continue the violation of the contracts, and advantageous to return to the observation of them. (Clarke and Hall 1832, 417)

Like George Washington and Alexander Hamilton, Calhoun was a strong disciplinarian, recognized for his enthusiastic campaign in support of the War of 1812. He saw men as brutal and nasty by nature, therefore in need of control so as to protect the well-being of the nation.

People do not understand liberty or majority. . . . The will of a majority is the will of a rabble. Progressive democracy is incompatible with liberty. Democracy is leveling -- this is inconsistent with true liberty. Anarchy is more to be dreaded than despotic power. It is the worst tyranny. (Jenkins 1859, 453)

James Madison, who in 1791 opposed the charter of the First Bank of the United States on constitutional grounds and vetoed a bill for its reconstruction at the beginning of 1815 on the grounds that the Bank was incapable of meeting the necessities of war, deemed its existence "indispensable" in 1816 and signed the charter of the Second Bank of the United States on April 10 of that year. The Bank was chartered for twenty years, its charter expiring on March 3, 1836. It had a capital of \$35 million, seven million of which were subscribed by the Government in return for 5% interest. The remainder was acquired by individuals and corporations. The Bank was managed by twenty-five directors, five of whom were to be appointed by the United States President, with the advice and consent of the Senate. The main goals of the Bank were to control the issuance of currency of the local banks, a wider circulation of uniform and safe notes, and centralization of financial resources to

meet emergencies and be ready to prevent financial panics. The resumption of the national bank's control over the state banks revived the conflict of interests between the two systems.

BUS II started to operate in Philadelphia in January, 1817, during financial difficulties, and the suspension of specie payments starting in 1814 continued through the crash of 1819-1820. The Bank survived the panic and the following depression, but opposition to special privileges granted to it by Congress continued to grow.

CHAPTER III: ANDREW JACKSON AND THE BANK WAR: 1829-1836

When Andrew Jackson, a Jeffersonian Republican, was inaugurated seventh President of the United States on March 4, 1829, the Second Bank of the United States, referred to as BUS II, was the single most powerful institution in the nation. The Bank, a private institution, acted as a Treasury of the United States and was the fulfillment of Hamilton's idea of an alliance between government and business. In 1829 the Bank's capital was \$35 million and

its annual profits were \$3 million. The Bank had 25 branches throughout the Union with ca. 500 employees all "liberally salaried." The Bank and its branches received and distributed the entire revenue of the nation. (Knox 1900, 63)

The Bank's power was based on the special privileges granted to it by Congress in 1816 when democratic principles were sacrificed to the pressing and practical considerations necessitated by the post-1812 emergency. The Bank collected the national revenues and was the only depository of public funds. It could use these funds for the profitable expansion of loanable capital to traders and entrepreneurs.

Through its authority to create new money to meet the needs of trade, the Bank became a substitute for the Mint of the United States. An unintended by-product of this practice was a tendency to exaggerate the expansion of money resulting in business cycles. By managing the volume of money in circula-

tion the Bank influenced the economic and social life of the nation.

Under Jackson's Presidency, the Democrats and the National Republicans clashed again over the national bank. For the Jacksonians BUS II was the most visible symbol of special privileges, monopoly and concentration of money power. The Jacksonians favored full governmental control of the issue of money and opposed delegating this sovereign right to individuals or corporations. They wanted to reduce the burden of taxation and eliminate the national debt. As in the past, their concerns were constitutionality, justice and economic equality. The National Republicans, later called the Whigs, adhered to the economic theories of Hamilton. They identified the prosperity of the propertied class with the prosperity of the nation. National debt was the road to wealth and the Bank of the United States was the medium through which that goal could be achieved. The Whigs distrusted democracy and did not want to keep the public funds in the Treasury, under public control. They believed that public money and flexible currency should be used for the expansion of private enterprise rather than being wasted for public purposes. The Bank of the United States was "the most convenient instrument through which the public money could be applied to private purposes." (Kendall 1872, 516)

The "bank war" launched by Jackson was more than a war against a particular bank or against an isolated issue. It was a struggle for the establishment of a democratic system for the nation. The new Republic was still in its formative years, the debates over its destiny were passionate, and the Constitution was tested and interpreted.

For Jackson, BUS II was an anomaly violating the Constitution and the Jeffersonian principles of democracy. The President was convinced that the Bank was unconstitutional because Congress has no right to abdicate its constitutional privilege of coining and controlling the value of the currency, and no justification "to make the rich richer and the potent more powerful" at the expense of the rest of the nation. Jackson also sincerely believed that the Bank and its money power would destroy the liberty of the nation by corrupting the integrity of the legislators and the press and thus the political and social fiber of the Republic.

Jackson expressed his convictions forcefully as early as 1829:

Both the constitutionality and the expediency of the law creating this bank are well questioned by a large portion of our fellow citizens, and it must be admitted by all that it has failed in the great end of establishing a uniform and sound currency. (Richardson 1896, 2:462)

Jackson proposed the establishment of a national bank operated and funded from government revenues whose purpose would be to administer public funds.

In his Second Annual Message, delivered on December 6, 1830, Jackson again called the attention of Congress to a reform of the banking system "in its principles and structure as to obviate constitutional and other objections." (Richardson 1896, 2:529) He urged Congress to consider a national bank not as a corporate body but as a branch of the Treasury, in charge of government finance.

In his Third Annual Message, given on December 6, 1831, Jackson pressed with more urgency for reforms in the banking system. Due to the government sale of public land, the Treasury enjoyed a surplus and the President hoped that within four years the public debt would be extinguished through redemption or purchase. "We shall then exhibit the rare example of a great nation, abounding in all the means of happiness and security, altogether free from debt." (Richardson 1896, 2:556.)

In December 1831, four years before the expiration of its charter, the Second Bank of the United States applied to Congress for the charter's renewal. In the subsequent hearings no serious objections were raised against BUS II, and

the bill for recharter was passed by both Houses close to the end of the 1832 session. Jackson's reelection was to occur in October of the same year.

On July 10, 1832, Jackson vetoed the bill on the grounds of unconstitutionality and of monopoly granted to private business at the expense of the public. Concentration of money power in the hands of the few, he warned, endangered democracy:

He told the two Houses that he never would put his hand to a charter of the Bank as long as he existed . . . He told the Congress that he clearly saw that the bill was tendered to him as the means of putting him to the test and of putting the people to the test too . . . (Cobett 1834, 163)

The Whigs calculated that should Jackson refuse to sign the bill, there was time to defeat his election or to compel him to give up his hostility to the bank. Jackson knew all this and in his veto message he said:

I have now done my duty to my country. If sustained by my fellow citizens, I shall be gratified and happy, if not, I shall find in the motives which impel me ample grounds for contentment and peace. (Krooss 1969, 2:832)

As the recharter of BUS II and the reelection of the President came at the same time, the Bank became a political watchword. The "war" between "Jackson and hard money" and the "Bank and its supporters" started there. The Whigs, under the leadership of Henry Clay and Daniel Webster, supported the Bank and formed an anti-Jackson and anti-Democratic coalition. Nevertheless Jackson was reelected by

an overwhelming majority. "During 1835 the Whigs gradually abandoned the Bank's cause on the democratic grounds that the people had spoken against it at the polls." (McFaul 1972, 76) Amos Kendall, a member of Jackson's Cabinet and a close friend of the President, illustrated the difference between the two parties:

The Democrats obey the Constitution. The Whigs disregard it. The Democrats wish to preserve the public money exclusively for public purposes. The Whigs wish to use it for their own purposes. (Kendall 1872, 518)

On September 26, 1833, Attorney General Taney issued an order for the removal of public funds from BUS II. After this date all public money, collected from revenues and other sources, was deposited with selected state banks, called "pet banks" by the opponents of the Administration. In justification of the measure to remove public money from BUS II, Jackson exposed the Bank's bribes of Congress and the press. In a letter addressed to the ministers of his Cabinet and read to them on September 18, 1833, Jackson condemned the Bank's meddling in politics and spoke of "the dangerous tendencies of the Bank of the United States." According to Kendall, the Bank records showed loans to political men, editors, speculators, and expenditures for "political electioneering and corrupt purposes." New evidence laid before the President clearly established "the fact that the bank controls, and in some cases substantially owns, and by its money supports some of the leading presses." (Richardson 1896, 3:12) It appeared that the Bank had a

very large part of the newspaper press in its pay at the time of the Presidential election, and used its lending power to influence Congressional votes in favor of the recharter. Jackson concluded that public money was not safe in a bank that "squandered" public funds for improper and corrupt purposes.

Jackson further accused the Bank of seeking to enrich itself at public expense. When the Bank learned that the government intended to use the revenue surplus to buy the public debt, it extended issuance of notes by over \$28 million in sixteen months, ending in May 1833. This measure was intended to prevent the withdrawal of public money for debt reduction, which would have deprived the Bank of capital for private interests. In Jackson's opinion, the Bank's attempt to thwart the Government's payment of its own debt justified an instant withdrawal of public money from the Bank. The President believed that, as an elected representative of the people, he had the duty to act on the evidence before him to protect the interest of the nation and the freedom and integrity of Congress and the press. Jackson knew that if he left the means of corruption in the Bank his veto could be overturned.

Nicholas Biddle, president of the Bank and a firm believer in the Bank's independence, spoke against a "fatal control"

of banks by government and challenged Jackson in the 1832 election. Fighting for the existence of the institution he justified the substantial press expenses and the circulation of promotional literature as necessary educational material to counteract the ignorance and misinformation of the public. He resolutely rejected any charges of impropriety by claiming that "he had never abused the power of the bank to an unworthy purpose." (McGrane 1919, 63)

With the removal of the public funds, the power of the Bank of the United States was broken. The Bank, left to operate on its own resources, finally failed. When the hopes for recharter were gone, the Bank applied for incorporation in the state of Pennsylvania, granted on February 12, 1836, and moved its business there. It became insolvent in 1837, along with many other banks. "Its entire capital of thirty-five millions of dollars was dissipated and lost . . ."

(Kendall 1872, 402) The Bank resumed its operations in 1839 and went down in ruins in 1841. "Its end was so ignominious that no one wanted to remember that he had ever believed in it." (Sumner 1889, 341)

The public debt was paid at the end of 1834 and the problem was, what to do with the Treasury's surplus of revenues? The Congress decided, against Jackson's objections, to distribute it to state banks in proportion to the state's

population. These deposits augmented the banks' lendable funds and as the banks proceeded to convert public money into bank capital they fueled inflation. In addition, receipts from vast speculations in public land purchases expanded the banks' deposits. A spirit of wild speculation stimulated a multiplicity of bank charters. In the general euphoria "banks were started for the sole purpose of issuing notes that might be turned in at the land offices for public land." (Knox 1900, 281) The receipts from land sales were in notes issued by state banks, and when the banks failed, as they often did, the Treasury was left with worthless paper and close to bankruptcy. According to Knox, the revenues from the sale of public land rose from \$5 million in 1834 to close to \$25 million in 1836. During the existence of BUS II, public money in the Bank did not exceed \$8 million at any one time. "By November 1, 1836, eighty-eight state banks in twenty-five states with a total capital of \$77,576,449, held public deposits amounting to \$49,377,986." (Knox 1900, 80)

On July 11, 1836, the Secretary of the Treasury issued "The Specie Circular" directing the deposit banks and land offices to accept only gold and silver in payment of public lands after August 15th of that same year. The consequence of the Circular was a run for the short supply of gold and silver and the collapse of the inflated currency. Knox blames the

President for the financial collapse in 1837 which was precipitated by his edicts. "The removal of the deposits to the State banks and the issue of the specie circular were both acts of financial recklessness on the part of the President. . . ." (Knox 1900, 82) William Graham Sumner, professor of political and social science at Yale College, and a disciple of Herbert Spencer, concluded that "the surplus was doing so much mischief that the best thing to do with it was to throw it away. Unfortunately it could not be thrown away without doing other harm." (Sumner 1889, 323)

The End of Jackson's Presidency

In his eighth and last Annual Message, on December 5, 1836, Jackson urged further reforms. He expressed the opinion that the payment of the public debt was not sufficient for national tranquility without a concurrent reduction in taxes and in the unnecessary accumulation of public revenues beyond the wants of the government:

No people can hope to perpetuate their liberties who long acquiesce in a policy which taxes them for objects not necessary to the legitimate and real wants of their government. (Richardson 1896, 3:240)

Jackson criticized the governmental decision to transfer the revenue surplus to the state banks "whose interest and effort it is to make large profits out of its use." In Jackson's opinion, the surplus should have been returned to people who produced it, in the form of public expenditures, instead of being deposited with "sundry banks." Jackson

advocated hard currency to avoid the excessive issuance of paper money and the booms and busts resulting from wild fluctuations in the volume of currency not based on precious metal.

Justice, unity and vigilance were the themes of Jackson's Farewell Address, given on March 4, 1837. Recognizing "the honorable feeling of State pride and local attachments," Jackson stressed the necessity of unity and brotherhood for the safety of the Union. Like Jefferson, Jackson emphasized the virtues and character of the people as the foundation of free government:

No free government can stand without virtue in the people and a lofty spirit of patriotism, and if the sordid feelings of mere selfishness shall usurp the place which ought to be filled by public spirit, the legislation of Congress will soon be converted into a scramble for personal and sectional advantages. (Richardson 1896, 3:298)

Evaluation of Jackson's Ideal of Democracy

Jackson considered strong government a necessity for the maintenance of democracy. He pitted his power against the power of the Second Bank of the United States and did not hesitate to use and expand the President's prerogative to achieve the goals of social justice. When Jackson became convinced that the rich and powerful tilted the scales in their favor, he considered it his duty to intervene on behalf of the people who had elected him to office. Jackson, like Hamilton, used the power of the government to

achieve his goals. The difference was that Hamilton had the support of an oligarchy, Jackson of the general public; Hamilton used the government to support a privileged segment of the population, Jackson used it for the whole community.

Jackson's Administration illustrates the impact of political and social philosophies on economic decisions. Jackson recognized that equality of talents, education and wealth, due to natural gifts or superior industry, cannot be institutionalized, but he rejected unjust laws which promote these inequalities. In his message vetoing the Bank recharter, dated July 10, 1832, Jackson talked about the class system in America and emphasized that class distinctions were not based on economic position only but on access to favors and privileges:

It is to be regretted that the rich and powerful too often bend the acts of government to their selfish purposes . . . every man is equally entitled to protection by law; but when the laws undertake to add to these natural and just advantages artificial distinctions, to grant titles, gratuities, and exclusive privileges to make the rich richer and the potent more powerful, the humble members of society -- the farmers, mechanics, and laborers -- who have neither the time nor the means of securing like favors for themselves, have a right to complain of the injustice of their Government. (Krooss 1969, 2:831)

Jackson was an advocate of hard currency. In his opinion, the elasticity of paper money was a defect, not an advantage. Jackson and his supporters argued that easy money was good only for the profit and safety of the Bank and the speculators. His hard money policy had three main purposes:

One was essentially economic: to prevent periodic depressions; another essentially political: to prevent the rise within the state of independent powers, not responsible to the people and able to defy the government; and the third essentially social: to prevent the rule of a moneyed aristocracy systematically exploiting the "humble members of society." (Schlesinger 1945, 119)

Jackson's interventions in business and his use of Presidential power outraged many of his opponents. William Graham Sumner defended unrestrained individualism and vested interests, and feared the rule of the people. For him Jackson was "a dangerous man" intoxicated with "adulation and success," manipulated by the will of the masses into a tyrant with "bulldog ferocity," aiming to establish a "Napoleonic type of the democratic empire" and "personal government." (Sumner 1889, 278-279, 291, 299) Sumner argued that

Jackson's administration unjustly, passionately, ignorantly, and without regard to truth assailed a great and valuable financial institution, and calumniated its management. (Sumner 1889, 339)

Historians and commentators disagree on the meaning of Jacksonian democracy. Some celebrate Jackson as a champion of democracy and his era as the full flowering of American democracy; others see in him "King Andrew," a "tyrant," a "despot", a "dangerous radical" inciting the poor against the rich. Theodore Roosevelt labeled the Jacksonian era "a millenium of minnows;" Franklin D. Roosevelt, an "unending contribution to the vitality of our democracy."

Arthur Schlesinger, Jr. sees the focus of the Jacksonian policies in the restraint of the power of the business community. It was a question of political power: Who should control the state? The powerful or the masses?

The tradition of Jefferson and Jackson might recede, but it could never disappear. It was bound to endure in America so long as liberal capitalistic society endured, for it was the creation of the internal necessities of such a society. American society has come to accept the struggle among competing groups for the control of the state as a positive virtue -- indeed, as the only foundation for liberty. (Schlesinger 1945, 505)

Schlesinger illustrates the class consciousness of the Jacksonians and their belief that only labor can produce wealth by quoting Kendall:

"Those who produce all wealth are themselves left poor. They see principalities extending and palaces built around them, without being aware that the entire expense is a tax upon themselves." (Schlesinger 1945, 306)

Bray Hammond, a former Assistant Secretary of the Federal Reserve Board, disagrees with Schlesinger and his lack of appreciation of the central bank's beneficial function. Hammond sees greed, not idealism, in the Jacksonian movement. It was a

conflict of farmer and entrepreneur for dominance over American culture. . . . Enterprise won, it got banks by thousand, and it devoted Americans to dollars. . . . My quest disclosed . . . that the Jacksonians were not peculiarly agrarian; that the Bank of the United States was not "the money power;" that Nicholas Biddle was not the schemer who deserved what he got; . . . that Americans have not been mostly idealistic. (Hammond 1957, viii, vii)

Hammond concludes that Jackson was not the conqueror of the evil "money power" but its victim. The Bank of the United States "was a federal institution which stood too much in the way of credit expansion to suit popular interests."

(Hammond 1957, 287) Hammond presents the Jacksonian measures against the Bank as a combination of five elements:

Wall Street's jealousy of Chestnut Street, the business man's dislike of the federal Bank's restraint upon bank credit, the politician's resentment of the Bank's interference with states' rights, popular identification of the Bank with the aristocracy of business, and the direction of agrarian antipathy away from banks in general to the federal Bank in particular. (Hammond 1957, 329)

Hammond argues that the Jacksonian movement, with its support of states' rights and its strong agrarian sentiments, was used and dominated by the new commercial class which wanted to destroy the old, privileged capitalists class. The new entrepreneurs wanted cheap and abundant money and free banking, and opposed the restrictions of the Bank of the United States. The struggle was not for the democratization of money control but for laissez faire; it was a struggle of the new order against the old one. The blow was not against "money power" but against the older capitalists. Hammond claims that the destruction of the Bank "left the poor agrarian as poor as he had been before and it left the money power possessed of more money and more power than ever before." (Hammond 1957, 329)

James Sharp, similar to Schlesinger, sees the Jacksonian movement as a struggle for democratic control over money and currency, continued by the Greenbackers and the Populists. Contrary to Hammond, Sharp argues that the Jacksonians dealt a blow to the money power. While the Whigs supported the Bank, the majority of the Democrats supported radical reforms. The Democratic Party did not engage in the battle over banks in the interest of the entrepreneurs, as Hammond claims, but fought against the commercialization and vulgarization of American life.

If the laissez faire logic of the Jacksonian antibank and anticorporate argument eventually led to the enthronement of the business ethic in the last half of the nineteenth century, it is one of history's cruelest paradoxes. (Sharp 1970, 321)

Ralph C. H. Catterall, professor of economics at the University of Chicago, appreciates the beneficial role of the Bank of the United States.

Up to the period of the Bank War, the connection between the bank and the government was an immense benefit to both, but particularly to the government . . . From this point of view, it becomes obvious that Jackson and his supporters committed an offense against the nation when they destroyed the bank. (Catterall 1902, 476)

Similar to Hammond, Edward Pessen, professor of history at the City University of New York, sees Jackson's era as "an age of materialism and opportunism." (Pessen 1969, 351) Jackson did not give power to the common man "but to the shrewd, ambitious, wealthy and able politicians who knew best how to flatter him." (Pessen 1969, 347)

John M. McFaul disagrees with Hammond and the entrepreneurial historians who misinterpreted "the economic interests and political actions of state bankers."

Entrepreneurial historians ignore the significant (if not always successful) Jacksonian attempts to regulate the pet banks through administrative edict and congressional legislation after deposit removal. (McFaul 1972, 9)

McFaul highlights the political differences between the Whigs and the Democrats and argues that the Jacksonians subordinated economic interests to political interests. He comes to an ironic conclusion:

Jacksonians with their anti-state, anti-government bias ended up strengthening both state and government. It shows how fragile is political ideology in American politics, especially when that ideology conflicts with political actions necessary to govern effectively. (McFaul 1972, 14-15)

Jackson's struggle over the control of public money was raised again, one hundred and some years later, by the "populist" Congressman from Texas, Wright Patman. His objections to the central bank closely echoed those of President Jackson.

CHAPTER IV: MARTIN VAN BUREN AND THE INDEPENDENT**TREASURY: 1837-1863**

Martin Van Buren, a Democrat, became President in March 1837. In May of the same year, banks suspended specie payments and a panic followed. The government had \$28 million in public revenues deposited in the state banks, which were indispensable to the public service. The failure to obtain the money when needed had shaken the government's confidence in the banks' reliability. The banks were happy to receive public funds into custody but embarrassed when asked to return them.

