SPRAGUE, O. M. W.
Foreign exchange.

LECTURE JANUARY 12, 1912

O. M. W. Sprague

The subject of my lecture today is "Foreign Exchange." Foreign Exchange seems commonly to be regarded as a very mysterious subject, one beset with innumerable complications. The general principles of the subject are, however, by no means abstruse. To conduct a Foreign Exchange Department does require a special training and a certain natural aptitude, but any intelligent person can, I think, readily secure a general understanding of the subject taken as a whole, and such a general understanding is of much value, I think, to persons engaged in other branches of banking.

First let me define Foreign Exchange. It is the business which is concerned with the buying and selling in one country of rights to money in other countries, either immediate or in the future.

Much of our Foreign Exchange business is closely paralleled with certain kinds of domestic business carried on in all banks. I refer to the business of making payments between different parts of the country. In particular, the domestic exchanges are closely analogous to the Foreign Exchange business. Domestic Exchange rates rise and fall within certain limits, which are set by the cost of shipping currency between any two places. The quotations are usually expressed in a

premium or discount on one thousand dollars. If it costs, for example, fifty cents to ship one thousand dollars between two places, the rate of exchange may be anywhere up to fifty cents above or below par.

Now, Foreign Exchange rates fluctuate in exactly the same way. They fluctuate above and below par to the export or import points, and these export and import points are determined by the cost of shipping, not currency, but gold. The quotations are, however, expressed in a somewhat different manner, and necessarily so, because of differences in currency between different countries. It would be a most roundabout fashion to express Foreign Exchange rates in the terms used in Domestic Exchange, although it would be possible.

If it costs, for example, $2.50 to send one thousand dollars in gold to England, then that $2.50 sets the limit to the possible fluctuation in exchange. The rate is not expressed in that way. The par of exchange between the United States and England is $4.86-2/3, because the amount of gold in a sovereign makes, when coined into United States dollars, $4.86-2/3, and exchange rates fluctuate above and below $4.86-2/3 by the cost of shipping gold to England.

In the case of France, the quotation is expressed in a slightly different fashion. Instead of being expressed in United States money, it is expressed in francs - in the number of francs which the gold in a dollar will make. Now, the gold in a dollar will make 5 francs, 18 and a fraction centimes.

Exchange on Paris, therefore, fluctuates above and below by the cost of shipping gold to Paris.

Exchange on Berlin is, like that on London, expressed in United States money, but ~~is not expressed in the monetary unit, or is not measured by any single German monetary unit.~~ Instead of taking the mark, 4 marks are made the basis of the quotation. Now, the gold in 4 marks, coined into dollars, makes 95 and a fraction cents. Consequently, exchange on Berlin may rise and fall by the amount that it costs to send gold to Berlin.

When exchange is expressed in your own currency, a rising quotation indicates an approach toward the export point. It indicates that there is a demand for remittance to Europe - say, England - which is in excess of the supply. Thus, the gold export point to London is about $4.88. When, however, quotations are expressed in the currency of a foreign country, just the opposite is the case. A fall in the quotation then indicates an approach toward the export point. ~~That will be obvious if you take an example of this sort.~~

Suppose you have to make a payment of a thousand pounds in London. If exchange is toward the export point, you will ~~make to~~ pay more, ~~naturally~~, than if it were toward the import point, because at the export point you have to pay the gold value of ~~a~~ the sovereign plus the cost of shipping the sovereigns, and that is, naturally, expressed by an advance ~~in the rate.~~ If the rate were $4.88 you obviously would have

to pay more to get your thousand pounds than you would if the rate were $4.86.

Suppose, however, you have to pay a thousand francs in Paris, and the quotation is expressed in francs. Clearly you have to pay more to get your thousand francs in Paris if you can only get 5 francs 16 centimes for a dollar than if you could get 5 francs 18 centimes for a dollar.

Now a few words as to what determines the export and the import points. What are the expenses incurred in shipping gold? The very obvious expenses are, freight, insurance, and the cost of packing the gold. These elements of expense, however, are somewhat variable; the freight charges may not be uniform, and it makes a good deal of difference what sort of gold you are shipping. The most inexpensive form for the purpose is gold in bars. ~~That~~ It can be packed more handily, and there is less loss from abrasion than there is if you ship coin. Gold bars are secured from the United States Treasury, a nominal charge being exacted. In the past it has not always been possible to get an adequate supply of gold bars, but in the future that difficulty will probably not present itself, because the Government has recently been empowered to hold gold in the form of bars against gold certificates in circulation. Formerly all the gold against the gold certificates had to be coined. Therefore, the export point will be in the future, on the average, a little less than in the past, because

Have inserted a paragraph here about Bank of Eng. price of gold & interest on gold in transit.

now it will always be possible to get gold bars.

