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Mark Carlson's *The Young Fed:* A Review Essay.

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Note: A condensed version of this book review will appear in Business Economics.

Mark Carlson has written a new book on how the Federal Reserve handled banking problems during the 1920s, titled *The Young Fed: The Banking Crises of the 1920s and the Making of a Lender of Last Resort*. One scene early in the book comes at the open of business on a Monday morning in 1926 when a crowd of customers was about to run on Park National Bank in Kansas City. The head of the Federal Reserve Bank of Kansas City showed up, and in his own words he "mounted a chair in the rear of the room and called the attention of the crowd to the information we had regarding the soundness of the bank, stating who I was." Meanwhile, the Fed had sent "a huge stack of bills, silver, and gold" which couriers conspicuously carried into the bank and placed in plain view. The bank survived the run that day, perhaps only because of the Fed's actions to support it.

So far, the scene is recognizable as a lender of last resort action, close enough to a textbook discussion. But there are some additional, more awkward details. The bank had asset losses. Worse, the asset losses turned out to be more severe than the Kansas City Fed had appreciated. The investors who were going to provide the bank with fresh capital instead decided to pull out. Some time after the Fed "facilitated a further reorganization of the bank" with a new investor. Thus the Fed moved well past a lender of last resort role and took on the role of matchmaker and orderly resolution specialist. Carlson's book contains case studies of fourteen banks that came under pressure and turned to the Fed for a wide variety of this kind of help, lender of last resort and beyond.

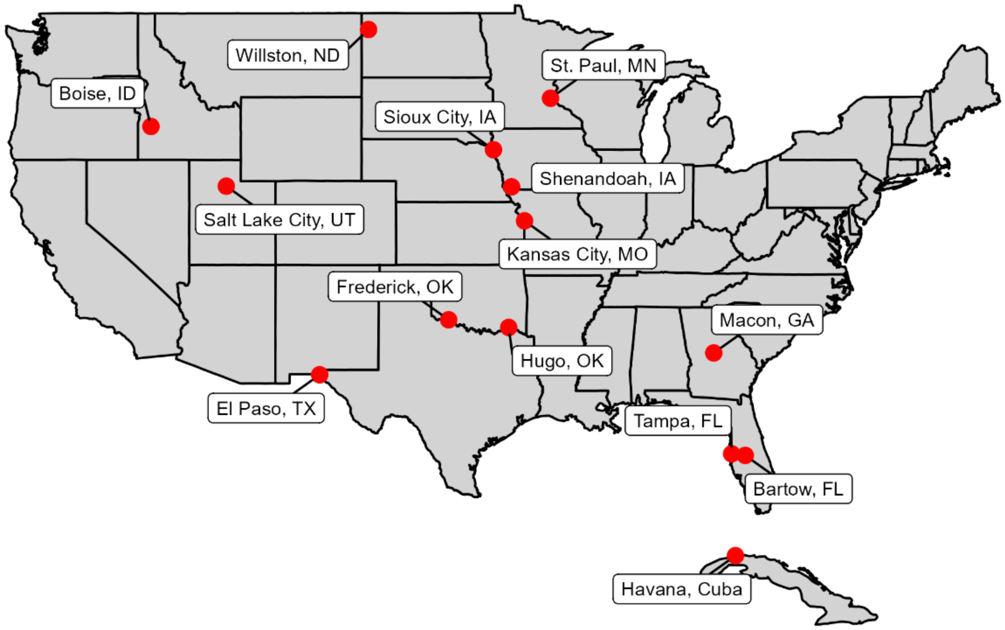
To unpack where the textbook leaves off and Carlson's account picks up, let's peel away the layers of this scene in Kansas City a bit more. But before I go on, I need to disclose that I have collaborated with Carlson on several research and Federal Reserve policy projects.

An undeveloped banking system

What was the underlying problem in the case of the Kansas City bank? It turns out the bank's owner had recently been labeled an "incompetent" by a bank examiner and was running the bank into the ground. One of the downsides of having tens of thousands of local banks in the 1920s was that not every wealthy local investor necessarily had great banking acumen. In addition, sometimes these local investors closed their pocket books, or went broke themselves. Many communities across America were one or two bank failures away from significantly degraded access to banking services. If local investors were unavailable to step in, there were no large nationally operating banks that could fill the gap. Moreover, all the banks in a town or city tended to be exposed to the same local economic problems, and therefore were likely to all come under pressure at the same time. In Kansas City, the Park National Bank episode came after the failure of three other local banks, and Park was connected to one of them, leading to contagion.