The President urged Congress to exercise its supervisory power in his Special Session Message on September 4, 1837. Van Buren attributed the existing conditions to "the spirit of reckless speculation" prompting overissuance of bank notes and excessive loans. He expressed "the desire, long existing among the people of the United States, to separate the fiscal operations of the Government from those of individuals or corporations." (Richardson 1896, 3:328) Van Buren wanted business out of government and government out of business:

A system founded on private interest, enterprise, and competition, without the aid of legislative grants or regulations by law. . . free from the influence of political agitation. (Richardson, 1896, 3:330)

The Democrats viewed the banks' privileges as a violation of the principles of free trade and a threat to democracy. They blamed the legislators for yielding to the dictates of business, for exaggerating the benefits of public debt, for increasing the government's dependency on banks, and for granting special privileges to bankers.

Since the national and state banks had failed as custodians of public funds, Van Buren sought a remedy for the existing crisis in the establishment of an Independent Treasury through which the government would be in charge of its own funds. Under the proposed system, the Treasury was to collect the revenues in gold and silver, in order to prevent collection of depreciated and irredeemable currency, and keep the proceeds in the Treasury and the Subtreasuries until needed instead of depositing them in the banks. Bypassing financial intermediaries and their claims on public funds, Van Buren departed from the past practices which had assumed banks were safer custodians than government officials.

The use by the banks, for their own benefit, of the money deposited with them has received the sanction of the Government from the commencement of this connection. . . . They have no right to insist on a connection with the Federal Government, nor on the use of the public money for their own benefit. (Richardson 1896, 3:333, 381)

Van Buren attributed the past government's use of banks to emergencies rather than to the exercise of sound policy. While the President realized that speculation could not be prevented by legislation alone, he insisted that the government must stop augmenting the banks' capital and their fractional reserves thereby causing the fatal expansion of loans. The President ascribed the past failures of banks to the faulty structure of the system and not to accidents.

A Clash of Ideologies

The Independent Treasury system again ignited the disputes between the Whigs, who followed the Hamiltonian tradition, and the Democrats, who followed the Jeffersonian and Jacksonian traditions. The Whigs supported a close bank-government connection; the Democrats favored a government free from the domination of financial interests and from the dependency on banks. The Democrats insisted that public funds should be in the custody and under the control of elected public officials and authorized personnel. They supported their argument by citing past experiences showing that public money in private hands was "hazardous" to government operations. The Whigs considered the accumulation of public funds in the Treasury vaults as an "idle" capital.

The Independent Treasury was an extension of Jackson's hard money policy, aimed at restraining the power of the business

community over political, economic and social issues, as outlined in Chapter 3. Van Buren's proposal put into effect Jackson's plan for the establishment of a federal bank operated and funded by government. Jackson's transfer of public funds from the Second Bank of the United States to the state banks was only a temporary measure.

The Democrats viewed the national bank as a foreign model that violated the American democratic system and were incensed by the influence of financial interests on Congress. Van Buren opposed the Whigs' attempt for the reestablishment of a national bank and in his Special Session Message of September 4, 1837, expressed his belief that the bank

would impair the rightful supremacy of the popular will, injure the character and diminish the influence of our political system, and bring once more into existence a concentrated moneyed power, hostile to the spirit and threatening the permanency of our republican institution. (Richardson 1896, 3:331)

The Independent Treasury reversed the Hamiltonian design of government which relied heavily on the advice of business leaders at the exclusion of other interests. While Hamilton had seen mutual benefits in the liaison between the banks and government, Van Buren viewed the connection as "injurious to both, as well as the general interest of the community at large." (Richardson 1896, 3:494) While the Democrats sought an alliance between the government and the

general public, the Whigs strove for an alliance between government and business.

The Independent Treasury

The Independent Treasury Bill failed in 1837. At Van Buren's insistence it was reintroduced in December of 1839 and became law on July 4, 1840, passing by a narrow margin. However, even before it became operative, the law was repealed in August 1841, under Harrison's administration when the Whig party dominated Congress and attempted to revive a national bank.

The Independent Treasury Act added four Subtreasuries to the Treasury in Washington: New York, Boston, Charleston and St. Louis. All were equipped with vaults for the safekeeping of public funds. One clause of the Act stipulated that after June 30, 1843, all payments to or by the government were to be made in specie only. The banks, with the Whigs' support, attacked the law threatening their profits as a conspiracy against private property and as an instance of government authoritarianism. The Independent Treasury was a deflationary measure because the public funds, held in the Treasuries, reduced the volume of the banks' lendable funds by cutting their ability to create new money through the fractional reserve system. When fully in operation, the banks would have had to keep large reserves of gold and

silver in their vaults, further reducing their lending power and cutting into their profits.

Earnestly as the State banks had aided Jackson in pulling down the power of the Bank of the United States, they now, with equal earnestness, fought against the Independent Treasury. The election of Harrison in 1840, to succeed Van Buren, was accomplished by the union of all the dissatisfied elements in the country, and they were so many that the campaign of that year will long be remembered as a popular upheaval. (Knox 1900, 87)

The End of the Independent Treasury

In 1841 the Whig party, under Henry Clay's leadership, campaigned for the renewal of the national bank on the pattern of the First and Second Bank of the United States. With the inauguration of William Henry Harrison on March 4, 1841, the Whigs' expectations were high, but their hopes died with the death of the President only one month after he took office.

John Tyler, the Vice President, became the new President on April 6, 1841. The Whigs had little respect for the "accidental" President whom they had helped into the Vice Presidential position, never expecting that he might indeed accede to the Presidency. Henry Clay had considered himself the Whig leader and had looked at Tyler as a puppet that could be manipulated. Tyler rejected the snubs of his own party members and turned to the Democrats for support and advice.

Tyler defeated the Whigs' hopes for the reestablishment of a national bank on August 16, 1841, by vetoing the bill entitled: "Act to incorporate the subscribers to the Fiscal Bank of the United States." He claimed the bill was unconstitutional because it violated the states' rights. Another bill, rushed through both Houses, was sent to Tyler for signature on August 9. This was the bill for the repeal of the Independent Treasury Act. The President signed it without hesitation on August 13, realizing that the Treasury could well function without the Subtreasuries.

By putting an end to the hopes for the establishment of another powerful private monopoly under the auspices of the government, Tyler ended the fifty-year contest between the Jeffersonians and the Hamiltonians over the national bank which had sharpened the differences between the two political parties. The disputes had originated in 1791 over the creation of the First Bank of the United States, were rekindled twenty years later over its recharter, culminated in the "bank war" over Jackson's veto in 1832 and finally subsided after Tyler's veto in 1841. By 1846, the threat of the "bank monster" had disappeared, the Democrats had lost a major political focus, and the Whigs had discovered that they could continue making fortunes under the free banking system. The decentralized banking system remained in existence until the 20th century when a new national bank,

designated the central bank of the United States, was created in 1913 under the name of the Federal Reserve System.

From August 13, 1841, when the first Independent Treasury Act was repealed, until August 6, 1846, when the same act was reenacted, the Treasury funds were paid in and paid out very much as they had been under the Independent Treasury Law, and after 1846 the Independent Treasury system was exclusively in operation until the passage of the National Currency Act in February, 1863. (Knox, 1900, 89)

CHAPTER V: THE NATIONAL BANK ACTS 1863-1864

The outbreak of the Civil War in 1861 absorbed the nation's energy, and the general attention shifted from bank issues to war and slavery. The hard currency orientation of Jefferson and Jackson became a luxury swept aside by the desperate need for money. "The antislavery crusade thus drained off the energies, diverted the enthusiasm, and destroyed the party of Jacksonian democracy." (Schlesinger 1945, 505)

In 1861 there were 1,600 banks, organized as private corporations under the laws of thirty-four states, with no uniform currency to be pooled in emergency. "The incapacity of the state banks to act together suggested to the Secretary his plan for a national system." (Knox 1900, 135) Salmon P. Chase, 1808-1873, a Republican, suggested gradual withdrawal of the state bank notes from circulation and the issuance of national bank notes secured by government bonds. As a Secretary of Treasury, 1861-1864, Chase managed the war's financial operations and had the authority to borrow money on government credit. Like his predecessor, Alexander Hamilton seventy years earlier, Chase proposed to unite the interests of the government with the interests of the moneyed business community and decided to borrow rather than heavily tax the population and the large industrial con-

cerns. At that time the taxation system was not highly developed and direct taxes were assumed to be antiproduc-
tive.

The system of taxation was extended in 1864 and 1865. While in 1863 the Internal Revenue receipts formed 5.3% of the total government receipts, in 1866 they accounted to 49.4%. (Mitchell 1903, 129)

Up to the Civil War, the Treasury had never issued paper money and had paid its obligations in silver and gold. To meet the war needs during a shortage of gold and silver, the government resorted to issuance of paper money during the war. In 1862 Congress authorized the printing of \$150 million U.S. paper money, known as "greenbacks," to meet the immediate needs of the Army and Navy. Although the greenbacks were approved as a temporary measure to be retired after the war, they remained in circulation for over thirty years. At the same time, convertibility of currency into specie was suspended and that measure remained in force until 1879. In 1863 the National Bank Act authorized the further printing of \$300 million in national bank notes to meet the pressing necessities of war. The notes, secured by interest-bearing government bonds, rested on the good faith of the government and the success or failure of the Union armies. The 1863 Act was superseded by the National Bank Act of 1864 which remained in effect until replaced by the Federal Reserve Act of 1913.

How the National Banking System Worked

The National Bank Act of 1864 provided a uniform national currency secured by a pledge of United States bonds and established the office of the Comptroller of the Currency charged with the execution of the law. Under the law, any individual possessing \$50,000 to \$200,000 could apply for a national charter to form an association to engage in the business of banking. The nationally chartered banks had to invest 30% of their capital in federal bonds, bearing an annual interest of 6% in gold, to be held as security by the Treasury until redemption. In exchange for the bonds, the Comptroller gave the banks national bank notes equal to 90% of the current market value of the United States bonds. The government's provision allowing the banks to circulate notes up to 9/10 of the capital loaned was designed to induce state banks and rich individuals to invest in government bonds and give a wide circulation to the national notes, uniform in engraving and form, and sustained by the credit of the country. To induce state banks to change into national associations, the newly chartered banks were given the privilege to act as government agents and depositories of public funds, if so designated by the Treasury, thus supporting the system of Subtreasuries established by the 1846 Independent Treasury system. To stimulate conversion, the national banks were exempt from state and federal taxation. It had been hoped that the conversions and investments in

government bonds would sufficiently augment the volume of money. But the inducements were not strong enough to offset the uncertainty about the outcome of the war. The national banking system depended on the faith and credit of the nation, but bankers were unwilling to invest in government bonds when the security of their investments was in doubt. They asked for absolute certainty in addition to high interest in gold and silver. Only toward the end of the war, in 1865, when a 10% federal tax was levied on the state notes, driving them out of circulation, did the conversion become visible.

The number of National Banks increased from 638 in January, 1865, to 1,513 in October of that year; the capital between the same dates went from \$135,618,874 to \$393,157,206, and the circulation from \$66,769,375 to \$171,321,903." (Knox 1900, 100)

The trend was reversed shortly afterwards when the emphasis shifted from note issues to deposits as the major form of money.

A question arose of how the national banks should pay for the government bonds. While Chase insisted on specie payments, the bankers wanted the government to hand them over the bonds in exchange for a book credit; "in other words, to create the money they loaned to the government." (Knox 1900, 1262.) Finally, the banks exchanged greenbacks for interest-bearing government bonds.

The history of government subsidies repeated itself in 1958 in the "\$10 billion giveaway" connected with World War II, as described by Alvin Hansen. To finance World War II, the government gave the commercial banks \$69 billion in earning assets in the form of government securities to make it possible for the banks to finance the war. The banks reaped a handsome windfall from the war but they wanted more. They deplored the fact that the commercial banks were not the only beneficiaries of the war issues. In addition to the \$69 billion of war issues, the Federal Reserve banks absorbed an additional \$22 billion of new U.S. securities thus "shortening" the commercial banks. To "undo" what was done more than ten years earlier, commercial banks in search of more profits came up with "a bold and unashamed" proposal formulated by the American Bankers Association's Economic Policy Commission. The Commission asked the Federal Reserve Board to transfer \$9.8 billion, or 41% of their interest bearing assets in the form of U.S. government securities in their portfolio of \$24 billion, to commercial banks. In its place, the Board would receive an equivalent amount of commercial banks' unearning cash assets held as required reserves by the Federal Reserve. In short, the Commission asked that billions of dollars' worth of government bonds be transferred to member banks without cost to the banks. The bankers asked the government, in effect, "to hand them on a

silver platter \$9.8 billion of earning assets." (Hansen 1958, 50)

The national banking system raised public objections: "Why it was not better for the Government to issue its own notes rather than to grant this privilege to the National banks." (Knox 1900, 98) The interest payments on the government bonds could have been saved had the government issued the notes directly to the people without the banks as intermediaries. Senator John Sherman of Ohio explained that public faith was not sufficient to sustain national currency without enlisting the pecuniary interest of the private capital. Like Alexander Hamilton, Sherman saw unity of interests between the banks and the general public. "There must be a combination between the interests of private individuals and the Government." (Krooss 1969, 2:1362)

The difference between the national banking system of 1863 and the early national banks up to 1832 was that the First and the Second Bank of the United States were the sole depositories and managers of the government funds. The national banking system of 1863, in contrast, consisted of many independent national banks bound only by the same law under the charter of the Comptroller of the Currency. Under the new system, the Treasury replaced the old private monopoly and was in charge of receiving, keeping and disbursing

revenues, while the national banks could only be invited to help in debt management. "The national banks and the legal tender notes are two of the important heritages of the war of 1861-1865. Both were born of the necessities of that period." (Knox 1900, 187)

Weaknesses and Criticism of the National Banking System

Bray Hammond argues that the federal government failed in its goal to control the issuance of money by concentrating on note circulation instead of deposits as the major form of money. By depriving the states of monetary power, the government

deprived them, however, only of what was in fact minor and obsolescent. It failed, as had happened before, to take account of deposit credit as the principal form of money. In principle and intent it was a resounding victory for the federal control of the monetary supply. In practice, since it omitted the major part of the monetary supply, it proved to be highly imperfect. It assured the economy of a paper currency that was uniform in appearance and value . . . But it failed to give the federal government control of the amount of money supplied or more than partial regulatory powers. (Hammond 1957, 734)

The belief that deposits are physical money kept safe in banks' vaults prevents us to see the power of the deposits. As Hammond explains, deposits are really not deposits but loans to the banks, utilized as working capital. Through the fractional reserve system banks can create money by multiplying the deposits several times to meet the demands for loans. The clients are the creditors and the banks are the debtors.

So confused and fallacious was the understanding of this perplexing subject which of course still eludes the efforts of most people to comprehend it and keep it comprehended. (Hammond 1957, 688)

One of the aims of the government's financial policy during the Civil War was an even distribution of the war burden over the whole population. By choosing the wrong financial policies, the just distribution of the war burden was defeated. Simon Newcomb maintains that while the banks reaped a handsome windfall from the war, this was detrimental to the public interest. In his opinion it would have been better for the government, in the case of the most urgent necessity of war, to print the notes rather than to accept the offer of the national banks to exchange notes for bonds. Printing the notes would have saved the annual interest and the burden of a debt increased by the payment of interest.

Thus, the only effect of the National Banking system is to increase the interest on the public debt by \$15 million in coin . . . How could such a measure ever be considered beneficial to the public credit? (Newcomb 1865, 216)

Newcomb calculated that the interest of \$15 million, paid in gold, was actually equivalent to \$30 million in currency. Newcomb claims that the national banking system was "most deleterious to the financial interests of the Government . . ." (Newcomb 1865, 218) He blames the legislators for passing measures without critically examining them, and for relying on the opinions of financial experts and their

assurance that the national bank policy would benefit the public. He ascribes the general reliance on experts, as the only qualified judges, to the fallacious belief that finance and banking are mysterious disciplines that can be mastered only in schools or in practice. He stresses that the principles of finance are simple and can be examined by common sense, careful thinking, and observation of current events. The belief that finance is beyond a layman's comprehension still prevails. Rule by experts has become a given of our society, which believes that knowledge of the good belongs to the technocrats, thus confusing substantive with formal rationality. Legitimation of domination by the Federal Reserve is fostered by claims to special knowledge, much like domination by the priestly classes was achieved by claims to specially divine knowledge. We look up to the Chairman of the Federal Reserve Board for ultimate truth since the operations of the central bank are shrouded in a great deal of mystery. The late Congressman, Wright Patman, exposed these fallacies in his writings and agreed with Newcomb that the principles of banking were simple and could be understood by common men, if given sufficient information.

The national banks were favored for their services as fiscal agents of the government.

It may well be doubted whether the Government can afford to pay \$40,000,000 a year for their services.

. . . In the National Banking system we pay enormously for what is an unmitigated evil from the very beginning, with no benefit of any kind to counterbalance it. (Newcomb 1865, 221-222)

Elbridge E. Spaulding, a Representative from New York, "compelled by sense of duty," refused to consent to the injustice of interest payments favoring the bondholders:

I am opposed to all those amendments of the Senate which make unjust discriminations between the creditors of the Government. A soldier or a sailor who performs service in the army or navy is a creditor of the Government. The man who sells food, clothing, and the material of war, for the use of the army and navy is a creditor of the Government. The capitalist who holds your seven and three-tenths Treasury notes, or your six per cent coupon bonds is a creditor of the Government. All are creditors of the Government on an equal footing, and all are equally entitled to their pay in gold and silver. (Spaulding 1869, 127)

In support of his argument Spaulding calls on Jefferson, a hard currency man, who during the war with Great Britain urged issuance of paper money by government, backed by taxation, as the only way to cover the expenses of a great war.

So it will be seen that Jefferson, so far from regarding it as an evil that coin should be banished from circulation during war, regarded it as a great advantage: because the Government would then be able to circulate its own notes, without interest, in the place of the coin of individuals. Treasury notes issued by the Government, he regarded as a loan from the people, without interest, and the only available resource in time of war. (Spaulding 1863, 12)

Growing Hostility Toward the National Banks

Hostility toward the national banks grew among the western and southern debtors who asked, why should not the govern-

ment control its own notes and thus save the interest which goes to the banks?

Why should there be any national bank at all? Why should "the business of issuing money and controlling its volume" be turned over "to a few persons who used their power to their own interests?" Why should not the government itself issue money direct to the people and at reasonable rates? (Hicks 1931, 93)

Complaints about the high interest paid to bankers by the government and excessive interest rates charged by banks mounted. The grievances culminated in the demands for political and economic justice of the Populist movement, presented in the next chapter.

**CHAPTER VI: THE RECONSTRUCTION AND THE REFORM MOVEMENTS:
THE GREENBACKS AND THE POPULISTS, 1867-1896**

The postwar years were the years of financial reconstruction and the man entrusted with the task was Hugh McCulloch, Secretary of the Treasury 1865-1869, who was a banker by profession. President Andrew Johnson left the financial matters of the nation in McCulloch's hands and did not interfere with his decisions.

McCulloch's goal was to check inflation and to restore prosperity by returning to the currency convertibility into gold and silver. He took a strong stand against the "irredeemable" greenbacks, called "people's money," but left the national bank notes, called "bankers' money," untouched. McCulloch's objective was to withdraw the greenbacks from circulation by converting them into interest-bearing bonds. For McCulloch, the return to the specie standard and the contraction of the greenbacks were more than a financial issue, they were legal and moral issues. In his opinion, it was unconstitutional for Congress to issue paper money, except as a measure of great emergency. Since such emergency no longer existed, McCulloch instituted a speedy reduction of the greenbacks in order to bring this currency up to the specie standard. He believed that an excessive issue of paper money was not only the major cause of inflation but

also the cause of "horrible immorality" which negatively affected the industriousness and honesty of individuals:

There is no fact more manifest than that the plethora of paper money is not only undermining the morals of the people by encouraging waste and extravagance, but is striking at the root of our material prosperity by diminishing labor. . . and if not speedily checked, will, at no distant day, culminate in widespread disaster. The remedy, and the only remedy within the control of Congress is, in the opinion of the secretary, to be found in the reduction of the currency. (Sherman 1895, 374)

McCulloch's distrust of irredeemable paper money fringed on religion, as demonstrated in the speech he gave in Fort Wayne in October 1865:

By common consent of the nation, gold and silver are the only true measure of value. They are the necessary regulators of trade. I have myself no more doubt that these metals were prepared by the Almighty for this very purpose, than I have that iron and coal were prepared for the purpose for which they are being used. I favor a well secured convertible paper currency -- no other can to any extent be a proper substitute for coin. (McCulloch 1900, 201)

McCulloch's preoccupation with curbing inflation by the speedy contraction of greenbacks precluded his recognition of the danger of depression.

The Consequences of McCulloch's Deflationary Policies

John Sherman, the Republican Senator from Ohio, considered McCulloch's policy of the rapid contraction of money "a great misfortune."