A very important element of expense is time. If one of the fast express steamers is sailing, the "Lusitania" for instance, the ~~export~~ import point is lower than during a week when no fast ship is sailing. ~~On an export of a million dollars' worth of gold even a day's interest is, obviously, a factor.~~ The interest, however, counts only in one direction; ~~it~~ only ~~counts~~ in case you are importing, ~~never in case you are exporting~~. If you export a million dollars' worth of gold, you can sell sight exchange at once to an equivalent amount. Consequently, you are not out of your money at all. Suppose, however, it is a case of importing gold. Then you are out of the interest the money would have earned in London while the gold is in transit, and for that reason the gold import point is somewhat further ~~below~~ away from par than the gold export point. If we assume, for example, that the gold export point is about 1-1/2 cents above par, then we will probably find that the gold import point is something like 2 cents below, the difference being increased or lessened as foreign interest rates rise or fall ~~on account of this matter of interest counting when the gold moves one way and not when it moves the other.~~

There has been a slow but pretty steady reduction in the possible range of exchange fluctuations in ~~the last 20 or 30 years~~. 20 or 30 years ago the export point was about $4.90. It is now in the neighborhood of $4.88. The import point was then in the vicinity of $4.82. It is now ~~at~~ somewhat above $4.84. But from what

~~So much for the possible fluctuations in rates of exchange above and below par.~~ has been said you will see that the exact point at which gold can be exported or imported at a profit is subject to much variation even over short periods.

So far I have only spoken of sight exchange. A glance in the newspaper will show that there are various other rates regularly quoted, - bankers' bills ~~and commercial bills~~ and various kinds of commercial bills, drawn for varying periods of time. Now, these rates are always below the sight rates. They vary with sight rates in a perfectly definite fashion, but they also vary for certain other reasons. If you should find that the sight rate was $4.86, you might find that the rate on bankers' sixty day bills was $4.83, and you might find that the rate on a certain class of commercial bills was $4.82-1/2, and on another kind, perhaps, $4.82.

The quotation on time bills is less than that for sight exchange by the varying cost of discounting these time bills in the foreign country on which they are drawn, If the rate of discount on a sixty day bankers' bill is 3% in London, then the quotation for a bill of that sort in New York will be the sight rate of exchange in New York less the discount on that bill in London. If the discount rate in London advances on that particular sort of bill, then the quotation ~~on that bill~~ will move somewhat further away from the sight quotation, ~~and~~ the reason that there are these different prices or quotations for various kinds of time bills is that there are a variety of discount rates in the London market, depending upon the character of the bill. The lowest rate is secured by bills drawn on, and accepted by, a London banker. Then there are various other rates, running all the way up to the "bank rate;" that is, the rate of the Bank of

a little about clean bills inserted here

England, whatever that may be.

A little description of the more important kinds of time bills will, perhaps, not be unnecessary. Most of the goods exported from this country to Europe give rise to documentary bills of exchange. The seller draws upon the purchaser, or upon the bank of the purchaser, and the various documents are attached to the bill of exchange, the most important being the bill of lading, without which it will be impossible to secure possession of the goods. Documentary bills are of various kinds. They may be documentary for payment, or documentary acceptance bills. If they are documentary payment bills, the purchaser of the goods cannot get possession of them until he has paid the bill of exchange. Now, these documentary payment bills are of two general classes, first, those on perishable goods and othergoods which the purchaser is pretty certain to want immediately on arrival, and, second, those in connection with goods which the purchaser is not likely to want until the maturity of the bill. If the purchaser wants the goods and makes the payment, he is allowed a rebate, which is 1% below the Bank of England rate, whatever that may be. Therefore, the price of such bills in this country is readily figured by taking the sight rate of exchange, determining what the Bank of England rate is, deducting 1%, computing that rate of discount and deducting it from the sight rate. ~~If should, perhaps, be said that there may be discrimination in the case of bills of this sort if you are not entirely~~

confident of the solvency or the credit of the drawer of the bill.

If the goods are of a kind which are not likely to be wanted by the purchaser until maturity, then you ~~cannot get that bill discounted~~ in London. The bill will not be ~~discounted in London, it will not be paid until maturity, and if you buy it here you~~ or your agent in London may be obliged to hold it until it matures. But perhaps you would like the money, perhaps you do not care to finance this business during the life of the bill. You may in that case use such bills as collateral with your London correspondent. ~~They cannot be discounted, but they may be used as collateral,~~ and you may draw your own bill on your London correspondent, the London correspondent accepting that bill, and it can then be discounted. Thus your balance will be built up.

~~Now the~~ Documentary acceptance bills. ~~These~~ are of two kinds,-those which are drawn for acceptance by a merchant and those which are drawn for acceptance by a bank or accepting house. Naturally, the latter get the better rate in the London market, because ~~they~~ the acceptors will be universally known and ~~make a class of bills generally desired~~. The documentary acceptance bills on merchants will be discounted at a slightly higher rate in London, and, consequently, the price of such a bill in this country will be slightly lower than documentary acceptance bills on bankers.

When goods are sold to other parts of the world than Europe, the arrangements are somewhat different. We do not draw

bills on South American cities, for instance, to any appreciable extent, There is not a sufficiently broad market in bills of exchange to make that a feasible arrangement. There are a number of possible arrangements, but I shall only mention one of them.