The Kansas City episode therefore illustrates how the US banking system in the 1920s was still fairly underdeveloped. In fact, *The Young Fed* tends to focus on the less financially developed parts of the country in the south and west, as shown in the map I made of the fourteen case studies that form the core of the book. Many of the banking problems of the 1920s were rooted in the volatility that affected the agricultural economy in the wake of World War I. It's not that Carlson omitted episodes in the northeast.

There just weren't many episodes of banking problems in the northeast, which was much more financially developed. Overall, though the 1920s were a time of much economic progress, parts of the commercial banking system had a troubled decade, and the number of banks contracted from an all time high of 31,076 in 1921 to 25,568 by 1929, even before the Great Depression set in. *The Young Fed* therefore is the story of the Fed superimposed on a financial system that was still a work in progress in many ways.



An active lender of last resort: crisis communications and cash stockpiles

Let's return to the scene in Kansas City, with the head of the local Federal Reserve Bank mounted on a chair in the lobby of the Park National Bank, trying to calm the bank's depositors.

I have been through enough annual ethics trainings to wonder whether the head of the Federal Reserve Bank should have used their official title to vouchsafe for the soundness of a privately owned bank in this episode. Putting that aside, I admire the image of an active, not a passive, lender last resort. The head of the Kansas City Fed did not simply sit at the Fed's headquarters and wait for the Park National Bank to ask for cash or a discount window loan. Instead, he left his office, mounted a chair in the Park National Bank's lobby, and used direct communication with the public as a tool of policy. Central bankers are fond of quoting Bagehot and affirming that they are lending freely, but Carlson's book is a gold mine of examples of how central bankers can go a step further to proactively make sure that a central bank's facilities are as useful as possible.

For example, recall that the Fed also arranged for a "stack of bills, silver, and gold" to be placed in the Park National Bank's lobby. Through multiple case studies, Carlson makes clear that the Fed used cash stockpiles like this as a part of its toolkit during the 1920s. Of the fourteen episodes studied in the book, four feature the Fed staging cash in advance of expected deposit withdrawals. A key part of this tool was publicly advertising the stockpiles as a method of psychologically calming anxious depositors. Technically, such stockpiles were not necessarily "lender of last resort" actions. If the Fed was simply supplying cash to banks when they drew down their reserves balances, discount window loans were not necessarily involved. Still, cash stockpiles were clearly a crisis tool and Carlson's account is now the most detailed description of the Fed's use of this tool in the literature.

Cash stockpiles were also used in Boise during the winter of 1921, when Federal Reserve Bank of San Francisco officials were afraid that further shipments of cash from its Salt Lake City branch, if needed, could be delayed by weather conditions. The Fed created a local "currency fund" to meet potential demands. The Federal Reserve Bank of Atlanta likewise created cash stockpiles in Tampa in 1929 and in Havana in 1926 after rumors of banking problems surfaced in each city. Yes, the Federal Reserve once operated a facility in Cuba, which for a time heavily used the US dollar. In the Cuba episode, the Fed chartered a train from Atlanta to Key West to convey the cash, which was then transported to Havana on "the gunboat *Cuba*, which was under the command of the Cuban postal authorities."

Cash stockpiles as a concept are a bit dated, since other payment instruments have displaced cash since the 1920s, though sometimes the demand for cash still rises abruptly and the Fed must meet the demand. The broader lesson is how a proactive lender of last resort can make its facilities more useful by ensuring cash is already in place when it's needed.

Continuous borrowing and the roots of stigma

The Park National Bank episode featured an acute need for liquidity by the bank, but the underlying asset problems at the bank had been present for quite a while. This is a common feature of the episodes in *The Young Fed.* Many other episodes do not really feature any particular emergency, but rather just involve banks that had slow drains on their deposits that led to chronic funding problems and long-term discount window borrowing. Like cash stockpiles, this kind of non-emergency borrowing doesn't strike me as necessarily a lender of last resort action. Even so, understanding how the Fed dealt with chronic borrowing is historically important insofar as this was a key formative experience for the Fed. Indeed, it was well known before Carlson's book that the Fed allowed many banks to borrow from it in the 1920s for long periods, years in many cases. Before this book I had a general awareness of this issue, but Carlson's book provides more information on how Fed policy evolved.

Chronic borrowing is the focus of most of the case studies in this book because many of those case were taken out of a survey conducted by the Board in 1927 that Carlson makes use of. In that survey, the Board asked Federal Reserve Banks to provide examples of loans to banks that were in poor financial condition and detail how the Reserve Banks handled these cases. This survey is a great archival find. The portraits that emerge are more complicated than just deposit losses or asset problems. In the undeveloped financial system of the 1920s, the Fed tried to avoid simply closing banks if doing so would lead to a significant hole in the banking services provided to a local community. Here, the Fed's dual role as both a bank regulator and a central bank liquidity provider was quite important.