Now, nearly thirty years after the passage of the act, [the Contraction Act of April 12, 1866] it is manifest that it was by far the most injurious and expensive

financial measure ever enacted by Congress. It not only compelled the United States to pay large war rates of interest for many years, but postponed specie payments until 1879. It added fully \$300,000,000 of interest that might have been saved by the earlier refunding of outstanding bonds into bonds bearing four to five per cent interest. (Sherman 1895, 384)

Sherman challenged the anti-inflationary measures of McCulloch and scorned the Secretary's predictions of doom and disaster. Sherman saw no need to curb inflation by rapid contraction of greenbacks; in his opinion, the revival of industry and the growth of wealth after the war would have increased the purchasing power of paper money, and brought it near to par with coins. This argument was espoused in the 20th century by the Democratic Congressman from Texas, Wright Patman, a severe critic of the Federal Reserve Board's "obsession" with inflation. Sherman underlined not only the unnecessary hardship of the expanded national debt on people, brought on by McCulloch's policies, but the derangement of the economy and the rise of popular opposition. While both McCulloch and Sherman favored a return to specie payment, they differed on the means to achieve it. McCulloch chose drastic contraction; Sherman relied on the gradual expansion of industrial production. Under the 1866 contraction act, An Act to Provide Ways and Means to Support the Government, \$4 million in greenbacks were to be retired per month. "Even the withdrawal of \$48 million a year was soon found to be oppressive and was subsequently repealed." (Sherman 1895, 378) The growing

public opposition to contraction led to the repeal of the 1866 Act in February, 1868. Sherman objected to "the absolute power" which allowed the Secretary of the Treasury to reduce the currency and fund the national debt at his discretion. Such power had not been granted to any of McCulloch's predecessors.

After the wartime boom of 1865, the business cycle turned downward and reached a trough in December, 1867.

It is apparent, therefore, that business conditions were deteriorating during almost the entire period when McCulloch was pursuing a policy of currency contraction. Things picked up after December, 1867, and business improved steadily until June, 1869, when another peak was reached. (Sharkey 1959, 82)

Between 1868 and 1873 prices and employment were on the rise only to reverse back to the 1866 depressed conditions. The financial panic of 1873 started with the failure of the leading banking house, Jay Cooke & Co. There is a diversity of opinions regarding the crisis. "Those who believed that the trouble was to be ascribed to a restricted currency were, if not the most numerous, the most clamorous." (Knox 1900, 274) The opposition argued that speculation and extensive borrowing locked up in unproductive enterprises, and the growing debts of individuals and companies were the cause of the trouble.

The Greenbacks Movement

The depression and unemployment of 1866, caused largely by McCulloch's contraction policy, gave rise to the working class movement called the Greenbacks movement. The Greenbackers demanded cheap and ample supply of paper money (the greenbacks) to be issued exclusively by the federal government and not through national banks. They demanded an increased volume of money to match the growing population, shorter working hours and a more equal distribution of wealth so as to enable the working class to participate in social and cultural life. Their demands included a speedy liquidation of national debt and a graduated income tax.

The Greenbackers were the most ardent critics of the country's financial system. They were resolved to return the control over money and government to the people and away from the special interests of the bankers and the capitalists. The movement developed in the West, coincided with the labor union movement, and culminated in the formation of the Greenback Labor Party in 1874. The Greenbacks' Platform of 1876 demanded that United States notes be issued and controlled by the government:

We hold that it is the duty of the Government to provide such circulating medium, and insist in the language of Thomas Jefferson, that "bank paper must be suppressed and the circulation restored to the nation, to whom it belongs." (Porter and Johnson 1970, 52)

In 1892 the Greenbacks coalesced with the People's Party, and the Greenbacks' ideology contributed substantially to the agrarian revolt. John R. Commons distinguishes two stages of Greenbackism:

The first, that of the National Labor Union, 1867 to 1872; the second, that of the Greenback Labor Party after 1873. The first was based on the theory of capital, interest and credit; the second on a theory of money and prices. (Commons 1958, 9:34)

The third party movements after the Civil War were an expression of the dissatisfaction with the Republican and Democratic parties that -- ignoring the fundamental principles of democracy -- fostered monopolies and supported a "radically wrong" financial system controlled by commercial bankers.

The Ideologues of the Greenbacks Movement

The "Father of Greenbackism" was Edward Kellogg (1790-1858), a New York merchant, who became a writer on monetary reforms. The Greenbacks based their program on Kellogg's writings. Kellogg saw the root of working class deprivation in the unjust distribution of wealth, in the concentration of monetary power in a few private hands, and in the scarcity of currency to meet the needs of the masses. Kellogg estimated that one half of the national wealth was held by 2½% of the population.

Money was a legal issue for Kellogg. Since Congress was entrusted by the Constitution with the power to regulate the value of money, it was also its duty to remedy the evils brought about by unsound monetary policies. He argued that the value of money was determined by the interest rates and not by the quality of the material it was made of, nor by the quantity. In Kellogg's view, the paper dollar was as secure as the silver dollar, because both values were determined by law. Since the interest rates on loans determined what proportion of earnings went to capital and what proportion went to the worker, the right of each had to be secured.

The rate of interest fixes the value of money. . . . If interest on money be too high, a few owners of capital will inevitably accumulate the wealth or products of the many. . . . The evil is legislative, and the remedy must be legislative. (Kellogg 1971, 74-75)

To achieve an equitable distribution of capital and to secure the prosperity of the country, the prevailing money monopoly had to be eliminated and a new monetary system established. The bankers' right to cause scarcity by withdrawing money from circulation could not be tolerated.

Some public means must be devised whereby the requisite amount of money for the people may always be supplied at the legal rate of interest. No government should make a currency of a material of which it cannot supply a quantity adequate to the wants of the people. (Kellogg 1971, 235)

The specie system meant not only scarcity but loss of control over money by the government and the people. Through

the specie payments the "capitalists control the money, and through the money control the government." (Kellogg 1971, 231) Kellogg developed a plan by which

the whole people, through Congress, would hold the power, and fix the rate of interest. They can by a vote put the system in successful operation without consulting capitalists, banks or brokers. (Kellogg 1971, 231)

He proposed the establishment of a governmental agency, the National Safety Fund. This agency would create and issue an ample supply of all the monies that would meet the needs of the growing population and be secured by the possessions of the country. It would also loan money at a low interest rate of 1 1/10%. The Safety Fund would have taken the power to regulate the volume of money away from the banking institutions and would have ended the bankers' claims of "expertise" on monetary policies and their influence over the government. Kellogg revived the Jeffersonian ideals of equality and trust in the sovereignty of the people:

In the United States, the people generally suppose that they have all the freedom and rights that a government can confer . . . But notwithstanding the apparent freedom secured to us, it may be easily shown that our laws inflict great evils upon us. (Kellogg 1971, xxv)

Alexander Campbell (1814-1898), a Representative from Illinois, held Kellogg's writings in great esteem. Inspired by his ideas, Campbell recommended currency reforms to the U.S. Congress in 1868 in a "workingmen's bill" entitled: "A bill to establish a uniform currency, provide for the management and liquidation of the national debt, and for other purpos-

es." Campbell proposed the establishment of a "True American Monetary System and Fiscal Agency" which would issue uniform paper money. The people and their representative government, not the "shylocks," would regulate and be in full control of money and interest rates. The bill called for the repeal of the National Banking Acts of 1863-64 and the monetary system developed by these Acts. Under Campbell's proposed act, the Treasury would issue non-interest-bearing certificates as lawful money in payment of all debts. The certificates could be converted into 3% interest-bearing bonds, replacing the bonds bearing 6% in specie, paid to bankers on the bonds deposited as a security against the receipt of circulating notes. By this measure the national debt could be speedily and easily liquidated.

Campbell, like Kellogg twenty years earlier, considered labor to be the wealth-producing power of the nation and demanded for the laborers a fair share of the profits from production. He saw the cause of workers' poverty in the "iniquitous monetary laws" which favor the upper stratum of society at the expense of the lower one. Campbell argued that political and religious freedoms are not sufficient to secure the natural rights of people, absent economic justice:

Our monetary laws, unlike our government, are founded on the aristocratic idea that the few should rule the many; that the many should toil for the few; that

producing labor should be the slave of money or non-producing capital. (Campbell 1868, 31)

Campbell stressed the necessity of a moderate work load and higher wages thus making possible the development of the workers' full human potential. As a Labor Reform Party leader, Campbell appealed to farmers to join the labor movement in an effort to overthrow "the shoddy banking system mis-called National" and end the oppression of the lowest stratum of society.

Ira Steward, a machinist from Boston, is called the philosopher of the Eight Hour Movement. In the 1860's he rejected wage control policies based on the capitalistic theory of labor supply and demand, and stressed psychological factors instead. He presented a new theory and argued that the standard of living determines the wages. The desires, opinions, cognizance, habits and customs of the workers were the forces that determine wages. The gap between the low and the high standards of living could be bridged by reducing the working hours from ten or twelve hours to eight hours a day without wage reductions, made feasible by technological progress. A shorter workday meant the workers would have more time and energy for education and participation in civic duties. This would help expand the workers' horizon, self-esteem and status in society. Steward reversed the supply-side theory of Alexander Hamilton by building economic prosperity on the workers' raised demands. A higher

standard of living for the workers meant increased consumption which in turn would stimulate production. Steward ascribed the strong resistance of employers to the shorter workday to their fear of losing control over an enlightened work force. The above passage is based on John R. Commons, Documentary History of American Industrial Society, Introduction to vols. 9 and 10.

The Populist Movement: 1870-1896

The effort to restore "sound money" through a contraction of currency brought great suffering to farmers and urban workers alike and led to a popular revolt.

Due to the scarcity of money, prices of farm products were pushed down while the interest rates went up; this enriched the creditors while impoverishing the borrowers and the producers. The farmers who relied on credit before cashing in on their next harvest were trapped. They had to sell at rock-bottom prices at harvest time and depend on credit from merchants and banks to sustain themselves and their families through winter. Their next crop was the only tangible asset they could mortgage. At the end of the season they found out that the accumulated debt exceeded the income they had received from the new harvest. The "crop lien system" impoverished the farmers. They were further exploited by the railroad monopoly and freight rates when shipping their

goods. Dependence on credits and railroads made them keenly aware of the power of the trusts and their own helplessness. The urban workers were also trapped by the "sound money" policy which depressed commercial activities and raised unemployment. Those who found work accepted working conditions that endangered their safety and health. They worked 10-14 hours a day in poorly lit and poorly ventilated places; they were exposed to injuries and lived in crowded wooden shacks.

The rampant industrialization after the Civil War bred monopolies and the "robber barons" on one side, and impoverished workers on the other side. Industrialization and the concentration of ownership went hand in hand. In the scramble for riches, the common man became the tool that paved the road to industrial growth and created the wealth appropriated by the "captains of industry." Some historians describe the plight of workers as a "new slavery" and the unrestricted power of wealth as "business feudalism." The "captains of industry" justified their right to riches with Social Darwinist theories. They extolled the benefits of unrestricted self-interest and the "survival of the fittest." The freedom of the property owner to realize quick profits by any means was viewed as an unalienable right. The growing monopolies not only controlled the markets, they also bribed the legislators and corrupted the laws of the

country. In the late 19th century the nation experienced what Jefferson had feared in 1816: "the aristocracy of our monied corporations which dare already to challenge our government to a trial of strength, and bid defiance to the laws of our country."

The populist movement united the discontented farmers and urban workers, and channeled their anger into political action. Their goal was a democratic control over America's economic and financial system, and they pursued with vigor the conviction that nothing short of structural reforms would change the condition of the common man. The Populists realized the hollowness of political freedom in the absence of economic freedom. They rejected the gold standard orthodoxy which placed "sound money" above the needs of the people thereby causing stagnation, unemployment, and poverty. They demanded cheap, ample money and advocated a "cooperative commonwealth," a society respecting human rights. In place of the railroad monopoly, they demanded a national system under government control, and asked for protection against corporate oppression, urging the government to intervene in the economy. In Lawrence Goodwyn's words, populism was more than a mass movement, and more than an ideology. The Populists generated a spirit of self-respect and human dignity, and kept alive the vision of man's possibilities and power to create a humane society.

The Spokesmen of the Populist Movement

The most eloquent spokesman and organizer of the farmers was Dr. Charles W. Macune of Texas, a lawyer and a physician by profession. He founded the National Alliance in 1877 and originated large-scale economic reforms and cooperatives. Through lectures and discussions he mobilized the farmers throughout the country. Macune realized that the principles of "human rights" had to be translated into reality and implemented to different circumstances.

Macune's most ambitious plan was the sub-treasury land and loan system to help the farmers escape the clutches of the creditors and give them control over their products and their lives. The sub-treasuries were federal warehouses to be erected in every county. The sub-treasury system would have bypassed the intermediary bankers and enabled the federal government to issue cheap and ample currency directly to the farmers.

In these "sub-treasuries" farmers could store their crops to await higher prices before selling. They were to be permitted to borrow up to 80 per cent of the local market price upon storage, and could sell their sub-treasury "certificates of deposit" at the prevailing market price at any time of year. Farmers were to pay interest at the rate of 2 per cent per annum, plus small charges for grading, storage, and insurance. (Goodwyn 1978 109-110)

Henry Demarest Lloyd (1847-1903), financial editor of the Chicago Tribune from 1875 to 1882, and its general editor

from 1882 to 1885, ran on the Populist ticket in 1894. Lloyd wrote on behalf of the working class, and exposed the unethical practice of monopolies. He exposed the fallacy of Social Darwinism and the prevailing business culture that claimed that what is good for business is good for society, by documenting the irresponsible social behavior of big corporations. Lloyd juxtaposed two different Americas: the ideal of a democratic America of equality against corporate America. "Politically we are civilized; industrially, not yet. . . . The true law of business is that all must pursue the interest of all." (Lloyd 1963, 7) He concluded that "the mania of business" had reached such an excess in America because of the country's vast natural wealth and free institutions. Lloyd was confident of the final victory of democracy: "The change will come . . . with peace or sword, freely through reform or by nature's involuntary force, is a mere matter of detail, a question of convenience, not the essence of the thing." (Lloyd 1963, 7)

Seeking to replace the prevailing doctrine of Social Darwinism and laissez-faire economics with ethics as the basis of social action, Lloyd turned to universal Christian values. Against unscrupulous competition, he placed cooperation; against unrestrained individualism, brotherhood; against selfishness, love. In his own words, Lloyd did not seek a utopia or a theoretical formula for a new world but asked

men to become men again by revitalizing the basic strands that were always present, although latent: the humaneness of man and the creative energy of the common people. Lloyd viewed man as "the social creator" and looked for solutions to social problems in peoples' hearts and minds; without a new consciousness nothing could change. One hundred years later, Vaclav Havel, President of the Czech Republic, expressed the same sentiment: "Without a global revolution in the sphere of human consciousness, nothing will change for the better in the sphere of our being. . . ." (Havel. The New York Times. 22 February 1990, A14)

Lloyd came to regard economic problems as fundamentally ethical in character, and the labor movement as an ethical revolt that would overthrow classical economics, demoralized labor relations and monopolistic exploitation of the masses, and vitalize the churches with a truly social gospel. (Destler 1963, 132)

The People's Party and The Omaha Platform

The People's Party was established in 1892 in Omaha, Nebraska. Their convention held on July 2, 1892, in the presence of 1654 delegates, crowned thirty years of efforts by the Greenbacks, the Farmers' Alliance and the Industrial Union. It sealed the agreement between labor, farmers and working class citizens.

The People's Party demands, enumerated in the Omaha Platform and Resolutions, challenged the corporate state and proposed to bring it under people's control. The democrats demanded

that government "only" issue currency in proportion to the size of population, and distribute it directly to the people "without the use of banking corporations." They also demanded that monies be allocated for "public improvements."

We demand a national currency, safe, sound and flexible, issued by the general government only.

We demand free and unlimited coinage of silver and gold at the present legal ratio of 16:1.

We demand that the amount of circulating medium be speedily increased to not less than \$50 per capita.

We demand a graduated income tax. . . . The government should own and operate the railroads in the interest of the people.

The telegraph and telephone, like the post office system, being a necessity for transmission of news, should be owned and operated by the government in the interest of the people.

All land now held by railroads and other corporations in excess of their actual needs, and all lands now owned by aliens, should be reclaimed by the government and held for actual settlers only. ("People's Party Convention, Omaha" 1892, 458)

The Resolutions, expressing the sentiment of the convention, included demands for shorter working hours, restrictions on immigration, direct popular election of United States senators, and an end to subsidies or national aid to private corporations. The convention nominated General James B. Weaver of Iowa, a former Greenbacker, for President and James G. Field, of Virginia, for Vice President.

The Detroit Tribune attacked the People's Party platform as "un-American, unpatriotic and unpopular."

The End of the People's Party

Shortly after Grover Cleveland became President in 1893, a financial panic broke out causing a period of severe economic depression which lasted until 1897.

The depression years increased support for the Populists. But when sufferings were mitigated by improved economic conditions, although the people were still victims of the same grievances, support for the Populists declined. In 1896, the People's Party in order to avoid extinction, fused with the Democratic Party and supported the nomination of William Jennings Bryan (1860-1925) from Nebraska for the Presidency against the strong protest of some prominent party members. Bryan had adopted many of the Populists' doctrines but made free silver the most important demand.

1896 was the year of the "battle of the standards" between the free-silver platform of the Democrats, demanding unlimited coinage of silver, and the gold standard advocates led by the Republicans. Bryan was an eloquent spokesman for free silver, for the end of economic abuses through antitrust laws, and for the improved living conditions of farmers, industrial workers, and the little people. The free silverites, similar to the currency reformers of the 1860's, sought to ease the hardship of deflation and high interest rates by expanding the money supply. The free coinage of

silver would have reduced the bankers' power to control the volume of currency because they held all of the gold but not most of the silver.

In the 1896 Presidential elections the Democrats were defeated by the Republicans and William McKinley became President from 1897 to 1901. Bryan was too radical for the voters, and the Republican campaign funded by the industrialists frightened the cautious voters. The controversy between gold and silver was settled by the Gold Standard Act of 1900, which became the basis for the U.S. monetary system.

The Populists failed in 1896 -- but their failure was by no means ignominious, and in one sense they triumphed at a later day when their reforms were introduced under other auspices and the "Pops" had become but a fading memory. (Durden 1965, x)

What Was the Populist Movement?

In answer to this question Lawrence Goodwyn wrote:

Populism in America was not the sub-treasury plan, not the greenback heritage, not the Omaha Platform. It was not, at bottom, even the People's Party. The meaning of the agrarian revolt was its cultural assertion as a people's movement of mass democratic aspiration. (Goodwyn 1978, 294)

Goodwyn saw Populism not simply as a brief triumph of democratic aspirations, in the midst of the prevailing capitalist culture, but as a "democratic promise."

The capitalist and socialist languages of political description available in the twentieth century cannot easily characterize the human ingredients that were at the core of American Populism. . . . But though the

evidence is culturally difficult to imagine, it is clear: the Populists did have a great sense of self as democratic citizens and a more hopeful view of democratic possibility than that which is culturally licensed within the modern progressive societies around the globe, either socialist or capitalist. (Goodwyn 1976, xii-xiii)

In Norman Pollack's words: "Populism was more than a protest movement; it was a glorious chapter in the eternal struggle for human rights. Modern America might profit from the populist movement." (Pollack 1972, 143)

The Populists refused to accept any ideology that violated man's dignity and his basic rights. The period after the Civil War was marked by deep contrasts, great aspirations and the development of mass democracy. The Populists aimed to bring monetary system and the corporate state under people's control. "Had Populism succeeded, it could have fundamentally altered American society in a socialist direction." (Pollack 1972, 19)

CHAPTER VII: THE PROGRESSIVE ERA: 1896-1913

The Progressive era was a time of moderation and compromise. Contrary to the Populists, the Progressives did not challenge the philosophy of Social Darwinism, but instead attempted to curb the most flagrant abuses of the monopolies by federal regulations. The aim of the Progressive policies was to strike a balance between the growing power of trusts on one side, and the labor unions on the other. The Progressive Presidents abandoned the passive role of government, they mediated in labor disputes and regulated business when required by public interest.

The struggle for democratic control over money and the equal distribution of the increased wealth between labor and capital ended with the Republican victory of William McKinley in 1896. While the Populists had demanded a basic restructuring of the economy as outlined in the Omaha Platform, the Progressives offered only piecemeal remedies.

During William McKinley's Administration, the attention of the nation turned to the Spanish-American war and the Populists' demands for banking reforms were pushed aside. After the assassination of McKinley, Theodore Roosevelt became President in September of 1901 and spread the Progressive Movement nationwide. Roosevelt was a man of strong

convictions; he expanded the role of government into social and economic spheres. Roosevelt used the power of the government to stem monopoly abuses as well as radical measures of labor to secure better conditions for workers. In response to the exploitation of natural resources, he initiated conservation projects. Unlike the Populists, Roosevelt accepted big corporations as an inevitable historical evolution and believed that trusts could be regulated by federal laws and their activities directed to serve the public interest.