A commission house exporting goods to South America will, very likely, be paid in 90 day drafts on some London bank, which will be drawn by the South American purchaser of the goods ~~from the New York commission house.~~ Well, this means that the commission house will be a long time out of its money. The time that the goods are going to South America, the time that is taken in sending the bill of exchange to London, and 90 days thereafter - something like six months will be absorbed before the maturity of this bill. The commission house in New York wants its money. It may itself draw a bill - a 90 day bill - upon a London bank - ~~commonly the same~~ bank on which the South ~~American bill is~~ to be drawn - and by selling its own 90 day bill in the New York market the commission house will get the ready cash. The 90 day bill will be sent to London and discounted on the London market. Thus, you see that London really finances, in such an instance, the shipment of goods from New York to South America. When the 90 day bill falls due, the New York house itself must, of course, provide payment, ~~and must certainly~~ the South American bill is not yet due. It may purchase sight exchange in New York, in order to meet its 90 day draft, and also draw another one to cover another 90 days,

By the time the second draft reaches maturity the proceeds of the South American draft will be at hand. Thus, by drawing two bills, each for 90 days, the New York commission house will throughout the period have secured the funds, through the London discount market.

Now let us take a case of imports to this country. The most common method of arranging payment is through a commercial letter of credit. Let us suppose that a Boston wool house is going to purchase a quantity of wool in Australia. It will secure, through some foreign exchange banker here, a credit with some London bank. Under the terms of this credit the agent in Australia of the Boston wool house will be empowered to draw documentary bills of exchange up to a certain amount. The purchase of wool is made, the bill on the London bank is drawn, the documents attached, and it is disposed of to some Australian bank. Thus the funds are provided for the wool. The Australian bank sends this bill with documents to its correspondent in London, and at the same time, very likely, will sell an equivalent amount of sight exchange in Australia against the credits which it will be given in London through this long bill. No one in Australia has any further connection with this transaction. The correspondent of the Australian bank in London takes the bill, with its documents, to the London bank on which it is drawn for acceptance. Having been accepted by the London bank which takes the documents, and the bill is discounted

in the open market and the funds provided with which to meet the sight exchange which we assume the Australian bank had sold. The London bank which accepted and took the documents then sends them on to this country, presumably to a shipping broker, according to instructions, or to the foreign exchange banker here through whom the arrangements were made. The wool house cannot get possession of the wool until it can get these documents, and the foreign exchange banker need not give up these documents until he is provided with funds sufficient to pay the sight exchange on London necessary to meet the payment of the time bill accepted by the London bank. Thus everebody is secured at every point in the transaction, in so far as the wool itself may be regarded as security.

It is a natural query, I suppose, at this point, why we do not finance any of this business. It is largely because the demand for capital in this country is such that rates for loans are higher, ordinarily, here than they are in European cities, and particularly in London. Of course, commissions have to be paid along the line in connection with this transaction that I have outlined in the case of the wool, but even with the commissions added to the London rates of discount the cost is, ordinarily, not what it would be at our prevailing rates for loans. If a lower average rate for loans comes in this country, then we may presumably finance not a little of our foreign trade, though it is doubtful whether we shall at any time in the immediate future displace London. It

is of considerable advantage to have some one city in the world which is a center for payments for all of the other countries. Just as in this country New York is the center for the ~~payment~~ settlement of ~~exchanges~~ payments between different parts of the country, London occupies that position for the world at large, largely for historical reasons, largely because of the extent of the English Empire, and even more because of the extent of English trade and investments. It seems to me extremely unlikely that the position of London will, in any time that is worth while considering, be seriously threatened by New York, or by any other financial center.

In the actual practice of exchange, bills are drawn on London; London itself draws very few bills indeed. In the case of our exports, for instance, commercial bills are at once drawn, and ordinarily those bills are discounted in the London market, and, as you have seen in the case of imports [redacted], while the goods are in transit the business is financed in London. The commercial bills of exchange drawn largely supply or feed the balances in London against which sight exchange is sold. Our merchandize exports amount to something like $2,000,000,000.00 annually. That provides an enormous amount of bills of exchange, mostly time bills, drawn chiefly on London, and to a lesser extent upon other foreign financial centers. Our importa amount to something over $1,000,000,000.00 a year - ~~between that and $1,500,000,000.00.~~ They do not give

rise to any considerable quantity of time bills. They are paid, very largely, in sight exchange, and the possibility of providing sight exchange comes through the proceeds of the bills drawn against exports. But merchandize payments do not make up, by any means, all of the foreign exchange material. It may be doubted whether they make up even half of it. There are a great variety of invisible exports and imports. Shipping charges, tourists' expenditures, remittances of home of foreign residents, are all very large items. Then there is the interest upon foreign capital, and on the other side of the account there is new capital - additional capital - invested in this country. Then there ~~are fluctuations~~ due to dealings in securities - resale to this country of securities held abroad. All these operations give rise to foreign exchange - create foreign exchange - just as much as merchandize dealings. What the total amount of such dealings may be no one can say. But there can be no question that we owe, year after year, probably something like $5,000,000.00 or $6,000,000.00, and for that reason we must export merchandize to a greater value than we import merchandize.