By the end of the 1920s the Fed had adopted a policy of discouraging continuous borrowing over long periods. That policy is one of the main historic roots of the "tradition against borrowing" and the development of stigma at the discount window, in which banks are reluctant to borrow because doing so became rare and interpreted as a sign of weakness.

Digging into the sources

Historians reading Carlson's book will be interested in understanding how he learned new information about the Fed's actions in the 1920s. Even after a century, there are two sources that have still been largely untapped.

Carlson's main source is a 1927 survey in which the Federal Reserve Board asked Reserve Banks for examples of loans to financially troubled banks. This survey has been in the National Archives for decades but Carlson is the first to make such use of it.

A second source is the set of minutes of the Boards of Directors of the Federal Reserve Banks of Atlanta, Dallas, Minneapolis, and San Francisco. Few researchers have made use of these minutes, the most well-known cases being studies of the New York Fed's minutes by Milton Friedman and Anna Schwartz, and by Allan Meltzer. Additional examples include citations to the Atlanta Fed's minutes in a study by Carlson along with Kris Mitchener and Gary Richardson, and in a study by Eugene White.[1]

Carlson includes only a small number of excerpts from these minutes but I was intrigued to see what revelations they offered. Since replication is an essential part of research, I reached out to the Atlanta, Dallas, Minneapolis, and San Francisco Federal Reserve Banks and requested to review the passages that Carlson quotes in his book. It was easy to replicate and confirm the conclusions that Carlson draws from these minutes. In addition, I found the original documents to be a fountain of further insights. Each researcher brings their own lens to primary documents and makes choices about what to highlight, and my own eye caught some details I found very interesting.

For example, Carlson quotes the Minneapolis minutes to state that the Minneapolis Fed chose to shift its rediscounts toward shorter maturities in 1920 in order to avoid credit risk on longer-term loans. Reading the original material helped me understand the pressure on the Minneapolis Fed to reduce the amount of credit it had outstanding; they had received a message from Governor Young of the Federal Reserve Board expressing "the view that some method of forcing liquidation is urgently necessary" (November 8, 1920). Here we start to see the origins of the tradition against borrowing that would develop.

Carlson quotes the minutes from Dallas to state that Fed officials were very concerned about a regional financial crisis. Reviewing the minutes myself, I was struck by the sense of public responsibility felt at the Dallas Fed; one official wrote "I realized that upon my decision rested in large measure the welfare of the banks and business interests of El Paso and its surrounding country" (February 7, 1924, p. 18).

Carlson uses the Atlanta Fed minutes to reveal a portrait of a particularly active lender of last resort which took proactive steps to rush cash or offer services to banks that might need assistance. In the minutes I discovered some additional steps the Atlanta Fed took that I think are historically important, including steps to ensure enough liquidity was available to nonmember banks "through the agency of our member banks," a key step at a time when non-member banks did not have direct access to the Fed (December 14, 1928, page 8).

Finally, Carlson quotes the San Francisco minutes to discuss how the failure of a bank caused the Fed to acquire an unusual asset, a ranch in Utah. As someone who has studied real estate finance in history, what caught my eye in the minutes was that the San Francisco Fed sold the property through a five year sales contract (April 1, 1926, p. 563). Evidently, no better private financing was available, such as a 10-year loan common in commercial real estate markets today, that would have been more attractive than a

[1] See Milton Friedman and Anna Schwartz, (1963) *A Monetary History of the United States;* Allan Meltzer, (2003) *A History of the Federal Reserve*; Mark Carlson, Kris Mitchener, and Gary Richardson, (2011) "Arresting Banking Panics: Federal Reserve Liquidity Provision and the Forgotten Panic of 1929," in the *Journal of Political Economy*, and Eugene White, (2017) "Protecting Financial Stability in the Aftermath of World War I: The Federal Reserve Bank of Atlanta's Dissenting Policy" in *Financial Systems and Economic Growth Credit, Crises, and Regulation from the 19th Century to the Present* (2017) edited by Peter L. Rousseau and Paul Wachtel.

five year sales contract—a further sign of the relatively undeveloped nature of financial markets at this time.

Conclusion

When the Federal Reserve was first established, member banks actively used the discount window. As the banking system experienced losses in the 1920s, especially in agricultural parts of the country, the Fed faced a number of tricky questions about how to resolve the debts of member banks in poor financial condition. One view of this history is that it illustrates a downside of active use of the discount window. This view does not necessarily celebrate the development of stigma at the window, but it does help explain why Federal Reserve officials discouraged frequent use of the discount window after the 1920s. *The Young Fed* certainly provides fodder for this view, but I also think it points to another view. The Fed's discount window experience during the 1920s was also the product of a relatively undeveloped financial system that weakened the banking system, made resolution harder, and increased the tendency of banks to borrow from the Fed.