Roosevelt believed that big corporations as well as trade unions should be protected under the law as long as they acted "honestly," and advocated strong legal measures for dishonesty. The President's philosophy was that the captains of industry deserved "exceptional" financial rewards for "exceptional" abilities and for their contribution to the increased national wealth. Roosevelt separated people by their innate superior and inferior abilities, thus justifying unequal rewards. He was "sincerely convinced" that trusts should not be prohibited but rather supervised and controlled by the national government if found to be "hurtful" to the general welfare. Roosevelt believed that under then existing conditions only the federal government could match the strength of organized capital and organized labor and be capable of exercising control. He dismissed state

regulations as inadequate to handle national issues. Roosevelt accepted the existence of monopolies but distinguished between "good trusts" and "bad trusts" and between permissible methods and the unbridled use of power. Roosevelt advocated an active role of the federal government when abuses were evident, but cautioned against undue interference.

While the Populists, in the tradition of Jefferson and Jackson, opposed concentration of capital in the hands of a few, the Progressives viewed it as desirable. As Jeremy Taylor noted:

Capital works best -- or at least is almost irresistible in its power -- when it has been herded together. And this means it is a tool that is available only to financial megainstitutions. (Taylor 1990, 208)

The Populists demanded fair distribution of the increased national wealth created by labor and capital; the Progressives failed to appreciate the contribution labor made to economic growth.

In the First Annual Message to Congress delivered on December 2, 1901, Roosevelt stated:

It is not true that as the rich grow richer the poor have grown poorer. . . . On the contrary, never has the average man been as well off as in this country and at the present time. . . . The captains of industry who have driven the railway systems across the continent, who have built up our commerce, who have developed our manufactures, have on the whole done great good to our people. (Muller 1917, 9:3027)

In the Fourth Annual Message given on December 6, 1904, Roosevelt acknowledged the right of organized labor and organized capital but warned against abuses and stressed the necessity of control:

I believe that under modern industrial conditions it is necessary, and even where not necessary it is yet often wise, that there should be organization of labor, in order better to secure the rights of the individual wage worker . . . But when any labor union seeks improper ends, or seeks to achieve proper ends by improper means, all good citizens and more especially all honorable public servants must oppose the wrongdoing as resolutely as they would oppose the wrongdoing of any great corporation. (Muller 1917, 9:3077-78)

Appalled by the high rate of loss of life and maiming from railroad accidents, and by an unfavorable comparison with other industrialized countries, Roosevelt urged a "strong employer's liability law" which went into effect in the Taft administration. Roosevelt also pressed for a uniform child-labor legislation among the states.

In the Fifth Annual Message of December 5, 1905, following the doctrine of Social Darwinism, Roosevelt justified the inequality of wealth by the inequality of human abilities and concluded that the self-interest of the leaders of industry also benefited the public. He ascribed the striving of the "less fortunate men" for higher rewards and recognition to "envy" rather than to outrage over injustice. Having no other alternative, the workers resorted to strike.

The superficial fact that the sharing may be unequal must never blind us to the underlying fact that there is this sharing, and that the benefits come in some degree to each man concerned. Normally, the wage-worker, the man of small means, and the average consumer, as well as the average producer, are all alike helped by making conditions such that the man of exceptional business ability receives an exceptional reward for his ability . . . If, therefore, the less fortunate man is moved by envy of his more fortunate brother to strike at the conditions under which they have both, though unequally prospered, the result will assuredly be that while danger may come to the one struck at, it will visit with an even heavier load the one who strikes the blow. Taken as a whole, we must all go up or down together. (Muller 1917, 9:3090)

Like Jefferson, Roosevelt considered voting to be not only a right but a fundamental duty of every citizen to maintain a democratic government which derives authority from the people and is responsible to the people. Like Jefferson, Roosevelt warned against the corrupting influence of corporate money on government. In the Sixth Annual Message delivered on December 3, 1906, Roosevelt asked for political reforms:

I again recommend a law prohibiting all corporations from contributing to the campaign expenses of any party. Let individuals contribute as they desire but let us prohibit in effective fashion all corporations from making contributions for any political purpose, directly or indirectly.

Roosevelt warned that a failure to pass the bill will result in seriously hampering the Government in its effort to obtain justice especially against wealthy individuals or corporations who do wrong (Muller 1917, 9:3119-20)

Despite attempted reforms, we have a system of "legalized bribery" today:

Last year senators openly pocketed more than \$2 million in honorariums from government favor-seekers. And they collected tens of millions more in campaign contributions from the same special interests. ("The Senate on Trial" 1990, A26)

In the Eighth Annual Message of December 8, 1908, Roosevelt spoke about the power of the central government. He believed that the danger to American democracy lay not in the concentration of the administrative power in responsible hands, visible and accountable, but in being scattered and exercised in secrecy:

The power already exists, it does not have to be created. The only question is whether it should be used or left idle -- and meanwhile the corporations over which the power ought to be exercised will not remain idle. . . . Democracy is in peril wherever the administration of political power is scattered among a variety of men who work in secret, whose very names are unknown to the common people. (Muller 1917, 9:3210-11)

Roosevelt's last speeches are in sharp contrast to the earlier messages in which he had credited the captains of industry with performing a great public service. Faced with the accumulated evidence of corporate abuses of power toward the end of his administration, Roosevelt became more critical of big business. The business community showed low tolerance for Roosevelt's criticism and charged him with "subversion," "socialism," and "leftism." When accused of precipitating the financial panic of 1907 by attacking business, Roosevelt responded: "If trouble comes from having the light turned on, remember it is not really due to

the light, but to the misconduct which is exposed." (Hicks 1956, 610) Roosevelt believed that the financial panic was instigated by "malefactors of great wealth," to discredit his administration. He ascribed his popularity with common people to putting "into words what is in their hearts and minds but not in their mouths." (Morison 1965, 829)

The severe financial crisis of 1907 moved the legislators into action. The weaknesses and abuses of the national banking system had already been recognized in the previous century but they had not been acted upon because of major disagreements on reforms. The 1907 crisis stressed the need for an overall supervision of banks to prevent an overextension of credits and speculation, leading to recurrent panics; it also stressed the need for a flexible currency to counteract the business cycles.

In 1910, William Howard Taft's administration empowered the National Monetary Commission, chaired by the Republican Senator Nelson Aldrich from Rhode Island, to survey central banks of foreign countries and prepare a draft for the United States banking system. In 1911, Aldrich presented a bill proposing a national banking system to be controlled by bankers; in his estimate, the people best qualified by training and experience to assume such a responsibility. In his campaign speech on October 7, 1912, Woodrow Wilson spoke of "Aldrichism." In his opinion, Aldrich represented special

interests that sought to influence the laws of the United States.

After the 1912 elections, the Democrats' investigation of the banking establishment by the House of Representatives' Committee on Banking and Currency, known as the Pujo Committee, revealed the operations of a "money trust." By "money trust" the Committee meant:

An established and well-defined identity and community of interest between a few leaders of finance which has been created and is held together through stock holdings, interlocking directorates and other forms of domination over banks, trust companies, railroads, public service and industrial corporations, and which has resulted in a vast and growing concentration of control of money and credit in the hands of a comparatively few men. (Pujo Report on Money and Credit 1913, 130)

The Pujo Committee documented that the House of Morgan was in fact the U.S. central bank. Through stock ownership and interlocking directorates, J. P. Morgan controlled the country's major industries and decided singlehandedly who should get loans.

J.P. Morgan & Co., and the directors of their controlled trust companies and of the First National and the National City Bank together hold . . . 341 directorships in 112 corporations having aggregate resources or capitalization of \$22,245,000,000. (Brandeis 1914, 32-33)

Pierpont Morgan, however, refused to recognize his power in the financial world. He argued that credit was not based on money or resources but wholly on character: a man with

property and without character could not get credit from Mr. Morgan "on all the bonds of Christendom." Daily business transactions demonstrated the fallacy of Mr. Morgan's statement.

The widely publicized Pujo investigations aroused public awareness of the magnitude of corporate power that had been previously exposed by Theodore Roosevelt and William Howard Taft. The Aldrich plan proposing a single bank dominated by bankers excited public opposition and fears of the repetition of the Jackson-Biddle war of the 1830's.

Paul M. Warburg, a member of the banking house Kuhn, Loeb & Co., wrote on the shortcomings of the United States banking industry and took interest in the banking reforms. He sensed the strong populist sentiment in the country; therefore, when he appeared before the House Committee on Banking and Currency on January 7, 1913, he recommended a modified central bank:

I express the view that in order to bring about a well balanced control of the System it would be advisable to empower the government to appoint a little more than one-half of the members of the board of the central office, in addition to the ex-officio members and to permit the other members to be appointed by the banks.
(Warburg 1930, 55)

Although Warburg's suggestion was not accepted in 1913, it was later incorporated into the Banking Act of 1935. Warburg made a distinction between non-political arguments, made by

professional bankers, and the arguments made by the representatives of the government, who as elected politicians, had a biased opinion and pleaded on the basis of their self-interest.

Who Should Run the Central Bank?

The Democratic Congress presented alternate bills to the Aldrich proposal. Congressman Carter Glass of Virginia, co-author of the Federal Reserve bill, favored Warburg's recommendation and proposed a regional reserve system represented by a central board in Washington, D.C., consisting of bankers and government officials under the supervision of the Comptroller of the Currency. The then Treasury Secretary, McAdo, proposed a central bank under Treasury control. Senator Robert Owen advocated a board of Presidential appointees to run the system. Glass, who feared too much political pressure from such a board, insisted that three members on the board be chosen by the banks. Wilson resolved the dispute over the board in adopting Owen's proposal, and insisted that the control of the banking system and of issuance of money must be public, not private. He counteracted the attacks of the financial community by the frequently quoted statement: "Which one of you gentlemen would want me to appoint railroad presidents to the Interstate Commerce Commission to fix passenger rates and freight rates?" The bankers did not argue with this point of view

but, nevertheless, opposed the legislation. Their hope was that in due time they would be able to gain control of the monetary system. And they did, as discussed in Chapter 9 under the subheading **The Federal Open Market Committee**. While in 1913 Owen, in opposition to Glass, ensured that the government and not the bankers control the system, in 1935 Glass' proposal to advance regional banks' presidents from an advisory capacity to a seat on the Board won Congressional approval.

On December 23, 1913, President Wilson signed the Federal Reserve Act establishing the Federal Reserve System "to furnish an elastic currency" and "establish a more efficient supervision of banking in the United States." The system thus set up is a decentralized central system, combining private and public interests. It is under the supervision of the Federal Reserve Board in Washington, an independent government agency. The twelve regional Federal Reserve banks, under the supervision of the central Board, are private corporations with their own boards of directors described in detail in the following chapter. The Pujo Committee's specific recommendation that national banks should be prohibited from underwriting securities was not followed in 1913. This provision became law after the 1930's crash through the Glass-Steagal Act.

Contrary to the Populists of the previous century who wanted to change the monetary system in order to end social and economic oppression, the Progressives modified the structure, leaving the basic precept of issuance of money intact. The Progressives, however, exposed the weaknesses of laissez-faire economy and the fallacy of its purported self-adjusting mechanism. They challenged the dictum that unrestricted self-interest leads to public benefit. While they expanded the role of government, they left the power of capital in the hands of megacorporations, without attempting a more egalitarian sharing of the socially created wealth, as had been called for by the Populists.

The Progressive era ended with the outbreak of the First World War when the attention of the nation was once again turned from economic justice reforms to war.

PART II

THE FEDERAL RESERVE SYSTEM: 1913-1991

CHAPTER VIII: THE FEDERAL RESERVE ACT OF 1913

"An Act to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means rediscounting commercial paper, to establish a more efficient supervision of banking in the United States, and for other purposes." (U.S. Statutes. Statutes at Large. Vol. 38, pt. 1:251)

The Federal Reserve Act of 1913 was a response to the severe financial panic of 1907 and prior crises, ascribed to the scarcity of currency. The recurrence of financial panics and bank failures convinced Congress of the necessity of a strong central management supported by a network of regional boards. Between the end of the Civil War and the passage of the Federal Reserve Act of 1913, the country suffered from four major financial crises: 1873, 1884, 1893, 1907. In 1910, Oliver Sprague of Harvard listed many causes of the crises, among them: money stringency, unhealthy banking practices, loan contraction, concentration of deposits, and loss of public confidence in the banks. He came to the conclusion that an increase in loans "to meet the demands of depositors for money would have allayed every panic since the establishment of the national banking system." (Sprague 1910, 319) Sprague recommended the creation of a bank of last resort, ready to mobilize reserve funds and sustain any private bank. He emphasized the importance of a trusting public, prudential management and financial readiness for the prevention of future crises.

To avoid the danger of inadequate funds, the newly established Federal Reserve System was authorized to provide an elastic monetary mechanism to accommodate business, industry and agriculture. The System's capital was raised by member banks' subscription to the stock and linked the public features of the System and private banks. The central bank was a political compromise combining federal supervision of the banks with the autonomy of local banks; it was commended for coordinating public and private, national and regional interests. Unlike the central banks of other countries, with one central bank, the Federal Reserve was a decentralized system comprising the Federal Reserve Board in Washington, D.C. (a governmental agency), the twelve Federal Reserve banks (regional private banks), and the member commercial banks. The System reflects a historical evolution of past practices, habits and needs.

The Federal Reserve was conceived as a genuine public organization, an impartial and objective body, a protector of the banking industry and a fair allocator of credit. The System was provided with a significant degree of independence in the monetary operations to protect it from a preponderance of private and partisan interests. The central Board was created with the primary purpose of supervising the member banks, ensuring sound banking practices, meeting the financial needs of the trade, acting as a bank of last

resort, providing services for commercial banks and acting as the fiscal agent of the Government. The Board's function was technical and service oriented; it was not designed to control the supply of money since the contraction and expansion of money was believed to be automatic. The Federal Reserve was to mobilize ample currency in response to the free market forces. The pre-Keynesian economic system was assumed to be stable and self-regulating.

Originally, the Federal Reserve Board consisted of seven members, appointed by the President. The Secretary of the Treasury and the Comptroller of the Currency were ex-officio members of the Board, and the Secretary acted as Chairman. The other five members were appointed for ten years. In 1933, the tenure of the Board members was extended from ten to twelve years and in 1935 from twelve to fourteen years, one term expiring every two years. The Banking Act of 1935 removed the Secretary of the Treasury and the Comptroller of the Currency from the Board because of "undue influence." Presently, all seven members of the Board are appointed by the U.S. President, with the advice and consent of the Senate. The chairman and the vice chairman are selected by the President from among the seven Board members for a renewable term of four years.

Debates about the membership of the Board cover over 1000 pages in the Congressional Record. As in 1791, the question in 1913 was: should the U.S. Government or the private sector control the money?

Many of the big banks quite urgently insisted that the bankers should have representation upon the Federal reserve board. This was denied for the obvious reason that the function of the Federal reserve board in supervising the banking system is a governmental function in which private persons or private interests have no right to representation except through the Government itself. (Banking and Currency 1913, pt. 2:20)

A compromise was reached by establishing the Federal Advisory Council, consisting of one representative banker from each of the 12 Federal Reserve Banks to advise and make recommendations to the central board.

The banking community objected to the Act for giving too much power to the government over the monetary system; the Progressives complained of too little governmental control. A strong opposition came from the American Bankers Association who saw governmental control as a form of creeping socialism. According to Henry Parker Willis, professor of banking, Columbia University, major opposition to the Federal Reserve Bill came from those who supported the Aldrich plan under which the banks would have controlled and managed the federal system. Some bankers advised compliance with the reforms in the belief that the practice would neutralize the

objectionable features of the law. Willis ascribes the stilling of the opposition to the advent of the war.

The threat of the war, however, had presented other difficulties. The attention of the administration was diverted from the task of careful long-term organization of the bank machinery and was immediately directed to hasty measures of relief. (Willis 1952, 551)

Herbert Hoover backed Willis' criticism of the 1913 Federal Reserve Act by attributing the 1930's depression to the poor organization of the banking system: weak banking laws, too many different bank regulators, weak state regulations and inadequate national bank inspection. (Hoover 1952, 3:21, 23)

The original intent of the 1913 Act had been changed by practice. The theoretical separation of the Board from the influence of the bankers could not be achieved in the absence of a supportive structure. In the 1930's the Federal Advisory Council members were perceived as "puppets of Wall Street." In 1990, Thomas Havrilesky, professor of economics, Duke University, measured the private group's influence on the regulator and confirmed

the symbiotic view that Federal Reserve monetary policy responds to the signals from the banking industry as reflected in the directives of the Federal Advisory Council. (Havrilesky 1990, 17)

In 1967, the U.S. House Banking and Currency Committee found that the regulators were captives of the regulated. The Committee revealed concentration of economic power in the hands of a few and warned against the danger of "money monopoly" reminiscent of the early 1900's. The Federal

Reserve banks and their member banks are powerful allies of the Federal Reserve Board and provide a political network that has been mobilized for lobbying against bills attempting to curtail the Fed's independence. Wright Patman, Chairman of the Committee, came

to the inescapable conclusion that the Congress, the bank supervisory agencies, and the state banking agencies have failed miserably in either preventing or calling attention to superconcentration among financial institutions. (Control of Commercial Banks and Interlocks among Financial Institutions 1967, iii.)

Although the Federal Reserve System was created by Congress, Congressional oversight was weak from the beginning. The tradition seems to have become established among the majority of the legislators that politics should be kept out of finance. Since Congressmen are the elected representatives of the American people, "politics out of finance" means "people's voice out of finance." Congressional abdication of responsibility over the Fed is interpreted by the Fed as a sign of autonomy, further supported by the long tenure of the Board members and by the self-financing system of the Fed's operations. While insulated from the people and their representatives in the House, the Fed is not formally independent of the Executive and the Senate. The U.S. President has the power to appoint or dismiss, for a good cause, members of the Board. The Senate gives "advice" and "consent" to the Presidential appointees, but due to long tenures, this provision has become meaningless.

To ensure representation of regional economic needs in the national monetary policies, the country was organized into twelve districts, each with its own Federal Reserve bank board consisting of nine directors. Two thirds of the directors, the three class A and the three class B directors, are elected by the member banks of the district. The class A directors, representing the bank lenders, may themselves be bankers. The three class B directors, representing the borrowers, must be actively engaged in the district in business, commerce, industry or agriculture, and must not be officers, directors, employees, or stockholders of any bank. The three class C directors are appointed by the Federal Reserve Board to represent the public interest as a whole. The Reserve bank president, the first vice president and other officers and employees of a district bank are appointed by the board of directors of that bank.

The twelve Federal Reserve district banks are the principal fiscal agents of the government. They issue all notes of the federal government, and are depositaries of public funds; the Federal Reserve Bank of New York manages the government securities market. In addition, "both the member and non-member banks . . . may become special depositaries of the Treasury and carry tax and loan deposit accounts." (The Federal Reserve System Purposes and Functions 1963, 27)

These privileges are well entrenched. When in 1840 the

Independent Treasury took care of public funds, banks attacked the government as a tyrant. (See Chapter 4.) The Federal Reserve Bank of New York, because of its location in the financial center of the country, is the U.S. agent for gold and foreign exchange transactions. The dual banking system has roots in the past; only national banks have to join the System; the state-chartered banks are not compelled to become members. "Although almost half of the banks of the nation are not members, banks accounting for 85 percent of all commercial bank deposits are members." (Money Facts 1964, 15)

The Federal Reserve System is self-financing, except for the salaries of the members of the central Board in Washington which are paid by the government. The critics of the Federal Reserve System call the self-financing funding a backdoor funding because the Fed uses public funds supplied by the taxpayers. The System covers its self-approved budget and projects from the interest on the billions of dollars of government bonds in its portfolio acquired by crediting the government on the ledger. After covering all the expenses, including the Board office in Washington, D.C., salaries and dividends to shareholders, the Fed returns 90% of the profits from the portfolio to the Treasury counted as a miscellaneous receipt in the budget. In 1990, the Federal Reserve System's operating expenses were \$1.5 billion. In the same

year the Federal Reserve System had a total of 23,890 employees, of which 9,335 provided services to financial institutions. The single largest expense, 41%, represented services provided to depository institutions for which the Fed was reimbursed.

Altogether, 59 percent of our total expenses are either recovered through pricing or are reimbursable. . . . On a net basis the cost to the public of operating the Federal Reserve System is \$621 million of the total \$1.5 billion budget. (Budget of the Federal Reserve System and Proposals to Control Inflation 1991, 36)

While the Federal Reserve System is not operated for profit, it shows billions of earnings from interest on government securities. In 1938, Congressman Wright Patman proposed that only a small percentage of the U.S. bonds portfolio be held by the Federal Reserve and the rest be retired, thereby reducing government deficit. Since the interest on national debt is the Federal Reserve System's livelihood, it is reluctant to reduce its holdings. The funding mechanism of the system has raised the question of whether the national debt would be as high as it is if the central bank did not depend on it. The larger the national debt and the higher the interest, the more profit is accrued by the lenders. Federal government deficit is the main reason for borrowing. In 1984 the Congressional Budget Office estimated that a 1% interest increase on government securities adds two billion dollars to the national deficit the first year and almost thirty billion dollars in five years. (Federal Debt and

Interest Costs 1984, 21) To avoid a conflict of interests, a separation of the lending from the money-creating function has been suggested.