In addition to all of these exchange creating factors, there is the matter of temporary loans made by one foreign market in another foreign market. They may be made in a variety of different ways. A foreign exchange house enjoying good credit abroad may, for example, draw bills upon a London correspondent payable say in three months. Those bills, if accepted by the London correspondent, may be readily discounted

thus giving the American exchange house credit to that extent in London, and enabling it to sell here an equivalent quantity of sight exchange. That is what happens when you read about foreign borrowing. There is no money, ordinarily, sent across. What actually happens is that a time bill is drawn on and accepted by a London bank, discounted in London and sight exchange to an equivalent amount sold here, thus giving the exchange house the money here, but no money has passed between the two countries. This is done, maybe, by an exchange banker for one of his clients who may deposit collateral security here. Sometimes the initiative may be taken by a foreign bank which desires to loan in this market. In that case it may or may not assume the risk of a change in the sight rate of exchange, for the profit in foreign loans is very largely determined by the course of the sight exchange rate. If, for example, the sight rate of exchange is $4.85 and a long bill is drawn, say at $4.82, reflecting the discount rate in London. Now, if you borrow in that way, when the long bill matures you must supply enough sight exchange to meet it. If the sight exchange rate remains at $4.85, then you have only paid the 3 cents on each pound for the use of the money during the period, Suppose the sight rate has gone to $4.87 then you have to pay a good deal more - you have to pay 5 cents for each pound. This will explain largely, I think, why ordinarily these foreign loans usually do not involve any movement of money. They usually come when the rate of exchange is high - toward the export point. When

we are approaching the export point and money is likely to be tight, and rates for loans, in New York, for example, are likely to be high, is the time that it may be desirable to borrow in foreign markets.

For example, if you would have to pay 5% on collateral loans in New York, and the rate in London is 3%, then it may be worth your while to borrow in the way I have mentioned, and particularly so if the sight rate is around $4.87, or a little higher, because then it can't get away from you very much. It can't go much above $4.88 anyway, and it may go much lower before you have to make the payment, and if it goes down that reduces by so much what you are actually paying for the money during the three months.

If, however, you should enter upon this transaction when the sight exchange rate was $4.85, you would be, ordinarily, very ill advised indeed, because the possibilities are that the exchange rate might go up to $4.87 or $4.88, and then the cost of your loan would be very heavy.

What this borrowing does is to provide, by means of the loans, additional sight exchange, and it thus, probably, prevents gold exports and brings down the sight rate of exchange to normal, but it does not involve - it is not necessary that it should, for any purpose whatever - a positive movement of money.

The foreign lender, as I intimated a moment ago, may

be willing to take the risk of a fluctuation in the sight exchange rate, or he may not. If he is willing to take the risk, he loans in currency.

Suppose, for example, that the quotation on bankers' time bills is $4.83, and that someone in New York wishes to borrow $500,000.00. A bill is drawn for, say, a hundred thousand pounds, on London, by the agent of the London bank, acting on instructions. That bill is sold for $4.83, and the proceeds are turned over to the wouldbe borrower in New York; that is, he gets $483,000.00. When the bill matures the borrower must return $483,000.00 plus whatever rate of interest has been agreed upon, let us say 5%. The borrower has not been affected at all by fluctuations in sight exchange. Now, the foreign banker may desire to get back his money in London. He instructs his New York correspondent to buy sight exchange on London ~~for his money.~~ If the rate has gone down, then the London bank gains from having assumed the risk. If the sight exchange rate is down to $4.85, for instance, and it can buy a sight draft on London for a hundred thousand pounds for $485,000.00, it gets, obviously, higher return than if the sight rate were $4.87 and it had to pay $487,000.00 in order to get its money back to London.

When, therefore, the foreign banker is inclined to think that the rate for sight exchange is going down, he will be rather willing to loan in currency in this market. If his

opinion is the other way, then the risk will have to be assumed by the borrower here. He will be given a bill, which he can dispose of as he pleases, but at the maturity of the bill he must provide the means for its liquidation, paying whatever the sight rate may be.

You will thus see that interest rates have a profound influence upon the current or short time fluctuations in exchange rates. If we should have an enormously large balance of payments, for one reason or another - because of the falling off of merchandize exports, because of the resale to this country of American securities held abroad, and so on - no possible temporary borrowing would, for any great length of time, prevent the exchange rate from moving to the point. But within very considerable limits it is possible to postpone gold movements, if in this market interest rates reach a higher level than those in the foreign countries to which it is to make payments. Under such circumstances, if the credit of the market remains good in the foreign country, if its standing continues good, then very considerable temporary loans may be made, and that provides, for the time being, sight exchange, but, of course, if you draw a lot of three month bills now and make loans in that way, at the end of the three months it is necessary to make payments, or secure renewals, and renewals cannot be continued indefinitely.

I may mention one instance: In the active markets

of 1906, enormous quantities of temporary indebtedness were incurred by means of bills of exchange drawn on London and other European markets. In fact, the amount of such bills in that year ~~went to such an extent~~ was such as to involve gold imports, rather an exceptional result of temporary borrowing. The amount of such bills was so large that ~~toward~~ before the end of the ~~time~~ they were discriminated against in the London market, and then it became necessary to remit in payment, and that caused very serious strain in our financial markets in the early part of 1907.

Within moderate limits these bankers' bills serve a very useful purpose, because they tend to greater steadiness of the sight rate of exchange,-prevent its going to the export point when there is a very slight excess of demand for payment over the amount of London balances. ~~Sometimes a distinction in terminology is used, and~~ "Anticipatory Bills" ~~are spoken of~~ - Bankers' bills drawn in the Summer because it is known that in the Fall, on account of cotton exports, there will be a great quantity of commercial paper coming into the market. Anticipatory bills are in no sense different from any other bankers' bills; it is simply that, when used in moderate amounts and with that in view they really are anticipatory.

The term "Finance Bills" is also used. That is not a technical expression. It ~~really~~ simply means that a large number of bankers' bills are being drawn in order to finance financial

5/28/54

Original memo in possession of

Theodore Sprague, 13 Follen st.

Cambridge. Mass.

Author(s): O. M. W. Sprague

Title: Memorandum for the Council of National Defense: Gold and Credit Policies and Reconstruction

Date:

Page Numbers:

5/28/54

Original memo in possession of
Theodore Sprague, 13 Follen St.
Cambridge, Mass.

MEMORANDUM ON THE GLASS-OWEN BANKING BILL

by

O. M. W. Sprague

Converse Professor of Banking in Harvard University.

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In forming an opinion regarding the merits of the Glass-Owen Bill for the reform of our banking system, the measure must be considered from three points of view. In addition to some changes in the powers of the national banks, the bill provides for the establishment of entirely new banking machinery-- at least twelve regional reserve banks under the supervision and in the exercise of some of their powers under the control of a Federal Reserve Board. Whether these new powers granted the national banks and whether the new banking mechanism, if properly handled, will remove the recognized defects in our banking system, are matters to be judged in the light of sound banking principles and practice. Equally and indeed more important in estimating the wisdom of this legislation are the provisions regarding the choice of the management of the regional banks and the membership of the Federal Board. They must be such as may give reasonable certainty that a wise and conservative body of men will be secured. Finally the likelihood of securing the general acceptance of the plan by the banks must be considered, since they are to provide the necessary capital, and without their very general co-operation the plan could not be carried out.

While there are many and often fundamental differences between the Glass-Owen Bill and the measure proposed by the National Monetary Commission, the two plans contain a number of identical provisions and are in general sufficiently similar in purpose and method to make a somewhat detailed comparison advisable.

The changes proposed in the powers of the national banks require little comment. To take care of foreign business, the Glass-Owen Bill allows banks with a capital of one million dollars to establish branches in foreign countries; while the Monetary Commission Bill permitted the banks to invest in the stock of a new kind of bank, foreign national banks, to an amount not exceeding ten per cent of their own capital.

Both measures authorize country banks to make real estate loans-- the Glass Bill to an amount not exceeding fifty per cent of capital or of time deposits; the bill of the Commission only to thirty per cent of time deposits. The possible danger from the higher limit is, however, perhaps offset by a provision that loans secured by real estate must mature within nine months.

A more considerable difference is to be noted with reference to acceptances, regarding which a general power was granted by the Monetary Commission Bill; while the Glass Bill restricts their use to foreign business. It is here that the acceptance is chiefly needed, and it may be reasonably argued that its use may well at the outset be restricted in this way.

Some changes in methods of bank examination are found in both bills but are of no great importance, though a clause in the

Glass Bill, that no two successive examinations shall be made by the same examiner, should most certainly be eliminated. One of the administrative clauses of the bill designed to prohibit the taking of gratuities from borrowers by officials and directors is so drawn as practically to exclude note brokers and investment bankers from national bank directorates. This clause should be re-drawn.

The two measures contain identical provisions regarding capital and the disposition of profits in the new banking organization. Each national bank is to subscribe an amount equal to twenty per cent of its capital, one-half of which is to be paid in, the other half remaining a liability subject to call. After the payment of a five per cent cumulative dividend, half of the profits are to go to the Government, the other half to surplus; but after the surplus reaches twenty per cent of capital, all profits in excess of the dividend requirement are to go to the Government. If one could be sure that practically all the banks, state as well as national, would become members of the association, the payment of a smaller part of the subscription to the capital by each bank would probably be entirely adequate. A higher dividend rate, at least six per cent, would be a desirable change, especially in the case of the Glass Bill which, as we shall see, takes away from the banks some of their sources of income.

Both measures confine the deposits of the new institutions to be established to those made by the Government and by member banks. On bank deposits no interest is to be paid, but a provision in the Glass-Owen Bill requires such payment on Govern-

ment deposits-- a difference from the Commission Bill of no particular significance.

The general character of the discounting operations as determined by the two bills is very similar. Only under unusual circumstances is anything but commercial paper to be accepted for re-discount, except that the Glass Bill does place state and municipal bonds on the same footing. Some objection has been raised against this provision but it would not seem to be well taken. There is no strong banking reason for eliminating any class of securities; it is a matter that might well be left to the management, as is the case with the European central banks. Political considerations and the existing preference for collateral loans resulting from our faulty banking system make it, upon the whole, desirable to discriminate against security loans. The Glass Bill divides acceptable paper into two classes: one maturing in forty-five days, the other within one hundred and twenty days; thirty and one hundred and twenty days were the corresponding periods in the bill of the Monetary Commission. The amount of re-discounts which might be granted to a bank was subject to some limitations in the Commission bill. Whether the absence of similar restrictions in the Glass Bill is a defect should be given careful consideration.