Financial independence of the Federal Reserve is an essential component of its political independence. It means that the Federal Reserve System, unlike the other federal agencies, is free from the budgetary appropriations allocated by Congress and is exempt from audit of the General Accounting Office, an arm of Congress. Political independence means that the Federal Reserve System, although it fulfills a quasi-governmental function, is not subordinated to the Congress or the Executive. The Fed "operates outside the control of Congress and through its Board of Governors manipulates the credit of the United States." (Goldwater 1952, 282) The Board guards its independence with vigor arguing that disclosure and public audit would infringe on its independence needed to conduct a sound monetary policy, and would violate confidential agreements with foreign governments.

The recurrent financial crises of the 19th century were attributed to the inelasticity of currency. To correct this deficiency, the 1913 Act emphasized the need for an elastic currency. Through this mechanism, commercial banks can create money out of loans, within a given limit, and they

have made a systematic effort to induce the public to desire credit. The benefit of the elasticity of currency based on debt has been disputed. In the meantime, the creators of money, about 14,000 commercial banks, reap immediate profit from "minting" paper money. The aggregate and unintended consequences are risky loans and inflation. Laurence J. Laughlin, professor of political economy at the University of Chicago, urged legislators to separate banks from the dominance of the stock market. His advice was implemented 20 years later. Laughlin argued that the elasticity of currency had been overstated and ascribed the true cause of financial crises to speculations:

A crisis comes because credit has been unduly expanded in a period of prolonged prosperity; in an optimistic spirit men have entered into transactions beyond their actual means . . . and in time of fright collateral as well as goods fall in price. (Laughlin 1933, 380)

In 1913, Horace M. Towner, Representative from Iowa, attacked the Democratic Party for permitting Federal Reserve notes to be issued as the obligation of the United States in tune with the financial community wishes and for a deliberate attempt "to organize and equip it as an arm of the Government, as if to make sure that it should thus be in absolute control of the people." (Congressional Record, vol. 50, pt. 5:4895) By surrendering the note-issuing power to the reserve banks, Congress exposed the public to the control of banking and commercial interests. A bank has no inherent authority to issue notes for circulation as money; this

right must be expressly given. The authority to print currency is a prerogative of the government and any institution to which such privilege has been delegated thereby exercises a public function. In the early years of the Republic, this privilege was given to state banks and in 1863 to national banks against the collateral of government bonds to assure safe and uniform currency. National bank notes backed by interest-bearing government bonds incited a popular revolt. The Populists demanded that government recapture its prerogative and issue the non-interest-bearing money directly instead of issuing interest-bearing bonds to banks. Thomas A. Edison noted:

It is absurd to say that our country can issue \$30 million in bonds and not \$30 million in currency. Both are promises to pay: but one promise fattens the assurer and the other helps the people. (Money Facts 1964, 12)

In 1862, President Lincoln ignited a firestorm when he ordered temporary printing of the legal tender notes, dubbed "greenbacks," to pay for the pressing expenses of the Civil War.

Conclusion

Since its establishment, the Federal Reserve System insisted on its independence from political influence. Because of its insulation from the elected representatives and the voters, the System failed to reexamine itself. Outside probings into the System found serious flaws in its struc-

ture, and a failure of the promise to keep self-serving special interests out of public interest decisions.

In 1964, Wright Patman, Chairman of the Banking and Currency Committee, conducted a confidential inquiry about the affiliations of class B and class C directors of the Federal Reserve banks and found that

the heavy incidence of banking connections of the B and C directors all add up to a strong banking orientation among those who direct the affairs of the Reserve banks and select men who participate in open market deliberations. (The Federal Reserve System After Fifty Years. Proposals for Improvement of the Federal Reserve 1964, 68)

Thomas Havrilesky and his associates examined the background of the directors of the Federal Reserve banks for a period of 21 years, from 1950 to 1970, and found a lack of fair representation of diverse national interests. "Representatives from large manufacturing firms dominated the class B directors from the 1950-1970 period." (Havrilesky, Yohe and Schirs 1973, 613) The report questioned the purported "public interestedness" of the C directors dominated by "individuals from the manufacturing, wholesaling and retailing and public utilities sector" and concluded

that the Federal Reserve bank presidents despite their high professional (central bank) qualifications and their apparent integrity are bound, through parochial association, to reflect the viewpoint of the interests that appoint them. (Havrilesky, Yohe and Schirs 1973, 621)

In 1990, the House Committee on Banking, Finance and Urban Affairs, under the Chairmanship of Henry B. Gonzalez, issued a Staff Report critical of the structure of the Federal Reserve for failing "to reflect the diversity of the nation it was created to serve." The Report reveals that the Federal Reserve banks maintain banker and big business domination on their boards at the expense of the interests of consumers, labor, and small business even though the Federal Reserve Reform Act of 1977 required greater diversity in the class B directors to represent the public. The report gives examples of some of the "outmoded" and "anachronistic" aspects of the Federal Reserve System: the regional geographical structure is outmoded because it does not represent the dramatic shifts in population since 1913. The monetary policy of the Federal Open Market Committee is outmoded because it disregards the economic interest of large portions of the population. In addition, the Committee refuses to release promptly the results of its meetings. The report finds lack of minorities and women in the making of monetary policy, lack of labor representation and underrepresentation of consumers and small business interests on the Federal Reserve bank boards, dominated by bankers and their biggest manufacturing clients in the class B directors.

For its part, the Federal Reserve has a longstanding bias against consumer organizations. . . Many of the Directors are officials of powerful pro-business inter-

est groups such as the Chamber of Commerce, Business Roundtable, and the National Association of Manufacturers. It is hardly fair to single out consumer groups as being "special interest" groups: (A Racial, Gender, and Background Profile of the Directors of the Federal Reserve Banks and Branches 1990, 28-29)

**CHAPTER IX: THE BANKING ACT OF 1935 AND THE
FEDERAL OPEN MARKET COMMITTEE**

The Act of 1935 was designed to meet the emergency crises. Looking for an explanation of the 1930's financial crash, the blame fell on a weak administration and the decentralized operations of the Federal Reserve System, unable to control the flow of excess money into speculative ventures. While the Federal Reserve Act of 1913 aimed to correct the scarcity of funds by elastic currency and the easy expansion of the volume of money in circulation, the Banking Act of 1935 aimed to control the dangerous expansion of credits.

The Act intended to correct the aggregate expansion of bank credits and the weak supervision of the banking system by strengthening and clarifying the responsibility of the central Board and by concentrating all the credit mechanisms: the discount rates, the reserve requirements and the open market operations in Washington. The Act changed the original decentralized regional Federal Reserve System of 1913 into a centralized system and shifted the core of monetary policy decisions from the government-controlled Federal Reserve Board to a semi-private body, the Federal Open Market Committee.

Several versions of the reform bill were introduced, dealing with the reorganization of the Board and the open market policies. The original reform bill, drafted by Marriner S. Eccles, a newly appointed Chairman of the Federal Reserve Board, was sent to Congress by President Roosevelt as an administrative proposal. The bill was introduced in the House by Congressman Henry B. Steagall, passed to the House Banking and Currency Committee and in the ensuing Congressional hearings referred to as the "Eccles bill." The bill proposed placing full power and responsibility to initiate, adopt, and enforce open market policies in the Federal Reserve Board alongside the other two tools of money control already under the Board's jurisdiction: the discount rates (interest charged by the Fed on loans to member banks) and the ratio of reserves (the required percentage of deposits which member banks must hold as reserves). While the discount rates and the reserve requirements were considered at one time to be important tools in the control of credit, they have lost their influence due to open market operations. The open market operations -- the buying and selling of government securities -- has become the most single important mechanism of money control. When the Federal Reserve sells securities out of its portfolio, it reduces the volume of money in circulation and induces higher interest rates and the cost of credit. The reverse is true when the Fed decides to increase the money supply and consequent-

ly starts purchasing government securities in the open market. In the "Eccles bill," the Federal Reserve Board consisted of eight Presidential appointees in addition to the Secretary of the Treasury and the Comptroller of the Currency as ex-officio members. A committee of five Federal Reserve presidents selected by the twelve Federal Reserve bank presidents was designated as consultant and adviser to the Board with no voting rights.

Senator Carter Glass of Virginia, a member of the Senate Committee on Banking and Currency, and many prominent witnesses who testified in the ensuing Congressional hearings, accused the "Eccles bill" of intending to use the central bank for social planning. Glass' version of the bill changed the public nature of the Eccles bill by transferring control over money to a quasi-private Federal Open Market Committee, on which members of the Board have a bare majority. Glass' bill also weakened the government's control over money by removing the ex-officio members, the Secretary of the Treasury and the Comptroller of the Currency, from the Board because of "undue influence." The bill extended the tenure of the Board members from ten to fourteen years, and changed the name of the Federal Reserve Board to the Board of Governors of the Federal Reserve System. President Roosevelt signed the Glass bill into law in August of 1935. The reformed System was dubbed the Third Bank of the United

States. This law is contrary to the insistence of President Wilson in 1913 that the control of money must be public, not private. At that time, Wilson rejected Glass' proposal to have banking representation on the Reserve Board and insisted on purely governmental board as discussed in Chapter 7.

The Federal Open Market Committee

The Committee is the principal monetary policy-making body of the Federal Reserve System; it determines the volume of money and interest rates in closed sessions. The FOMC is composed of the seven members of the Board of Governors, who are appointed by the President of the United States to a fourteen year term, subject to Senate confirmation, and five presidents of the twelve regional Reserve banks. The New York Federal Reserve Bank president is a permanent member of the Committee and the presidents of the other eleven Federal Reserve banks alternate for short terms. The Reserve bank presidents are appointed by the boards of directors of the Reserve banks, subject to the approval of the Board of Governors.

Through the creation of the Federal Open Market Committee, called "the fourth branch of the government," the bankers got what was denied to them in 1913; they moved from an advisory position to a highly coveted policy-making position. The result of the Banking Act of 1935 is

that there are two governments in Washington -- the elected Government of the people and the autocracy that controls our financial destiny. . . . The Federal Reserve System is a quasi-private exercise of public power which is completely improper in a modern democracy. (Patman 1966, 300)

The Act of 1935 means that the President and the Congress cannot control the government's monetary policy necessary for a successful execution of national policy, because the Open Market Committee can negate the efforts of the elected representatives. Robert L. Owen, former chairman of the Senate Banking and Currency Committee, challenged the Act as unconstitutional:

The Bank Act of 1935 also authorizes five privately appointed persons to exercise the powers of the government in expanding and contracting the money supply through open market purchases, by permitting the Reserve Banks to name five members of the open market Committee. This provision was a possible means of paralyzing the Federal Reserve Board, if the five members privately appointed could find a single member of the Federal Reserve Board willing to entertain the private view. It, therefore, was unjustified as a matter of business economic policy. It was further unjustified as it is an unconstitutional act to put the governing power of the people of the United States under the control of private persons who are not appointed or elected by the people of the United States and who had taken no oath of office to be guided alone by the public interest. President Woodrow Wilson expressly refused to do this. (Owen. Note, Wright Patman's Archives)

In addition, the meetings of the Open Market Committee are open to the remaining seven bank presidents of the Federal Reserve banks who cannot vote but can participate in the debates and influence the decisions, while the

representatives of the Executive and Legislative branches of government and of other interest groups are excluded.

Eccles, in his memoirs, sheds light on the Banking Act of 1935. President Roosevelt needed without delay four billion dollars to finance his work-relief program and depended on banks to absorb the large amount of government bonds and provide the necessary credit. Under the then prevailing decentralized open market operations, a group of bankers could block Roosevelt's program by dumping the government bonds on the market thereby shrinking the money supply:

"Thus the urgency to overhaul the Federal Reserve System."

(Eccles 1951,187) Henry Morgenthau, Jr., Secretary of the Treasury, confirmed the President's preoccupation with the four billion bonds for the program and believed that Roosevelt sold the Eccles bill for Glass' support. Glass was a friend of the financial community and an advocate of bankers' membership on the Federal Open Market Committee.

"Mr. Morgenthau's own very confidential opinion is that the President sold out the Banking Bill in exchange for getting Carter Glass to support the four billion eight bill."

(Morgenthau, vol. 4:109)

There was also a rivalry between Eccles and Glass. Glass aspired to be the new Chairman of the Federal Reserve Board and was embittered by Roosevelt's choice of Eccles. Having

been bypassed for nomination and excluded from the formulation of the reform bill sent by Roosevelt to Congress, Glass launched a strong attack on the "Eccles bill". He called sixty witnesses to testify on the banking bills before the Senate Committee on Banking and Currency, and the majority of these witnesses was against the bill:

In addition to Winthrop W. Aldrich, James P. Warburg, and Professors Edwin W. Kemmerer of Princeton, Henry Parker Willis of Columbia and Oliver M. W. Sprague of Harvard, an impressive corps of other great and near-great names in the world of finance voiced their opposition. (Eccles 1951, 205)

The opposition to the "Eccles bill" was strengthened by the business community's suspicion of the "radical" Keynesian theories allegedly encroaching on individualism and freedom. While Eccles claimed he had never read Keynes, his cures for the ailing economy supported the recommendations of the British economist: the federal government has to expand its role in the national economy to ensure full productivity and employment. In June, 1932, Eccles spoke before the Utah State Bankers Convention and said: "There is only one agency in my opinion that can turn the cycle upward and that is the government." (Eccles 1951, 83) Contrary to the prevailing opinion which blamed extravagant spending for the crisis, Eccles argued that the major cause of depression was underconsumption due to unemployment and low wages. In Keynes' words:

For if effective demand is deficient, not only is the public scandal of wasted resources intolerable, but the individual enterpriser who seeks to bring these resources into action is operating with the odds loaded against him. (Keynes 1964, 380-81)

In Eccles' view, the problem was not a material crisis but a failure of political and financial leaders: steeped in the theories of thrift and scarcity, they failed "to use the superabundance of wealth which we have been able to produce." (Eccles 1951, 83) For openly expressing his views, Eccles was labeled by his fellow bankers a dangerous radical and was ostracized and pitied as a man who is "losing his mind." He was reprimanded for hurting business and advised to be much more careful in the future in his public utterances: "You should avoid giving the impression you think all is not well in our economy, because it might create a lack of confidence in our banking organization." (Eccles 1951, 84)

Criticisms of the New Deal mounted in 1934. Business representatives blamed government for failing to confront the crisis successfully and demanded a drastic reduction in government regulations and a voice in national policies. The "Eccles bill" was not defeated by the business community alone; the lack of public support was crucial to its defeat. While in 1913 the public, aroused by the widely publicized money trust investigations, opposed the Aldrich Bill sup-

ported by Senator Glass which gave bankers control over the central bank, such public awareness was lacking in 1935.

The Banking Act of 1935 concentrated power in the Federal Open Market Committee and is a victory for the early 20th century advocates of a single central bank led by Paul M. Warburg who had proposed a board consisting of members appointed by government and banks. (See Chapter 7.) In 1908, Paul M. Warburg (1868-1932), a member of the banking house Kuhn, Loeb & Co., and later a member of the first Board of the Federal Reserve System, influenced banking reforms in the United States. Aware of the populist mood of the country in 1908, Warburg considered it unwise to press for a single central bank and recommended instead a modified central bank as an initial step

that even Andrew Jackson, were he alive, would not be likely to oppose it. . . But it must be a step in the right direction, a measure which has clearly in view the final aim and which does not neglect any of the fundamental principles on which modern central bank systems have been erected in other countries, and which have already stood the test of storm and stress. (Warburg 1908, 7, 4)

Similar to the 1935 testimonies of Warburg Jr. and Winthrop W. Aldrich, Paul Warburg, thirty years earlier, saw democracy as an ideal form of government, not suited however to solve economic problems requiring efficiency and promptness.

Democracy is government by the people. It is the most self-respecting form of government. But, being the expression of the ever changing will of the masses, it is lacking in stability of policy, and continuity in

office of trained men. It furthermore abhors autocratic power vested in single individuals. (Warburg 1917, 17-18)

The trend of thought claiming that we cannot have economic democracy and need a higher authority to prevent us from ruining ourselves has continued from Alexander Hamilton to the present, and is offensive to the people and their representatives.

Who Should Control Public Money?

The rekindled struggle over money control was a contest between two opposing groups: one representing the broad national interest advocated by public-spirited administrators, the other representing banking interests advocated by financial experts and their friends. One group was convinced that, in time, private interests would misuse the stewardship over money, a privilege that no nation can safely surrender to banks; the other group was convinced that government control would be abused. The bankers and their supporters won the struggle in 1935.

The hearings on the reform bills on the pending Banking Act of 1935 before the House and Senate focused on Title II, dealing with the open market policies and the administration and operation of the Federal Reserve Board. The importance of the open market policies was described by Congressman Wright Patman of Texas as follows:

As Chief Justice Charles Evans Hughes so well said, the Constitution means what the Supreme Court of the United States says it means. In our economy, how we fare depends crucially on what the Open Market Committee of the Federal Reserve System says. We have as much or as little money to spend as that committee dictates. Banks have an abundance or scarcity of reserves to lend depending on what it decides. The committee determines the volume of bank reserves and the nation's money supply, primarily by instructing the New York Federal Reserve Bank to buy or sell securities in the open market. When the New York bank buys, it adds to reserves and increases the money supply. When it sells, reserves and money supply fall. . . . In its exercise of these awesome powers the Fed has made serious mistakes, and the time has come for basic change. (Patman 1975, 61:179)

The importance paid to Title II of the Federal Reserve Act of 1935, underlines the critical role discharged by the Federal Reserve Board. In 1913, the Federal Reserve Board's functions were conceived as technical and service oriented with no power or necessity to initiate monetary policies because the gold standard was supposed to automatically control the supply and the price of money. With the disappearance of this provision at the outbreak of the First World War, and shortly after the creation of the Federal Reserve System, the agency entered a new unchartered role. To cope with the new situation, the central bank started controlling the cost and supply of money, and initiated new rules and policies. The war changed the role of the Fed and it continued to grow into a formidable power further advanced and stabilized by law.

The power of the open market operations was discovered by chance in the 1920's when large amounts of government bonds flooded the financial market and were finally identified as the cause of violent changes in the price of money. The Federal Reserve tried several approaches to stabilize the gyrations of the cost and volume of money, resulting from the purchase and sale of government securities. Before the Banking Act of 1935, the open market policies were initiated by a committee representing the twelve Federal Reserve banks, primarily persons representing local interests. By law, their recommendations had to be approved by the Federal Reserve Board in Washington, D.C. The Federal Reserve Board directives, however, were not binding on regional banks who were free to accept or reject them. Eccles, as the new chairman of the Federal Reserve Board, resolved to remedy this situation by placing the final authority over the open market operations in the Board.

Open market operations are the most important single instrument of control over the volume and cost of credit in the country. . . . Authority over these operations, which affect the welfare of the people as a whole, must be vested in a body representing the national interest. (Banking Act of 1935. U.S. Congress. House 1935, 181-2)

Robert L. Owen, whose proposal for a government controlled Federal Reserve Board was approved by President Wilson in 1913, supported Eccles but pointed out the deficiency of the bill in omitting the legislative mandate. He argued that the formulation of monetary policy and its technical execution

are two different things. It is the President and the Congress who must set targets and formulate the monetary policy of the country; the Board can only use their expertise to efficiently execute them. Banks should do the lending of money, the government the controlling of its volume and supply. Owen reminded Congress of their constitutional duty and mandate:

Your power to coin money and regulate the value thereof under the Constitution of the United States, is the power of regulating the value of money by regulating the supply. (Banking Act of 1935. U.S. Congress. House 1935, 556)

Owen clarified the meaning of inflation by separating unjustified and justified expansion. In his opinion, justified expansion of money to meet the nation's needs is not inflation.

Thomas Alan Goldsborough, a Representative from Maryland, saw the banking system as having been "built up by the bankers themselves for the purpose of controlling money." (Banking Act of 1935. U.S. Congress. House. 1935, 411) He suggested that it is the bankers who make the banking laws; the legislators merely put them in a proper form. He ascribed this situation to the lack of familiarity with finance which prevents lawmakers from objectively evaluating the advice of bankers, and leads to an excessive reliance on the bankers' judgement. Goldsborough's observations parallel those of Simon Newcomb made seventy years earlier in

regard to the National Bank Acts of 1863-1864, and discussed in Chapter 5. Similar to Owen, Goldsborough advocated taking the control over money out of the bankers' hands and placing it where it should belong: "society itself." Only the technical part should be managed by banking experts; it is the legislators who must give directions. Like the Populists in the 19th century, Goldsborough questioned the government's policy of issuing money through the banks rather than directly. Why should the government, having every resource in the country, borrow money from a bank and suffer from lack of money? This situation has been compared by some critics to a rich man borrowing money from a pauper. It would also be cheaper for the government and the taxpayers if the government issued money directly to cover its needs, rather than printing bonds on which interest had to be paid to the banks.