We now come to differences of a fundamental character between the Glass-Owen Bill and that prepared by the Monetary Commission. These fundamental differences are in organization, and in matters relating to discount rates, note issue, and reserves.

A simpler form of organization and a simpler method for

selecting the management characterize the new plan. Under provisions in the Monetary Commission Bill, the banks were to be grouped into local associations, for electoral purposes and in order to guarantee the paper of members which was to be re-discounted. Local associations are eliminated in the new measure. Each bank is to deal directly with its regional association in securing re-discounts and in no case is its paper to be guaranteed by other banks. The Commission measure provided for fifteen branches which were to be directly operated by a national board. This board was to be directly engaged in the banking business, fixing a uniform rate of discount, appointing the managers of the branches, and determining to what extent authority should be delegated to the local directorate of each branch. The feature in the new bill analogous to these branches is the regional associations, of which there are to be at least twelve, but these regional associations are given a far more independent status and more important functions. While subject to control by the Federal Reserve Board in some matters, the directorate of each regional association is in most respects entirely independent. It is, for example, to take the initiative in fixing the rate of discount and is to act altogether independently in determining the amount of paper to be re-discounted for member banks, and in passing upon its quality. The only direct power over loans possessed by the central board is that of requiring one regional association to discount for other associations, and even in such cases the Board of the lending association would pass upon the security offered by the borrower.

The other functions of the Central Board are strictly supervisory, with the exception of its power over note issue and over the rates of discount charged by the various regional associations which, in the phraseology of the bill, are "subject to the review and determination of the Federal Reserve Board." In practice it is probable that in this matter and also in that regarding inter-regional association loans, the Federal Reserve Board would exercise its authority but seldom. The purpose of these provisions presumably is, and certainly should be, simply to enable the Board to exercise a restraining influence upon the regional associations and to enable it to prevent any working at cross purposes among them. The circumstances are quite inconceivable under which it would ever be desirable that the Central Board should require a regional association to discount at a lower rate than that deemed wise by its own directors. It is, however, not unlikely that, in some periods of active business and especially in those parts of the country where there is a relative scarcity of capital, the management of a regional association might fail to exhibit all the caution that the situation of affairs required. Every purpose to be served by giving the Central Board authority over discount rates would be secured through a provision granting it the power to require a regional association to advance its rates of discount.

It is a more difficult matter to include within the provisions of a statute just those situations in which it might become expedient for the Federal Board to require co-operation among the regional associations through inter-regional loans. After all,

the danger from an unrestricted power of this sort would seem to be slight. The Federal Board, however constituted, is most unlikely to force the management of a regional association to extend loans to other associations except on occasions of most serious emergencies. If it becomes clearly recognized that the primary function of the Federal Reserve Board is the exercise of a restraining influence over the regional associations, there is little danger to be feared from the wrong exercise of this power. This general understanding of the true function of the Federal Board is certainly quite as important as the method of its selection. It should also be noted that the Federal Board is not to take the initiative in this matter. It can only act upon requests for accommodation made by the Board of a regional association. A provision might well be inserted in the bill that no inter-regional loans can be required by the Federal Board at a lower rate than six or even seven per cent. Such a provision would largely remove the danger of frequent recourse to this means of securing funds by any regional association.

The very great differences in the powers and functions of the Federal Reserve Board of the Glass Bill and the Board of Directors of the National Reserve Association of the Monetary Commission Bill afford some ground for the distinctly different method of constituting these boards found in the two measures. Under the Monetary Commission Bill, the Board of Directors was to consist of five Government appointees and thirty-nine others chosen in various ways by the banks. According to the Glass Bill, there is to be a

board of only seven, three of whom are Government officials, the Secretary of the Treasury, the Secretary of Agriculture, and the Comptroller of the Currency, and four others to be appointed by the President with the advice and consent of the Senate. As the term of one of these four members would expire every two years, each President at the very beginning of his term would have occasion to appoint a majority of this board. It is further provided that one of the four members must be a banker. That this board must be appointed by the President, if popular support is to be found for a measure of banking reform similar to either the Glass or the Monetary Commission Bills, seems certain. It does not, however, seem wise or necessary that each President should at the very beginning of his term re-constitute a majority of the board. If all of the three Government officials are to remain on the board, it would require a board of eleven, one retiring every two years, to provide a body, the majority of which would outlast a single presidential term. The only apparent objection to a modification of the bill of this sort is the long term of sixteen years' service for each member which this arrangement would involve. Certainly some change should be made in the bill designed to remove the very real fear that the board might be directly subject to political influence.

In securing satisfactory results from the working of the new banking machinery to be set up under the provisions of the Glass-Owen Bill, the character of the management of the regional associations is quite, if not more, important than that of the

central board. These regional boards will be in most respects entirely independent of the central board; they alone will determine the amount to be loaned to member banks and will pass upon the merits of the paper offered for re-discount and upon the purchase of foreign bills. These boards will also have the power to raise or lower their rates of discount, subject only to review by the central board. The disposition to be made of the resources of each of the regional associations is entirely within the control of its own board of directors, except that it may be required to re-discount for other associations, but even here the board of the lending association would pass upon the security offered for such loans. Even if the central board were unwise and incompetent, there would seem to be no consequent danger that the funds entrusted to the regional associations by the banks would be endangered. They could only be lost through unsound banking on the part of the local boards.

The functions of the management of the regional associations are distinctly and even technically banking functions. It is essential, therefore, that the boards of directors of these associations should be chosen in such a manner as to insure the selection of men of wide banking and business experience. The provisions in the bill regarding this matter are simple and ingenious and if slightly modified seem altogether likely to yield good results. The member banks of each regional association are to be divided into three groups, as nearly as may be equal in number and of the same capitalization. Each group is to select one banker

and one person not an officer or director of a bank as members of the directorate of the regional association. This second group of three directors is to represent fairly the commercial, agricultural, and industrial interests of the locality. Finally, three additional directors are to be designated by the Federal Reserve Board, one of whom is to be the chairman of the board of the regional association. The selection of two-thirds of these boards by the banks might seem to guard sufficiently the resources invested by them in the regional associations, but, as their functions are strictly banking functions, at least the six directors selected by the banks and of course the Chairman should be persons who possess banking experience. The method of dividing the banks into groups for electoral purposes minimizes the influence of the large banks, but they are in a measure protected, since the right of withdrawal from the system is always open.

The resources of the regional associations cannot be estimated with any degree of certainty. If all of the national banks should subscribe to the arrangement, the regional associations would have a paid in capital of more than one hundred million dollars. The deposits of the United States Government will also generally amount to rather more than one hundred million dollars. These deposits are to be distributed among the regional associations by the Secretary of the Treasury, though doubtless in this matter the opinion of the Federal Reserve Board would have great weight. As in the Bill of the Monetary Commission, deposits of member banks are the sole remaining resource. Provisions regarding this matter

in the Glass-Owen Bill are, however, in every respect fundamentally different from those found in the Bill of the Commission. According to the latter, that part of the required reserve which may be deposited with reserve agents was left undisturbed. The banks were to be permitted to transfer to the national reserve association such part of their cash holdings as they deemed advisable and were to be allowed to count the deposit thus created as a part of their required cash reserve. It will thus be seen that the deposits secured by the National Reserve Association at the outset would not have involved any reduction in the reserves of the banks and consequently would not have made necessary any contraction of credit on their part. Any loans made by the reserve association would, therefore, have been a net addition to the available supply of credit. This was a serious defect in the bill of the Monetary Commission. If the National Reserve Association had been established four years ago, such loans as it might have made would not have strengthened the business situation; they would merely have strengthened the tendency to rely upon short time credit for purposes which properly should be met by means of investment capital.

The Glass-Owen Bill provides for a radical change in reserve requirements. Country banks are to hold a reserve of five per cent in cash in vault, instead of six as at present; are to establish a reserve of three per cent with their regional association at once, and at the end of a year increase it to five per cent; and may further keep the remaining one-third of their required

reserve with reserve agents for a period of two years more; thereafter this portion of their reserve may be left with reserve agents or transferred to the regional association, as the Federal Reserve Board may determine. The distinction between reserve cities and central reserve cities is to disappear at the end of three years. These banks are to maintain a reserve of twenty-five per cent for two years, then twenty-two and one-half per cent for a year, and thereafter a reserve of twenty per cent. An amount of cash equal to ten per cent of deposit liabilities must be retained in the vaults of the banks. Three per cent, and after a year five per cent, must be deposited with regional associations. The remaining five per cent may be held either in cash or with the association.

A somewhat elaborate calculation is required to form an estimate of the effect of these changes. On the basis of present liabilities and reserves if all the banks enter, the initial changes involving the deposit of three per cent of their deposit liabilities with the regional associations, together with the subscription to the capital of these associations, would make it necessary for the banks to re-discount with the associations to the extent of something like one hundred and fifty million dollars. The further change at the end of the first year, increasing balances with reserve associations to five per cent, would involve additional rediscounts of perhaps one hundred million dollars. And finally, if the Federal Reserve Board were to transfer from reserve agents remaining reserve balances, still another one hundred and fifty million of re-discounts would be required.

The first and perhaps the second step in this complicated rearrangement of reserves would seem to be wise and also entirely feasible. The one hundred and fifty millions of re-discounts, and even the two hundred and fifty millions, would give the reserve associations a moderate amount of business at the outset without involving any danger of credit expansion. Some business the reserve associations must have, if they are to exercise any influence over the banking situation. But the further transfer of all reserve balances from agents not only would seem to be unnecessary but also almost certain to endanger the success of this plan of banking reform. It would give the reserve associations an unnecessarily large amount of business and render the banks unnecessarily dependent upon them for accommodation. Further, there is every reason to believe that a very large number of banks would decline to become members of the associations on these terms. Country bankers would resent the loss of the interest which they receive from reserve agents, and reserve agents would lose virtually the only advantage which they possess over their neighbors operating under state charters. General and hearty co-operation of the banks is essential to any scheme of banking reform; but since the advantages from a better system are far more important to the community generally than they are to bankers or to the investor in bank shares, unnecessarily burdensome requirements should not be imposed upon the banks.