Dr. Irving Fisher, professor of economics, Yale University, supported Owen's argument and warned Congress not to give such a tremendous power over money to the Federal Reserve Board without a statement of policy, because of the danger of future abuses:

It would almost certainly come, if so great and dangerous power were put in the hands of the Federal Reserve Board and it would be manipulated for some ulterior purpose. (Banking Act of 1935. U.S. Congress. House 1935, 520)

A strong opposition to the "Eccles bill" was led by Winthrop W. Adrich, chairman of the Chase National Bank of the City of New York, and James P. Warburg, son of the late Paul W. Warburg, a vice chairman of the Bank of Manhattan Co., New York, who represented the bankers' point of view. Their opposition focused on the danger of "political control" that would be created by centralizing the present regional system under Congressional power. Their argument that government control of the Federal Reserve System and public money would be misused and lead to sinister consequences echoes Alexander Hamilton's warnings in 1791 when the predecessor of the central bank, the First Bank of the United States, was created. From the beginning of the banking controversy, political control meant tyranny for those who mistrusted government by the people and feared the rule of the "masses."

In a testimony before the Senate Committee, Warburg stated:

All history is there gentlemen, to show you what happens when the long arm of the Treasury reaches out into the control of the credit machinery. All the history shows such proposals as this one before you to be the favorite device of spendthrift governments. (Banking Act of 1935. U.S. Congress. Senate 1935, 76)

People who label the government as "spendthrift" are those who disagree with the government programs. Being in control of money, they can make it difficult for the federal, state or local governments to borrow money at high cost to finance social policies. Warburg further implied that the sponsors

of the reform bills tried to "tyrannize," "communize," "socialize" and "nationalize" the banking system. "I am not the one who sees a Communist under every bed, but I sometimes wonder if the authors of these bills realize whose game they are playing." (Banking Act of 1935. U.S. Congress: Senate 1935, 76) Warburg saw a "kernel" of Keynes in the present proposals and rejected his teaching which could not be supported by the judgment of practical men like himself. Warburg believed that the deficiencies in the Federal Reserve System could not be cured by law because no person was "omniscient and omnipotent enough" to comprehend and direct the complex and delicate mechanisms of the market. All that was feasible was to find the best experienced bankers, divested of private interests, and entrust them with the job of running the central bank. Warburg preferred the status quo to a "rush" action and recommended a further study by a group of experts.

Aldrich, similar to Warburg, strongly opposed changing the character of the Federal Reserve System from regional to central under the "dictates" of political authorities who would use the credit and currency system to their political advantages. Like Warburg, Aldrich saw the bill as "potentially despotic" claiming it distorted the original balance between private and public interests and destroyed the independence of the central bank.

As noted by Henry Ford, the bankers see despotic government only when it rules against their interests. When in 1933-35 Congress passed a temporary law prohibiting interest payment on demand deposit (it had been enacted during the Depression to help banks accumulate capital) "the fact that it is regimentation of the banks has never been raised by the banks." (Ford. "Henry Ford's Timely Statement on Money.")

Conclusion

The Congressional hearings on the Banking Act of 1935 show continued conflict between the two philosophies first exemplified in 1791 by Thomas Jefferson and Alexander Hamilton in the debates over the First Bank of the United States.

The witnesses who opposed government control over money, based their argument on the danger of political domination and recalled historical examples of "spendthrift" and "totalitarian" governments. The conclusion from these premises was that monetary matters must be left in the hands of the bankers who alone are qualified to manage public money. The change in the principle and purpose of government from rule by a monarch to rule by elected representatives transferred their fear of the king to their fear of the rule by the people. The Federal Reserve's insistence on insulation from the government and the people is based on the fear that the

"masses" would exercise their power and make demands on the economy through their elected officials who would then take reckless steps to please their constituents. The notion that bankers alone are competent to manage public money and must be shielded from the demands of the people and the government, is alien to the form of government which rests on the capacity of the people to govern themselves and detests authoritarian rulers.

The opposition argued that the issuance and control of money was entrusted to the Congress by the Constitution. As in 1791, they claimed it was unconstitutional and unsound to give such power to a non-elected body. They defended the role of the government as protector of a stable and sound society and "politics" as the profession of the legislators. The populist-oriented group of witnesses distinguished between technical and political decisions. The role of the technocrats is to execute in a professional manner the directives of political representatives who are accountable to the people. Since the issuance of money and its control are closely connected with political and social problems, monetary decisions go far beyond the jurisdiction and knowledge of bankers.

The 1935 Congressional testimonies show the impact of ideologies on national policies and challenge the claim that

judgments in economics are objective and value-free. Summing up the testimonies, a question arises as to whether the Federal Reserve System as it exists today can represent the wide spectrum of interests that comprise the public interest. The bankers claim that their banking-business background has given them expertise in a highly complicated field, enabling them to make the best judgment in the public interest. While the bankers emphasized skills and expertise, the public representatives pointed out that the role of government goes beyond technical aspects of money management. The two conflicting approaches to monetary policy are historical examples of the formal/instrumental rationality and the substantive rationality types as developed by Max Weber. The formal mode of thinking is concerned with purely economic problems and focuses on short-term and linear solutions. The substantive mode of thinking is concerned with the social consequences of economic action and with values such as justice and equality which cannot be measured and calculated by formal rationality.

The Federal Reserve System is a public institution; it derives its legitimacy from the government and the public. While the central bank's decisions affect the entire population and the budgets of federal, state and local governments, the Federal Reserve insists on secrecy and insulation from the public and the government. As a consequence, the

public has no chance to express its approval or disapproval of the Federal Reserve monetary policies. The central bankers emphasize traditional principles of banking and like Hamilton, some 150 years ago, they consider allocation of money for social programs a waste rather than an investment for human betterment. Like Hamilton, they fear the pressure of public needs on money supply. Their idea of national well-being means efficient allocation of public money to stimulate the efforts of large corporations rather than to meet the needs of small entrepreneurs and the general public. The bankers adhere to the supply-side theory that favors concentration of money in the hands of a few, rather than its equitable distribution to the people. They believe that the benefits given to a few will trickle down to the rest of the population. The social consequence of this policy is that it makes the majority of the people dependent upon the wealth of a few.

Why did the technical point of view of the bankers win over the substantive orientation expressed by some public representatives who distinguished between the formulation of national policies and their technical execution? While in the 19th century and the beginning of the 20th century the Democrats demanded public control of money and refused to accept bankers' logic as a guiding principle, the general mood in the country in 1935 acknowledged the bankers' exper-

tise as a legitimate claim to domination. While in the 19th century and in 1913 the control over public money was widely debated and the bankers' philosophy was challenged, the 1935 situation presented no chance to the public to be involved and to influence the decisions. I attempt to find an answer to this issue in the final chapter under the subheading:

A Retreat from the Ideals of Jeffersonian Democracy.

CHAPTER X: THE FEDERAL RESERVE SYSTEM AFTER FIFTY YEARS

In the 1960's there was a need to reexamine the Federal Reserve System, fueled by the changes which had occurred in the previous fifty years. The 1913 Federal Reserve Act did not intend to delegate national monetary policies to the Federal Reserve Board; its main responsibilities were to supervise banks for the purpose of increasing the security of the banking industry, to act as a bank of last resort ready to provide necessary resources to banks in case of emergencies, and to maintain a stable dollar. Its objective to stabilize the dollar came into conflict with the government's responsibility for a high and stable level of employment mandated by the Employment Act of 1946. In the course of time, the Federal Reserve has become one of the most influential institutions that decides national economic policy affecting everyone. While the agency fulfills a quasi-governmental function requiring coordinated activity with the economic and social goals of the government, it has been unwilling to make this commitment, and Congress has failed to provide monetary policy guidelines to channel the power of the Fed. Due to the lack of an effective Congressional control, the System expanded its original technical and service-oriented functions, becoming an arbiter of national monetary policy. Such expansion was not contemplated in the original vision. At the same time, the Fed's basic

structure has not changed; it is largely controlled by monetary technicians and financial and industrial interests.

In 1964, the House Committee on Banking and Currency conducted a comprehensive evaluation of the banking and monetary system. The independence of the Federal Reserve, both from public pressure and from the President and Congress, was the theme of the hearings that lasted three months. Can the national objectives of the administration be fulfilled in the face of Federal Reserve independence? Fifty witnesses from the ranks of economists, academics, financiers, central bankers, and labor and public administrators, presented a broad range of viewpoints. Witnesses from outside the System presented a well-meaning criticism of the Federal Reserve and suggested improvements in its structure and function so as to secure coordination between monetary and fiscal policies. No malevolent intent was implied in the criticisms and the deficiencies were ascribed to different philosophies and points of view.

Based on the testimonies, the Committee on Banking and Finance proposed some revisions of the system, outlined in The Federal Reserve System After Fifty Years, Proposals for Improvement of the Federal Reserve, from which I quote freely: To emphasize the public character of the Federal Reserve, the Committee proposed changes in the structure and composi-

tion of the Fed's central management. They recommended abolition of the Federal Open Market Committee and transfer of the open market decisions (the major tool of money supply control) to the Federal Reserve Board consisting of five Presidential appointees. This means that all the three tools of money control: the determination of open-market policies, discount rates and reserve requirements would be vested in the Federal Reserve Board. To ensure the effectiveness of monetary policies, the tenure of the Board members was to be reduced to five years from the present fourteen years. It was further proposed that the Federal Reserve banks' stock be retired to avoid the continued payment of the 6% interest to the shareholders.

To insure public control over the expenditure of public money, the Committee recommended that the General Accounting Office conduct public audits of the Federal Reserve Board and the Reserve banks. All interest received by the Federal Reserve System on the U.S. government securities was to be paid to the Treasury and the Fed was to be subjected to the budgetary appropriation procedures of Congress. The congressional appropriation process allocates the available revenues and is a tool by which public money is controlled. In 1958, the Federal Reserve had an annual income of about 700 million dollars. Almost all of that came from interest on its portfolio of about 25 billion dollars of government

obligations. The practice has been that from this income the Federal Reserve covered its self-approved expenses, and at the end of the year returned the remainder to the Treasury.

Last year [1958] after the Fed had collected about \$700 million on its \$25 billion of Government securities, it paid out what it wanted for expenses and turned back into the Treasury \$524 million. (Congressional Record, vol. 105, pt. 10:12482)

To assure coordination with the policy and responsibility of the Government and to attain the national goals of maximum employment, production and purchasing power, it was recommended that the President provide guidelines for monetary policies. Should the Federal Reserve monetary views diverge from the President's recommendations, they should be filed with the President and the Congress. To permit the Federal Reserve Board to concentrate on monetary policy, the bank supervisory function was to be transferred to the Comptroller of the Currency, the Federal Deposit Insurance Corporation or possibly a newly created federal banking authority.

Among other proposals was a bill recommending that commercial banks pay interest to the Treasury on the Government tax and loan balances kept by the banks, amounting on an average to two billion dollars a year.

The Federal Reserve's Independence and Democracy

A great part of the debates concentrated on the independence of the central bank from the President and the Congress and, therefore, its insulation from the electorate. In general, the witnesses outside the banking system attempted to harmonize fiscal and monetary policies, while the witnesses who were inside the banking industry favored separation. Advocates for independence argued that a central bank must be protected from political manipulations and "irresponsible governmental tinkering" if economic stability is to be achieved. The proponents of government control over the central bank argued that the concentration of economic and financial power in the hands of a few men had gone too far and was contrary to a democratic form of government. It was also pointed out that independent monetary policies, when at odds with the government's fiscal policies, were unsound and costly. The central bankers justified their independence by law, tradition and expertise. They claimed that the legislators who created the Federal Reserve System firmly established the principle of independence which has been preserved through subsequent amendments. Critics of the Federal Reserve claimed that Fed's independence has been "usurped" not given. The word "independence" was nowhere to be found in the laws pertaining to the Federal Reserve System. The Federal Reserve bankers emphasized their specialized knowledge enabling them to conduct a sound monetary

policy. This knowledge has been reinforced by continued research of highly skilled personnel, and could not be duplicated by any other institution.

Milton Friedman stated that democracy cannot tolerate concentration of power in the hands of a small number of men without effective political oversight: ". . .it is most undesirable politically to give so much power to individuals not subject to close control of the electorate." (The Federal Reserve System After Fifty Years 1964, 1134) Friedman pointed to three main technical defects of an independent central bank:

First, dispersal of responsibility, which promotes shirking responsibility in times of uncertainty and difficulty, and second an extraordinary dependence on personalities, which fosters instability. . .

A third technical defect is that an independent central bank will almost inevitably give undue emphasis to the point of view of bankers. (The Federal Reserve System After Fifty Years 1964, 1172)

Friedman recommended a monetary system which would not be subject to major mistakes. While "Congress is less likely to make major mistakes than a Reserve Board is, although it may make more minor mistakes" (The Federal Reserve System After Fifty Years 1964, 1152), he preferred a rule of law rather than of men. He suggested that Congress legislate a formula specifying a fixed percentage by which the money supply could grow. Another argument against independence,

advocated by Friedman, was the Fed's insulation from the public. The central bankers have nothing to lose if they make mistakes or act against the public interest because the public cannot vote against their policies. The lack of a feedback mechanism means that the central bankers have been unable to learn from errors and their policies have ossified into dogmas incapable of accepting nonconformist points of view.

Professor Paul Samuelson spoke about the overall structural defects in the division of power that put monetary policies in conflict with fiscal policies. In his opinion, the Federal Reserve is "preoccupied" with the defense of price stability and ready to "mop up" any inflation that may result from looser fiscal policies stimulating the economy's growth. By tightening the money supply, the Fed stifles the rate of economic growth which in turn determines the employment rate. Samuelson concluded that:

The founders of the Federal Reserve really didn't know what they were doing. But surely none of them thought they were designing an engine that would be a bulwark against growth. (The Federal Reserve System After Fifty Years 1964, 1126)

Contrary to Friedman's recommendation of impersonal control over money supply, Samuelson advocated that the central bank should be responsible to the Executive. In case of "irreconcilable conflict" the Federal must yield, with the opportunity to protest to the public and the Congress.

A central bank that is not responsible is irresponsible, rather than independent. To be responsible means to be responsive. . .

But it does mean being responsive to the changing values, views, moods, and even fads of the American citizenry. It does mean a definite relinquishment of an adherence to certain thought-to-be eternally sound doctrines, dogmas, and principles. (The Federal Reserve System After Fifty Years 1964, 1105)

Samuelson opposed

a central bank that is like a Supreme Court, or 1831 House of Lords -- truly independent, dedicated to the public weal but answerable for its decisions and conduct only to its own discretion, and to the consciences of its men in authority as they each envisage their duty. (The Federal Reserve System After Fifty Years 1964, 1105)

Professor Henry H. Villard of CUNY agreed with Samuelson and emphasized the overall coordination of economic policies:

But I do not see, in a democracy, any alternative except to give the power to make decisions on basic economic policy to the Executive. This does not guarantee that he will make the right decisions all the time, but I do not think there is any possibility of setting up a group of experts who should have this power. (Federal Reserve System After Fifty Years 1964, 1043)

Nathaniel Goldfinger, director, Department of Research, American Federation of Labor and Congress of Industrial Organizations, rejected the superiority of the technocrats and experts who replaced the popular government by "philosopher kings."

The persistent inference that representative government means runaway inflation, unless some superboard made up almost exclusively of technicians and bankers filters out all such possibilities, is offensive in a democratic society and is disproved by America's economic history. (The Federal Reserve System After Fifty Years 1964, 1474)

The view, prevalent when the Banking Act of 1935 was enacted, that technical expertise in banking qualified people to guide the nation's monetary policy was rejected in 1964. The banking specialists were criticized for "parochial" views "metooism" and "occupational myopia" that may have been the roots of the Federal policy's errors. Although the Federal Reserve Board represents able and competent people from various walks of life, it does not represent the "middle-of-the-road" economic thinking of the country. To end the stagnation and bring the Board in touch with the real life it was suggested that at least one person should represent the public dissent and debate monetary policies with the majority. Such a person would also provide a channel between the Committee and the President. The chief defect of the economists and statisticians at the Fed has been that although highly skilled, learned and technically efficient, their performance has shown no relevance to real-life situation. Money management is not an esoteric subject; it affects the lives of all the people.

The central bankers' mode of thinking goes back to the 18th century philosophy of Alexander Hamilton as illustrated in the testimonies. As in 1791, one hundred and seventy-three years later, the witnesses in favor of the central bank's independence argued that government cannot be trusted with money, therefore, the central bank must be protected from

manipulation and "irresponsible governmental tinkering." The presumption that only an independent central bank can maintain the nation's economic stability has become a truism.

T. H. Milner, Jr., president of the National Bank of Athens, Athens, Ga., described the role of the central bank thus:

The system that we have now though insulates a group who are in a sense the father managers of our economy similar to the father of a family. His wife and children are always exercising political pressures on the father to try to get him to spend money for this, that or the other.

But as long as the father is the breadwinner and has the control of the finances of the family, then he can use his best judgment in deciding how the earnings shall be spent, rather than yield to the political pressures of the members of his family. (The Federal Reserve System After Fifty Years 1964, 1707)

William McChesney Martin, chairman of the Federal Reserve Board, recalled Alexander Hamilton's statement:

It would, indeed, be little less than a miracle should the credit of the bank be at the disposal of the Government, if, in a long series of time, there was not experienced calamitous abuse of it. (The Federal Reserve System After Fifty Years 1964, 24-25)

Martin justified the broad power of the central bank by arguing that the public would constantly pressure their political delegates for more gratification which just cannot be satisfied. Martin concluded that restrictive decisions are more willingly tolerated by the public when "decided by public officials," meaning the Board, than they would be if decided by political representatives.

While the Federal Reserve spokesmen feared too much pressure for spending on the part of the public, Leon H. Keyserling criticized the Federal Reserve policies for operating under an erroneous philosophy of scarcity:

We are still pursuing national policies which incorrectly assume that restraint rather than adequate expansion is central to the wage problem. . . . What the U. S. economy needs are those programs and policies which would vastly expand the incomes and outlays of private consumers, with special concentration on the 2/5 of our total population who live in poverty or deprivation. (The Federal Reserve System After Fifty Years 1964, 1748, 1750)

Alfred Hayes, president of the Federal Reserve Bank of New York, opposed the notion that the central bank is an "anti-democratic" institution and justified the bank's authority by its legality. Congress has given up a portion of its inherent prerogative in the belief that the Federal Reserve's independence from Congress will be in the interest of the nation. He quoted his predecessor Allan Sproul:

I believe that it has been the continuing intent of each succeeding Congress that the Federal Reserve banks should be allied to government but not part of government. (The Federal Reserve System After Fifty Years 1964, 536)

A. L. Mills, Jr., governor of the Federal Reserve Board, argued that the System, although independent of the government, "is not irresponsive to the thinking and the policies of whatever administration holds office." (The Federal Reserve System After Fifty Years 1964, 106)

The witnesses outside the Federal Reserve System argued that the policies and the composition of the Board are inevitably connected and that broader representation of various viewpoints and experiences would change the Board's policies.

The witnesses from inside the System contended that monetary policy failures are not connected with the structure or the composition of the Board but are within the tolerance of human error and difference of judgments. It is noteworthy that in 1913 the Republicans and the financial community opposed the Federal Reserve Act and the Democrats favored it. During the passage of time, the big bankers gained control of the Federal Reserve System they had originally opposed. In 1964, the Republicans and the bankers defended the status quo and adamantly opposed any changes which would make the Federal Reserve responsive to the President and his economic policies. "Why change something that works well and exchange certainty for uncertainty?" The central bankers were not only against the proposed changes in the structure of the System but warned that such steps would impair their ability to do the job delegated to them by the Congress.

While the status quo supporters demonstrated a cohesion of views for the maintenance of continuity, expertise and efficiency, the pro-reformers differed widely on how the Board should be organized in regard to the number of members, length of tenure and Board's composition. In the

debates about the semi-private Federal Open Market Committee, one side advocated its abolition because of the private bankers' heavy influence upon national policy decisions which, they argued, should be in the hands of a Board appointed by the President. The opposition argued that the regional bank presidents' viewpoints, technical experience in banking, and broad contacts should bear upon the complex monetary decisions.

While the witnesses for independence lauded past Congresses for their wisdom in delegating their sovereign power over money to an independent agency, Paul Samuelson saw it as a folly:

And it is an illusion that we can create a body for all times which will protect us from our own mistakes . . .

I think that such a trustee notion was a delusion in every century but is peculiarly so today. (The Federal Reserve System After Fifty Years 1964, 1107)

The Federal Reserve Twenty Eight Years Later

In 1991, the structure of the Federal Reserve System remains as it was in 1964, although additional responsibilities have been delegated to the Federal Reserve which highlight its structural shortcomings. The bills, formulated from the recommendations presented at the hearings, were not enacted and the public character of the Federal Reserve was not strengthened. The semi-private Federal Open Market Committee still conducts monetary policy; the members of the Federal

Reserve Board still have a tenure of fourteen years, with the exception of the Chairman and the Vice Chairman; and the System continues to cover its self-approved budget and projects directly from the Treasury's pool of money thereby bypassing the Congressional appropriation process by which resources are allocated to all other agencies. Although the Federal Reserve handles public money, it remains exempt from the audit of the General Accounting Office, an arm of Congress.

The central bankers are adamantly opposed to giving up their financial independence for fear of weakening their freedom. Control of its own budget is an essential factor of its independence and has been acknowledged by Congress who found no major abuses of the Federal Reserve fiscal affairs. The Federal Open Market Committee still discharges monetary policies independently of Executive or Congressional control and is in a position to negate the fiscal policies of the government if it believes them to be inflationary. Leo Raskind, Professor of law and economics, Vanderbilt University, urged Congress to change the statutory framework of the Federal Reserve System to bring it up to date and give the President the responsibility for the monetary policies:

When the President who has authority to make decisions involving nuclear war, is barred by statute from responsibility for the monetary component of economic stabilization policy, the need for change is apparent. (The Federal Reserve System After Fifty Years 1964, 1669)

Obstacles to Change

Like people in general, the bankers opposed those changes that would restrict their entrenched interests and weaken their privileged position. The central bankers refused to release their power in the fear that they would lose their independence and become a department of the Treasury as they were in 1913. The Federal Reserve has a deep-rooted sense of self-protection and has used its ample funds to mobilize networks of bankers and the American Bankers Association to fend off any legislation in its disfavor. The ABA has launched strong campaigns whenever a signal has been given by the Board or the bankers. There is fluidity between the Federal Reserve Board and the private banking industry as revealed by Arthur Burns, chairman of the Federal Reserve Board.

In 1973, Arthur Burns, chairman of the Federal Reserve Board, spoke to the Reserve City Bankers Association at their annual meeting in Boca Raton, Fla., advising them how to avoid government control and prevent consumer-friendly legislation. Burns cautioned that sharp increases in interest rates would arouse the attention of Congress, therefore, only gradual increases should be taken:

Negotiations with Congressmen are particularly difficult because there is considerable belligerency between the executive and the legislative branches. And any group which is favored by the Administration is likely to come under pressure from the Congressmen. (American Banker 1973 1, 14)

The central bankers are aware that their independence hinges on avoiding an open conflict with the government. They are also aware of the importance of general public backing, and are sensitive to criticism and leaks that could damage their image of propriety as revealed by Marriner S. Eccles (see Chapter 9). The central bank spends a great deal of public money building up an image of trustworthiness, high morality, guardianship of sound money, and economic stability.

Obstacles to change are also embedded in the government. Getting a piece of legislation through Congress is a slow process in democracy, especially when opposed by a strong minority that can stop the process in the Committees and Subcommittees where the chairmen have a strong influence.

In the opinion of Mr. Goldfinger, the proposed changes in the Federal Reserve Board are not adequate. The problem is that the structure of the Federal Reserve System is not representative of the American society:

I think that one of the serious difficulties within the Federal Reserve System, the System is essentially dominated by the thinking and the experiences of monetary technicians, bankers, and big business people.

However, their thinking and experiences are highly limited certainly in terms of the employment, unemployment, productivity, automation problems that I tried to emphasize in my testament. (The Federal Reserve System After Fifty Years 1964, 1489)

The Federal Reserve continues to exclude labor, consumers and small business interests from counsel in its policy

making process. It justifies this exclusion by concerns about the influence of "special interests" and political activities of the labor unions:

Labor organizations have no apparent representations anywhere in the Federal Reserve System. In fact, many directors of the Federal Reserve district banks are members of the United States Chamber of Commerce, the National Association of Manufacturers, and other local "employers associations" -- groups with long histories of opposition to organized labor. (Federal Reserve Directors 1976, iii)

The testimonies stressed the need and the desirability of bringing the Federal Reserve up to date with the current events but displayed a lack of unity on how to proceed and what type of change would be desirable. In contrast, the central bankers stood unanimously against any forceful changes. The centralized and automated structure of the Federal Reserve proved to be more powerful than the will of the individuals opposing its immense power as illustrated by Robert W. Lawson, chairman of the Richmond Federal Reserve bank. In his speech to the American Bankers Association in Hot Springs, Va. on October 5, 1975, Lawson congratulated the bankers for their great lobbying assistance to the Fed:

The bankers in our district and elsewhere did a tremendous job in helping to defeat the General Accounting Office bill. . . . It shows what can be done when the bankers of the country get together. (Maintaining and Making Public Minutes of Federal Reserve Meetings 1977, 88)

The proposed reforms of the Federal Reserve System failed to materialize not only because of the internal disagreements among the legislators, but because of the capability of the top management of the System to quickly and efficiently mobilize resources in their favor. In Max Weber's analysis of bureaucracy, the master can pull the strings of the apparatus to serve his interests and the specific interests of the organization, not necessarily the general interests and needs. The network of the twelve regional Federal Reserve banks and their branches, whose autonomy was largely diminished through the centralization in 1935, continues to be liberally staffed and funded, and provides a readily available political support to the top management when needed. To change the System, a consolidation of energies and efforts of the executive and legislative branches and the general public would be required. Since there is a lack of consensus within Congress, hostility between the Executive and the legislators, lack of awareness and support from the public, no change can be legislated.

Lewis Coser's theory of conflict is applicable in the case of the Federal Reserve. Coser sees conflict not as a single cleavage on a single line that splits a society apart, but as a mesh of conflicts which keeps it together. Whether hostility will lead to conflict depends, in our case, on whether unequal distribution of wealth and power is consid-

ered legitimate. Withdrawal of legitimacy is the first condition for conflict to take place. But withdrawal of legitimacy is not enough, it must be accompanied by a rise of emotions. Withdrawal of legitimacy and arousal of emotions have to be further sustained by mobilization of energies into an organized group. None of these conditions however were demonstrated in the 1964 hearings. These incremental steps occurred in the 19th century, culminating in the coalition that created the Populist movement. The legitimacy of the Federal Reserve Board was not questioned in the 1964 hearings; only the structure, composition and lack of governmental control were criticized. The legitimacy of the Federal Open Market Committee was assailed but even there disagreements arose: are the bankers on the FOMC private or public officials? All the criticisms were mild and well-meaning, with no display of hostility against the members of the Board who were held in high esteem. John Kenneth Galbraith's observations support the findings:

The Federal Reserve System is treated by nearly all economists with reverence. . . It makes many mistakes but these are always interesting errors of judgment. They are examined not critically but respectfully to discover why men of insight were wrong. (Galbraith 1975, 116)

The Meaning of Independence

In the testimonies the central bankers stressed the Federal Reserve System's independence as an integral part of its proper functioning, delegated by law. But from the beginning

of its existence, the independence of the System from private banking and big business interests has been disputed.

The 1976 Congressional Staff Report asked:

Independent from what? Surely not banking or big business, if we are to judge from the massive interlocks revealed by this analysis of the district boards. . . . Only two segments of American society -- banking and big business -- have any substantial representation on the boards, and often even these become merged through interlocking directorates. (Federal Reserve Directors 1976, iv, iii)

The Report shows that seventy three of the 108 directors of the Federal Reserve banks, almost 70% are or have been past officers, directors or employees of financial institutions. Like the testimonies in the 1964 hearings, the study raised serious questions about the impact of narrow private interests on the central bank's policies and the lack of diversity in the thinking of the monetary experts. Since the regional banks, through the presidents, represented on the Open Market Committee, feed their opinions into the national monetary policies, the lack of broad representation and diversified points of view on the regional bank boards raise doubts about the quality and objectivity of the presidents' advice. The broadened duties and responsibilities delegated to the Federal Reserve through consumer and similar statutes in 1970, highlight the shortcomings of the central management.

The 1976 Report recommended reform of the regional banks boards and stressed the necessity of freeing the Federal Reserve System from the "built-in conflicts of interest" to make it "more open in its activities. . . . We should celebrate our Bicentennial by reversing the trend away from Thomas Jefferson." (Federal Reserve Directors 1975, iv, v)

This call for Jefferson is reminiscent of Franklin Delano Roosevelt's call in 1925: "Hamilton we have today. Is there a Jefferson on the horizon?" These calls ask for a substantive rationality and a humane approach to society.

CHAPTER XI: SUMMARY AND CONCLUSIONS

The two conflicting philosophies of Jefferson and Hamilton shaped political, economic and cultural life in the United States. I have classified them as the populist and the technocratic way of thinking. Jefferson's and Hamilton's philosophies were first reflected in the disputes over the First Bank of the United States created in 1791, and continued to run throughout the history of banking. The populists and the technocrats diverge sharply in the understanding of the human nature that underlies their political and social philosophies. The protagonists of these two conflicting cultures have different roots, different orientations, and transcend political parties and social class affiliations.

I characterize the populists as those who believe that people are free and equal in dignity and rights. Their roots are in the moral and humanitarian tradition of Jeffersonian democracy and they temper reason with compassion. For the populists, technological advancements are not the end of human development. They strive for social justice and seek to secure the economic and social conditions under which the realization of democratic principles is possible. The populists trust the essential goodwill in people and their ability to govern themselves. Through expanded access to the ballot they seek expanded access of the people to

political power. The government, for the populists, is the guardian of justice and they oppose granting special privileges to one segment of society, thereby artificially inflating its influence, wealth and prestige that in turn threaten political, social and legal equality. Their traditional striving for a fair distribution of socially produced wealth is in tune with Karl Mannheim's meaning of economic justice:

Redistribution of income and public control of resources and their use may well serve considerably to broaden educational opportunities. . . . Such raised self-esteem and efficiency is feared by vested interest groups. (Mannheim 1951, 262)

Characteristically, the technocrats trust the supremacy of science and the technical knowledge of the specialists. Since they distrust the capacity of common people to govern themselves, they block any structural opportunity for mobilization of working class interests, preferring to entrust the nation's affairs to a few top professionals. The technocrats seek governmental subsidies and favors, but oppose governmental intervention in business on behalf of consumers. The technocrats abandoned democratic procedures as obstacles to efficiency and to formal procedures; they adopted instead rules of technology helpful to their goals. Gross inequalities in society are justified by superior talents; the concentration of wealth in the hands of a few is explained by harmony of interests. Equality, for technocrats, is a levelling process incompatible with liberty;

it is also an impediment to economic growth and progress. The two groups differ on the meaning of investment. For the technocrats, investments for national health, low income housing, extension of unemployment compensations or inoculations against measles may be useful or wasteful, but are not properly called investment because they do not contribute to an increase of capital.

The protagonists of the two conflicting cultures view the central bank from opposing points of view. For the populists, the Federal Reserve represents a fourth branch of government; as such, it violates the Constitution. The technocrats see the central bank as a protector of economic stability as long as it is run by experts and is beyond the reach of the legislators. For one group, the bank is an antiquated institution, an anomaly in a democratic system which is based on public accountability, responsiveness and visibility; for the other group, the bank is a bulwark of economic security and national prosperity.

Alexander Hamilton laid the theoretical and practical foundations of central banking which are still in existence today. He placed the First Bank of the United States under private direction so as to shield it from the pressure of public necessity that might sap its vitality. Hamilton saw the Bank as a tool of national prosperity through its man-

date to concentrate capital as a depository of public funds, to issue and create paper money, and to assist the government in financial matters. Hamilton sought to link the interests of business and of the state for the mutual benefit of both. Having a low regard for common people and their representatives, he placed the First Bank of the United States and its money-creating power out of the reach of the legislators. In the opinion of the Hamiltonians of today, a government aiming at the prosperity of the country cannot be a government run by the people and their never-ending demands for more money. The continued reliance of government on the advice of business leaders and financiers increased the latter's influence over political decisions and public opinion. Their counsel has been criticized by the populists not only for its narrow business-oriented perspective, but for its biased view of human nature. Under the pretense of competence and the necessity of independence from wasteful partisan politics, the Federal Reserve has assumed the role of a monetary policy maker and operates in secrecy.

Jefferson opposed the First Bank of the United States on moral and constitutional grounds. He questioned the right of the government to create a monopoly through grants of exclusive privileges. In the 1830's, Andrew Jackson bluntly accused the Second Bank of the United States of political manipulations and of corrupting the legislators and the

press by offering bribes. He did not hesitate to use his Presidential powers for the protection of the "humble members of society."

Woodrow Wilson carried the Jeffersonian tradition into the 20th century. He located the strength of the nation in the character of the common people and was convinced that real wisdom is compounded of the experiences of ordinary men. "I have often thought that we overlook the fact that the real source of strength in the community comes from the bottom." (Wilson 1942, 13)

Like Jefferson and Jackson, Wilson did not believe in a passive government. He saw democracy as an evolutionary process requiring that principles adapt to changing times. Wilson was convinced that Jefferson, had he lived, would favor a government assisting the weak and the powerless. He used his influence to check the monopolies and did not hesitate to intervene to ensure a proper working of the free market. In his own words, he was not against big business but against governmental grants of special privileges artificially nourishing its growth. Against the pressure from the financial community and the recommendations of the National Monetary Commission chaired by Senator Nelson Aldrich, a spokesman for financial interests, Wilson insisted that the newly created Federal Reserve System must be

under the control of the government and not of the bankers "so that the banks may be the instruments, not the masters, of business and of individual enterprise and initiative." (Wilson 1942, 55) Like Theodore Roosevelt, Wilson found it necessary to counteract the power of the monopolies with the power of the government. He extended governmental control through regulations, initiated by Theodore Roosevelt, to the executive supervision of the regulators. The Federal Reserve Board comprising Presidential appointees, analogous to the Cabinet appointees, was granted powers of control over vast interests as described in Chapter 8.

Wilson spoke about the differences between the Hamiltonians and the Jeffersonians in his campaign speech in Buffalo, N.Y., on September 2, 1912. He described Hamilton as "a great man" but "not a great American" because he was a monarchist who worshipped the old political regime. Hamilton and his followers' hierarchical concept of government rubbed against the principles of American democracy. "But the trouble is, and the trouble has been since the beginning of time, that these men do not understand the interests of common men." (Wilson 1956, 92) In Wilson's opinion, the "masters of finance" need to be consulted and heard only as a part, not as the whole of the people.

Like the populists in the 19th century, so the populists in the 20th century reject the claims the masters of industry make on wealth, and their unwillingness to recognize the worker's crucial contribution to the creation of national prosperity. The populists dispute the trickle-down assumption that if a few prosper, all will prosper: "We have been foolish enough to settle national elections on the belief that it was so." (Wilson 1942, 53) The populists reverse the trickle-down theory of wealth distribution and claim that the prosperity of the people will push up every class that rests upon them. Similar to John Maynard Keynes, the populists emphasize the importance of demand geared to equitable distribution of purchasing power.

An important restructuring of the central bank took place in 1935 when the regional system was changed into a highly centralized system. Most importantly, the Federal Reserve Act of 1935, dubbed the Third Bank of the United States, changed the public orientation of the Banking Act of 1913 by transferring the core of monetary policy decisions to the semi-private Federal Open Market Committee. The newly created FOMC, under an excessive influence of the Federal Reserve banks' presidents, has exercised national monetary policy since 1935.

The 1991 study prepared for the use of the Joint Economic Committee: Central Bank-Government Relations in Major OECD Countries, presents the Federal Reserve System as an anomalous organization in a major democratic industrialized nation in that it grants power to the central bank's officials who are neither elected nor appointed by elected officials. For example, the Bank of England -- a model for Hamilton's First Bank of the United States -- was nationalized in 1946 and is subordinated to the Chancellor of the Exchequer who makes the final monetary decisions and is responsible to the Parliament for their implementation, in turn entrusted to the Bank. All of the Bank's officials are appointed by the Prime Minister acting on the advice of the Chancellor of the Exchequer. The sixteen directors are appointed for four years and the Governor and Deputy Governor for five years. In the same period, the United States turned in an opposite direction by giving a decisive voice in national monetary policies to private bankers. Paul Samuelson calls the Federal Open Market Committee probably "the most powerful group of private citizens in America." (Samuelson 1970, 273)

In 1991, Senator Paul S. Sarbanes introduced "A bill to provide for a Federal Open Market Advisory Committee, and for other purposes." The bill (S. 1611) eliminates the Federal Open Market Committee and relegates the presidents of the Federal Reserve banks to an advisory position as was

the case in the original 1913 Act. "The Advisory Committee shall advise the Board on the conduct of open-market operations." (Monetary Policy Reform Act of 1991, p.2) A parallel bill, H. R. 3176, was introduced by Representatives Lee H. Hamilton, Byron L. Dorgan, David R. Obey and Philip R. Sharp. The banking community unleashed a campaign against the bills and professor Allan H. Meltzer, Carnegie Mellon University, speaking for the Shadow Open Market Committee, stated:

The inflationists in Congress, led by Senator Sarbanes have introduced legislation to make the Federal Reserve less independent and, therefore, less willing to control inflation promptly. . . . The proposed legislation confuses independence with accountability. (Meltzer 1993, 4)

The Shadow Open Market Committee is a group of academic and business economists organized in 1973. The Committee follows the Federal Reserve's policies, encourages discussions on alternative economic policies and recommends policies that "promote economic stability and high employment."

Allan Murray in the Wall Street Journal, 1 August 1991, commented as follows:

The Fed is unique among major industrial nations for the power it gives to central bank officials who are neither elected nor appointed by elected officials. . . . Yet the 12 Fed presidents, despite all their influence, toil in relative obscurity. Who are these quasi-private public policy makers? The answers to these questions are clouded in the Fed's mystique and arcane traditions. (Murray 1991, A1)

A Retreat From the Ideals of Jeffersonian Democracy

As long as the populists and the technocrats publicly discussed and exchanged their ideas, they provided a broad perspective on social reality and contributed to the general understanding of social issues. The loss of the populists' voice in public affairs symbolizes the retreat from the ideals of traditional democracy and an increased dominance of the technocratic rule marked by extreme realism, as illustrated by the changes in the Federal Reserve System in 1935. Why did the populists' passionate advocacies of economic and social justice in the 18th, 19th and early 20th century, lose to the technocrats? The necessities of the First World War and the ensuing financial crisis turned the nation's effort to practical solutions and helped strengthen the status of the technocrats. The new generation's trust in the supremacy of science and technology, the expanded fields of knowledge combined with the pressures of daily existence and lack of leisure time, led to an increased demand for speedy solutions and an excessive dependence on professionals, resulting in a diminished confidence and influence of the layman. In a cultural orbit infatuated with science and technology, the traditional ideas of democracy are the losers because they do not neatly fit into scientific rationality.

Science and technology brought about fragmentation and narrow specialization; they led to an overestimation of the competence of technicians to solve private and public problems that require value choices rather than technical know-how. Business criteria of efficiency, where the few decide for the many, are at odds with the democratic process demanding that all opinions and interests be taken into consideration. A democratic process goes through an initial phase of disorder and requires time and patience for evaluation and solution. The efficiency argument has been used by the Federal Reserve representatives in defense of secrecy and independence from the slowness of governmental procedures.

Because of the paranoiac mania for Federal Reserve independence, the Federal Open Market Committee, the real hard core of policy in this country, does not even let the Secretary of the Treasury or the Council of Economic Advisers inside the door to explain the Administration's fiscal outlook for strategy. (Tobin 1965, 46)

An explanation as to who created such a system and why Congress turned over control of national monetary issues to a non-legislative organ, can be surmised from the remarks and admissions of some Congressmen, found in Congressional documents. In 1942, Representative Wright Patman gave the following explanation:

The answer is that such a system was built up over a long period of time. Congress passed monetary laws without giving a great deal of attention to them, being told that money was a mystery and very few people understood it and those understanding it were the ones

wanting the monetary laws. . . . All such bills were referred to as a bill to further strengthen our sound monetary system. (Congressional Record, vol. 88, pt. 8:A46)

The above admission supports Max Weber's explanations of how technocrats can come to control parliaments. Absent an effective parliamentary control, real power slides into the hands of the technocrats:

Weber believed that the specialized experts organized into smoothly functioning units by the bureaucratic managers would provide these elite managers with a decision-making ability foreign to the parliaments and the courts. He foresaw the dilemma that contemporary congresses would face when presented with problems beyond their collective expertise. There is a continuing trend toward the abdication of decision making by the elected representatives of the people and toward the increasing importance of nonelected decision makers. (Glassman 1984, 5)

Most Congressmen are not conversant with financial issues and rely on the advice of bankers when formulating banking laws. In 1989, 46% of the Congressmen listed law as their occupation, 31% business or banking and 21% public service/politics. "Lawyers continued to dominate the occupational category with 184 House members and 53 senators citing the law as their primary or secondary occupation."

(CO Guide to Current American Government, Spring 1989, 115)

Congressmen who oppose banking interests are silenced as "dilettantes" and "greenhorns" meddling in financial affairs. In the 1935 Congressional testimonies, the arguments for tighter government control over money reminded the

bankers of the "wide-eyed radicals" of the Populist era. The bankers branded the Congressmen's position as un-American and as unwittingly playing into the hands of Communism and socialism as described in Chapter 9.

The lack of knowledge is further compounded by the use of professional jargon and confusing terminology. Representative Wright Patman admitted:

Now, in reading these reports of bankers, I can't understand them because the language is written in a way that I don't understand. . . . The monetary policy, of course, is usually embraced with the statements that are given out by people in authority and those people have some idea, . . . whether money is going to be easy or going to be hard. (Congressional Record, vol. 100, pt. 6: 7781)

Similar to the Congressmen, most U.S. Presidents lack interest in or knowledge of financial issues. President J. F. Kennedy had to be reminded of the difference between "fiscal" and "monetary" policies: "Remember, Mr. President, "M" stands for Martin." McChesney Martin was then chairman of the Federal Reserve Board. President Eisenhower declined to be accountable for the monetary policies of the Federal Reserve System: "it is their responsibility." And yet, the President is ultimately responsible for maintaining the value of currency in coexistence with a maximum and stable employment level. Ignorance in any particular field leads to an exaggeration of the specialists' competence and creates a myth of superiority. Deference to money specialists has

almost a religious quality. Special technical knowledge and technical jargon shield the Federal Reserve from criticism by the majority of Congressmen and the public. General trust in the banking system is based on the lack of understanding and on the myth that finance is beyond a layman's understanding. Wright Patman, like the Populists in the 19th century, claimed that the principles of money are simple and their understanding them would dispel prevailing misconceptions. We could find that the Emperor has no clothes.

The lack of understanding and the resulting reluctance to be involved are compounded by the lack of a Congressional staff well versed in banking and economics. In contrast, the Federal Reserve Board boasts of having a research organization second to none. The legislators' lack of knowledge accounts for the unwillingness to take action and make any changes in the Federal Reserve System; they fear a reform could be worse than the present shortcomings. Having power to legislate is not enough if knowledge and willingness to act are missing. Many lawmakers are further limited in acting as the peoples' delegates because of financial obligations that enabled them to fund their campaign.

Fear of the money monopoly that government had legislated into being was expressed by Woodrow Wilson in his campaign

speech given at Madison Square Garden, New York City, on
October 31, 1912:

We have built a structure which we do not know how to change, and which we dare not touch. We fear that the men in whose interest we have built it up, the men who control credit from one end of the nation to the other, if they are not pleased with our action, will do something to destroy the prosperity of the nation. (Wilson 1956, 513)

Theodore Roosevelt publicly voiced his conviction that the financial panic of 1907 was instigated by "malefactors of great wealth" to discredit his administration, as described in Chapter 7.

Congress has given the Federal Reserve broad powers without explicit directives on how to use them. Representative Wright Patman, in an interview on September 11, 1972, complained about the seventy billion dollars of government bonds that the New York Federal Reserve bank bought over a period of years with printed money that didn't cost them "one penny" and on which it was collecting four billion dollars a year interest.

And you know, you can't get members to say a word about that! They're afraid of the big banks. The banks have built-in intimidation, built-in intimidation against every member of Congress and against every member of the legislatures of the fifty States. (Patman. "Interview with J. B. Frantz." 1972, 37-38)

To Frantz' response that "They might dry up your money sources." Patman replied: "Of course they'd ruin themselves first."

Intimidation and lack of technical knowledge do not necessarily mean lack of resolve and political leadership to intervene in matters of national interest, as illustrated by the following historical examples:

Andrew Jackson risked the Presidency when he spoke against the irresponsible power of private interests and launched the "bank war" against the Second Bank of the United States in the 1830's, as described in Chapter 3. The President

had a regrettable ignorance of finance. He had no acquaintance with the technique of usury which long use alone can give. But his instincts in such a matter were as keen and true as the instincts of the populace that supported him. He knew that the bank was a typical monopoly and he knew that such monopolies ever grind the faces of the poor and fill politics with corruption. (Chesterton 1919, 103)

The "amateur" politicians of the past century passionately expressed their opinions and acted with conviction regardless of adverse personal consequences. In 1835 the Whigs who stood for oligarchy, violating American tradition, "gradually abandoned the Bank's cause on the democratic grounds that the people had spoken against it at the polls." (McFaul 1972, 76) Alexis de Tocqueville also recognized the power of the "rule of democracy" against the "rule of aristocracy." The Bank, in his opinion, was a great, permanent and independent institution, and Jackson's and the common people's attack on the Bank were an irrational act based on lack of experience and knowledge of banking: "the people,

accustomed to make and unmake whatsoever they please, are startled to meet with this obstacle to their authority." (De Tocqueville 1863, 1:227) Seventy-eight years later, President Wilson won against the opposition of the financiers because the people were behind him.

A confrontation between President Truman and the Federal Reserve is described by Wright Patman in an interview with Joe B. Frantz in 1972. Truman insisted on keeping interest rates low on the long-term government bonds to enable the government to pay for the war without a crushing burden for the people after the war. William McChesney Martin, chairman of the Federal Reserve Board, always wanted higher interest rates and "maneuvered" an accord with the Treasury in the 1950's to raise the interest rates. When Truman found out what they were doing, he called them into his office and said: "You will be denounced as traitors to the country if you do that. You've got to change that or I'm going to tell the people the truth about it, and it's going to ruin every damned one of you." (Patman. "Interview with Joe B. Frantz." 1972, 35) Martin kept the interest rates low as long as Truman was in the White House, thus enabling the President to invest in free education for the veterans and pay off \$29 billion of the national debt before he left office.

In 1957, a bitter controversy between the Minister of Finance, Donald Fleming, and the Governor of the Bank of Canada, James Coyne, erupted over monetary policy and attracted public attention. The Bank was pursuing a tight money policy, in conflict with the Government's fiscal policy, at a time of high unemployment. While Coyne stressed the danger of inflation through deficit spending, the government insisted on fulfilling its responsibility for a high level of employment. The press started to ask, "Who is Coyne?" "The people do not elect the Governor of the Bank of Canada and he is not a king." Eldon M. Woolliam, expressing the sentiment of Parliament, refused "dancing to the tune of Mr. Coyne, the Governor of the Bank of Canada." (Woolliam 1961, 7092) The conflict between the two parties was settled by the recognition of the Government's authority over the Bank.

In 1946 the Bank of England, in existence for 252 years, was nationalized. The change from private to state ownership proceeded peacefully through cooperation. Great Britain, faced with mass unemployment, changed to a system of planned economy and the Parliament faced the postwar national emergency with the same determination with which it had faced the war. According to the Radcliffe Report the responsibility of the government for the volume of employment was the most radical change from the laissez-faire doctrine.

The political leaders accepted as one of their primary responsibilities the maintenance of high and stable levels of employment, and oriented their attention toward social planning for the common good. The conviction expressed by the Radcliffe Committee was that the central bank's policies must be in harmony with those initiated and determined by Parliament. The British experience exemplifies the predominance of political and social considerations over the purely mechanical ones and shows that a planned economy in the service of the well-being of its citizens is not incompatible with human freedom.

The British example shows that democracy and freedom are not incompatible with strong centralization; . . . Freedom should be guaranteed by democratic controls through established parliamentary channels. (Mannheim 1951, 112)

The views expressed in the Radcliffe Report are at variance with the accepted way of thinking in the United States that the Federal Reserve must be independent from political influence. Lack of coordination between monetary and fiscal policies and the predominance of the Federal Reserve's will over that of the President and Congress are recorded by Joe B. Frantz in an interview with Wright Patman. On December 6, 1965, in Johnson City, Texas, President Johnson expected a delegation from the Federal Reserve, headed by McChesney Martin, to discuss with him the new budget and his recommendations for the fiscal year so that the Federal Reserve could adjust the interest rates accordingly. Instead, the

delegation presented Johnson with their decision and said: "We didn't come down to discuss it with you, we came down to tell you that we've raised interest rates." In response, Patman wrote the only "mean letter" to "Lyndon" for "cow-towing" to the Federal Reserve. Patman's explanation was that Johnson "was raised with the Federal Reserve spoon in his mouth. . . his father organized the Federal Reserve in St. Louis. He just always worked with the big money people, you know." (Patman. "Interview with Joe B. Frantz." 1972, 37, 36) Through its control over the money supply, the Federal Reserve can reverse the fiscal policies and social programs of the Administration and of Congress. It can do so in a single meeting of the Federal Open Market Committee. In contrast, neither Congress nor the Administration can, under present law, undo the Fed's decisions.

Neil Postman, professor of Communication Arts at New York University, tries to confine technocrats to their proper sphere and argues that there are very few political and social problems that arise because of insufficient information.

The role of the expert is to concentrate on one field of knowledge, . . . This process works fairly well in situations where only a technical solution is required and there is no conflict with human purposes . . . And is disastrous when applied to situations that cannot be solved by technical means and where efficiency is usually irrelevant. (Postman 1992, 88)

Postman's statement parallels Max Weber's argument that science cannot provide answers to social problems which operate on a different level. Vaclav Havel, President of the Czech Republic, stresses the limits of technological civilization, resists its domination and seeks

the human dimension in all things. Science, technology, expertise, and so-called professionalism are not enough. Something more is necessary. For the sake of simplicity, it might be called spirit. Or feeling. Or conscience. (Havel 1992, 20)

In addition to a lack of understanding, reliance on experts, confusion between rational and substantive rationalities, lack of political resolve and shortage of qualified staff, a finite amount of time and energy that men can give are also important factors. The legislators are weighed down with heavy duties in Committees and Subcommittees, pressures from lobbyists, correspondence with their constituents, lectures and money-raising efforts for reelection campaigns. In 1989, 6,534 bills and joint resolutions were introduced and 242 were enacted. Under these circumstances, laws are sometimes enacted without the benefit of fully understanding the consequences.

Other factors that can influence the passing of bills are national emergencies which prompt hasty solutions and often unprincipled compromises. The First Bank of the United States was created to provide the necessary capital for the new Republic. The Second Bank of the United States was

chartered to meet the consequences of the war with Great Britain. The Federal Reserve System was established in response to the severe financial crisis of 1907. In 1933-1935, the threat of anarchy and economic chaos cemented the alliance between the bankers and the government and launched into operation the Federal Open Market Committee.

Lack of understanding of the money-creating process and the central bank's operations shield the Federal Reserve from public scrutiny and create an aura of legitimacy. Mystery is an important factor in the legitimation process. Jacob Viner, an economist at Princeton University, noticed that visitors to the palatial headquarters of the Federal Reserve System in Washington, D. C., tiptoe, whisper and stand in awe at the display of grandeur. He reminded them that it was their money they were staring at. Delbert C. Hasting, professor of statistics, University of Minnesota, and R. M. Robertson, professor of business economics, Indiana University, describe the churchlike atmosphere of the Federal Reserve's headquarters:

The marble halls and amber-lit, carpeted rooms epitomize the vast dignity of the monetary authority. . . . Indeed, an almost religious aura pervades the place . . . The physical atmosphere is simply an extension of a carefully nurtured public image of trustworthiness and high morality. (The Federal Reserve System After Fifty Years 1964, 1519)

The Federal Reserve operations are removed from everyday experiences, hence we fail to see the connection between

jobs and monetary decisions. In general, we are unaware of the tradeoffs between the "sound dollar" and unemployment rationalized by the Fed as the cure for inflation. The dominant economic position of the central bankers gives them power over the rate of employment and unemployment through control over money. A rising employment rate and an increase in consumption demands are taken as signs of forthcoming inflation, necessitating a rise in interest rates to slow down the economy. The critics claim that bankers overstate the inflationary consequences of full employment and are insensitive to the risks of recessions and the hardship of unemployment. An economic expansion does not necessarily usher in inflation. The "sound dollar" operations of the Federal Reserve extend into the political and social areas and show that economics cannot be separated from politics. The more we pay for loans, the less we have to spend for other national necessities. Leon H. Keyserling showed how the increased costs of tight money and rising interests

have borne down upon all levels of government, individuals, and private economic groupings, and how alternative utilization of the huge amounts involved in these increased costs would better serve the interests of the economy, the Nation, and the people. (Keyserling 1964, 2)

Through the Employment Act of 1946, the federal government accepted the responsibility for maintaining maximum and stable employment; failure to do so weakens the government's credibility. To govern responsibly, governments need to control monetary policies and mitigate the decisions of the

technocrats who can only administer a segment of the economy but cannot set national targets and priorities. While the bankers are responsible for a single aspect of the social world, the government is responsible for all its aspects. In democracy, a special agency cannot be delegated to perform the duty of the legislative and executive branches where the statutory power of government rests. Failing to exercise an effective congressional control over the Federal Reserve, the real power falls into the hands of the technocrats. The tension between the Federal Reserve goals and the government's goals exemplifies Max Weber's conflict between formal and substantive rationalities. The Fed approaches economic problems from a purely technical point of view and treats workers as a calculable means toward the attainment of a "sound dollar." The government, on the other hand, needs to respond to the overall needs of the population which cannot be calculated in monetary terms only.

The theory that inflation can be cured by high interest rates at the expense of maximum employment was abandoned by the Australian government. They pointed out that layoffs dampen spending and in turn lead to a drop in sales, thereby causing additional layoffs. The fear of unemployment can be as damaging to consumption as unemployment itself. Furthermore, threats to job security are socially damaging; they are a form of social intimidation and a tool to induce

conformity and acquiescence. In addition, interest on national debt is a form of retrogressive taxation; it transfers money from the poor to the well-to-do, since only the bondholders are rewarded. In a special study published in September 1984, the Congressional Budget Office assessed the effect of higher interest rates on the federal debt:

Higher (or lower) interest rates for government securities affect the interest costs on new borrowing and on existing debt that is being refinanced. CBO estimates that, if interest rates for all Treasury securities were one percentage point higher than the baseline beginning in January 1984, the federal budget deficit would be more than \$2 billion higher in 1984, and almost \$30 billion higher in 1989. (Federal Debt and Interest Costs 1984, 21)

The prevailing myth that Congress cannot do anything right undermines trust in government and allows the Federal Reserve to be the final arbiter over monetary policies. Cynical skepticism of government, the legacy of the American Revolution, carries mistrust of government from monarchy to democracy and raises the fear of a dictatorship of the "masses." Karl Mannheim stressed that "The threat to freedom does not come from a government which is 'ours,' which we have elected and which we can remove, but from oligarchies without public responsibility." (Mannheim 1951, 112-113)

Clark Kerr, former President of the University of California, Berkeley, agrees with Mannheim:

By and large, we have done very well in safeguarding the freedom of the individual and the groups from the overwhelming dictates of the state. But we have paid

less attention to the growth of private governments such as the corporation and the trade unions which now rank alongside public government in the influence they have over the lives of individuals. . . . The citizens in the industrial society of the future must learn how to manage not only their political leaders, but also the managers of all important aspects of national life, so that society may remain responsive to their desires for "life, liberty and the pursuit of happiness"; so that they may continue to have in the future as in the past the greatest of wealth and the greatest of freedom. (Kerr 1960, 90, 98)

A lack of popular trust in government weakens its power to rule, and this mistrust is nourished by the press. While the public and private conducts of the political representatives are under relentless scrutiny, the men in control of money are shielded from the public eye. The biased press reporting helps to sustain an image of trustworthiness and high morality of bankers and the belief that whatever they do is superior to the inefficiency of the government.

On November 23, 1937 Henry Ford, in an interview with the Associated Press, indicated the solution to the recurrent financial crises in the development of a monetary system that would meet the needs of the 20th century. To improve the situation, he suggested getting rid of the "textbook foolishness" and the commonly taught theories of how the Federal Reserve System works. He hinted at the tendency of the Fed to control and conceal information:

The lectures given by the paid officials of the Federal Reserve banks are interesting for their lack of any information on the subject . . . but discretely fail to

mention any of the important facts concerning it.
(Ford. "Henry Ford's Timely Statement on Money.")

Ford's concern about the lack of education on the subject of money was shared by Wright Patman who undertook to educate voters on the subject of money through "Weekly Letters," and to broaden his colleagues' knowledge through hearings on pending banking legislation.

In addition to ignorance, mistrust of government, biased press coverage, and insufficient attention to the subject of money in schools, the lack of leisure time diminishes the people's interest in the policies of the Federal Reserve System. The 19th century philosopher of the Eight Hour Movement, Ira Steward, was keenly aware of the social value of moderate labor and discretionary time, as discussed in Chapter 6. The feasibility of a six-hour working day raised in the 1960's has disappeared from discussions and the eight-hour working day became a myth at a time when public affairs have become more complicated and technical. An increased number of working people have been pushed to live farther and farther away from the cities where the jobs are located because of lack of affordable urban housing. The traveling time between work and home has been steadily increasing, leaving less and less time and energy for self-realization, the family, civic activities, culture and leisure. The structure of today's society weakens the power of the people and fails to provide, in Jefferson's words,

"congenial cultural and economic conditions" for the realization of a democratic society.

The unqualified faith in the wisdom of the specialists has weakened the laymen's confidence in their own resources and opened the door to manipulations. The domination of the technocrats is a concern of Neil Postman. As an antidote against the "totalitarian technocracy" he dares people to assume their right and become "resistance fighters"

who refuse to accept efficiency as the pre-eminent goals of human relations; . . . who do not confuse information with understanding; . . . who do not believe that science is the only system of thought capable of producing truth; . . . who do not wink at tradition for modernity's sake; . . . who admire technological ingenuity but do not think it represents the highest possible form of human achievement. (Postman 1992, 184)

Daniel Yankelovich, a member of the Kettering Foundation, sees the danger of self-governance in crowding out

the American public to participate in the political decisions that affect their lives. . . . They are shaped by economic experts, military experts, scientific experts, trade experts, PR experts, media experts. Less and less are they shaped by the public. (Yankelovich 1991, 54)

For Yankelovich, the image of Max Weber's "iron cage" is a reality. It is a place which leaves no room for individual freedom and participation. It is a world where technology has attained the upper hand over social organizations and where individual men and women are left out from the process of power.

The Role of Ideas in Society

The history of central banking in the United States shows the power of ideas and beliefs in the field of economics and politics:

Indeed the world is ruled by little else. . . . The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. (Keynes 1964, 383)

Starting with Thomas Jefferson and Alexander Hamilton, I have documented how their different and conflicting views of human nature, and those of their followers, have shaped economic and social policies. My construction of the two ideal types -- the populists and the technocrats -- was inspired by Jefferson's and Hamilton's diverse ideologies. Following Max Weber, I have classified the populists' policies as substantive in nature, meaning value-oriented and concerned with ethical merits. In contrast, the technocrats' policies are technical and mechanical; they can be calculated and quantified. I have classified them as formal/instrumental policies. Highlights of the major ideas and beliefs covered in this dissertation help to illustrate my conclusion.

The democratic form of government envisaged by Jefferson and his followers, a group I call populists, is derived from their trust in the common man's ability for self-government.

Contrary to the populists the technocrats, followers of Alexander Hamilton, believe that people in general are incapable of self-government and therefore in need of an expert-elite group of men to guide them. The First Bank of the United States, the predecessor of the current central bank, established in 1791 under the tutelage of Alexander Hamilton, was placed under private directorship to protect it from the legislators and the wishes of the people. Hamilton's beliefs survive in the present Federal Reserve System and challenge the central bankers' claim that their decisions are value-free. While the populists demand public control of public money, the technocrats insist on independence from the government and the people. The bankers claim that their expertise in a highly complicated field of banking best qualifies them to direct monetary policies. The populists challenge this presumption and contend that the bankers fail to see the larger picture, and are not the only ones who have the right to express themselves on questions deeply affecting society. While the technocrats see the central bank as a bulwark of economic stability, the populists see the bank, and the special privileges granted to it, as an anomaly in democracy.

The two groups diverge sharply in their views of national prosperity. The populists believe that the national income should be invested in the people and the infrastructure; the

technocrats advocate support of big business and concentration of money in megacorporations where it can be most efficiently and forcefully used. The populists seek increased levels of democracy in the economic field in order to free people from the fear of losing jobs or being financially ruined by sickness. The technocrats fear the despotism of the majority and oppose governmental planning as an encroachment on individual liberty. While the populists regard federal government as the solution to many social problems, the technocrats view government as an assailant on individual liberty. The technocrats adhere to Adam Smith's maxim that when individuals maximize their own self-interest they maximize society's well-being. While the populists base the prosperity of the nation on an equitable distribution of purchasing power, on the assumption that an increased demand for goods by a financially secure population will push up production, the technocrats advocate concentration of money in the hands of a few under the assumption that monetary benefits will trickle down to the rest of the people.

The populists recognize the crucial contribution of the worker to the creation of national prosperity and ask for fair share of the socially produced wealth; the technocrats take full credit for the creation of national wealth and are unwilling to fairly share the abundance. The application of

instrumental rationality by the central bankers is the cause of the conflict between money and labor. The central bankers are preoccupied with curbing inflation and ready to trade maximum employment for a "sound dollar." The populists see human misery in unemployment and insist on maintaining a maximum rate of employment. They see recession as the consequence of the bankers' application of hard brakes at the first scare of inflation.

My thesis confirms Max Weber's foresight that the progressive application of instrumental rationality would lead to an increased domination of experts and to a society ruled by technocrats. I located the high point of the technocrats' dominance and the diminished influence of the populists in the first half of this century as exemplified by the Banking Act of 1935 and the creation of the Federal Open Market Committee. The dominance of central bankers and their technocratic rule in the economic field spills into the social life and affects our daily existence.

The retreat from the Jeffersonian ideas of democracy means that we have retreated from principles of democracy based on economic, social and cultural equity of the people, and have left the field open to the dominance of the technocrats who are guided by instrumental reasoning. The trend away from Jefferson can be reversed only when the collective belief

that the technocrats have the answers to our social problems will change, and when the substantive rationality of the populists will again balance the instrumental rationality of the technocrats.

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