Some slight inducement to enter the system is indeed held out to the banks, since those who do not, will cease to be national

banks and must at once relinquish their right of note issue and either hold their two per cent bonds to maturity or incur certain loss in marketing them. Banks entering the system continue to issue notes, subject to a provision in the bill for their gradual retirement and the coincident exchange of their bonds for an issue yielding a higher rate of return. This privilege should also be extended to other United States bonds held by the banks, in particular to those which serve to secure United States deposits, inasmuch as these deposits are to be transferred to the regional associations. It is doubtful, however, whether the loss in connection with their holdings of Government bonds will be sufficient to induce by any means all of the national banks to accept the new arrangements provided for in the bill. It is even less likely that any considerable number of state banks will be converted into the national system, unless the bill is so modified as to make its provisions distinctly more attractive. Something in this direction would be accomplished if the capital of the reserve associations to be paid in were reduced to five per cent of the capital of the banks if the dividend rate were advanced to six per cent; and if part, at least five per cent, of the required reserve of country banks is left with reserve agents. None of these changes would in the slightest degree diminish the effectiveness of this plan of banking reform.

Another matter regarding which the new bill goes beyond its predecessor is with reference to the handling of checks. According to the Bill of the Monetary Commission, the branches of

the National Reserve Association might undertake clearing-house functions and transfer funds between branches at rates to be fixed by the managers of the branches. Under the Glass Bill, collection of checks and drafts on member banks is to be made free of cost for members by each regional association, and transfers of funds between associations are to be made at par. Under this provision of the bill, it will be necessary for each regional association to set up machinery for the handling of checks within its own region, machinery analogous to that of the foreign department of the Boston Clearing House. Further, all places in which there is a regional association will become par points for the entire country. It may be expected that, as a consequence, exchange charges on all checks will disappear. A Boston bank, for example, while unable to collect checks on Illinois points through the Chicago Regional Association, will be able to do so through some Chicago bank; and the Chicago bank, through its reserve association, will be enabled to remit to Boston at par. Transfers on the books of the reserve associations will vastly lessen the shipments of currency between banks in different parts of the country. Requirements for the use of cash will become more regular than at present and machinery for making settlements between different parts of the country which will not break down in future emergencies will have been provided. On the other hand, it must be admitted that the taking over by regional associations of this function takes away business which has been profitable to many banks, lessening the inducements for accepting the system.

Much more attention than the importance of the subject warrants has been given to the provisions in the Glass-Owen Bill regarding the issue of notes. Assuming that the reserve associations had been established four years ago and that their affairs had been handled conservatively, it is probable that no notes whatever would have been issued up to the present time. Throughout this period there has been in general an entirely adequate supply of banking credit; and even on the few occasions characterized by some strain, the cash and credit of the reserve associations would have been ample for every purpose without resort to the power of note issue. The bill provides for new issue of notes amounting to five hundred million dollars, together with such amounts in addition as will take the place of the existing note issues of the banks as they are gradually retired under provisions included in the bill. A limited issue is eminently wise, and the particular limit which has been set will permit quite as much increase in the currency as can possibly be needed for many years to come. These notes are to be a direct obligation of the Government and are to be issued to the reserve associations on the deposit of security and at rates to be determined by the Federal Reserve Board, if that board is convinced that there is a real need for the notes. This issue of notes is not to be subjected to any special tax. Reliance is placed upon the wisdom of the management of the reserve associations in applying for notes and upon the policy of the central board. A valuable safeguard, however, is found in the separate interests of the various reserve associations. Those managed with a high degree

of conservatism would doubtless oppose any considerable use of the limited right of issue by other associations, unless the need was evident. The criticism which would be directed against liberal issues to a recklessly managed reserve association should prove a far more potent safeguard than legislative taxation devices through taxation. The limited right of issue serves another useful purpose-- it will prevent the substitution of notes for gold certificates now in circulation, a substitution which would have provided the National Reserve Associations proposed by the Monetary Commission with the basis for an enormously and dangerously large lending power.

Taken as a whole, the Glass-Owen Bill seems to provide the means for very great improvement in our banking system. It is superior in a number of respects to the bill proposed by the National Monetary Commission, notably so in the provision that reserve requirements may be temporarily suspended by the Federal Board and in the absence of the requirement of a uniform rate of discount throughout the country, a most unsound and dangerous feature of the Commission bill. Unless some of the provisions of the Glass-Owen bill are modified, however, it does not seem probable that it would prove effective, because of the probability that large numbers of banks would not enter the system. Fortunately, the changes which are needed to make the bill more attractive to the banks do not involve concessions on principle. Surely it must be possible to formulate conditions regarding qualifications for membership on the Federal Reserve Board which will give bankers

confidence in its competence and freedom from political influence. Surely also sound banking under national charters does not require burdensome restrictions which will enhance the attractiveness of organization under state laws and jeopardize the very existence of the national banking system.

5/28/54.

Original memo in possession of
Theodore Sprague, 13 Fallen st.
Cambridge, Mass.

Author(s): O. M. W. Sprague

Title: Memorandum for the Council of National Defense: Reconstruction Policies and the Maintenance of Peace

Date:

Page Numbers: