Pan American Financial Conference

ADDRESS

OF

CHARLES S. HAMLIN

Governor of the Federal Reserve Board

BEFORE THE

PAN AMERICAN CONFERENCE

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ADDRESS OF CHARLES S. HAMLIN, GOVERNOR OF THE FEDERAL RESERVE BOARD, BEFORE THE PAN AMERICAN CONFERENCE, TUESDAY, MAY 25, 1915.

Mr. Chairman and Gentlemen:

This Conference of the sovereign nations of the Western Hemisphere with the Secretary of the Treasury of the United States is an event of deep significance to the whole civilized world.

If your deliberations are successful it will not only add to the prestige of the nations involved and to the distinction of the delegates, but, as well, it will add another achievement to the many already to the credit of the Secretary of the Treasury, and will place another laurel wreath upon the brow of the President for his victories in the cause of peace.

The scope of your deliberations, necessarily limited to the subjects assigned for discussion, need have been limited only by the confines of human knowledge. When we consider the achievements of the nations whose representatives are gathered here we realize what a wealth it constitutes, for you could speak with authority upon the achievements of your citizens in the realms of science, philosophy, art, music, education, history, medicine, or international law, as well as upon the questions you have come together to discuss. That limitations necessarily had to be imposed upon your deliberations, thereby restricting them to the field of commerce, transportation, and finance, is perhaps, after all, an advantage, for to discuss the many important contributions to the world's advancement made by those nations would require such time that from the very nature of things it could not be given.

I take it that the object of every government is to secure the greatest good of the greatest number of its people, and I believe the world realizes to-day that the prosperity of the people of one nation, in the long run, tends to the prosperity of those of other nations, while the adversity of one people must ultimately tend to the adversity of others. Just as the individual prospers best when his country prospers, so the nation prospers best out of the prosperity of all nations. [Applause.]

In past centuries this great truth was not realized. On the contrary, it was boldly advanced by thinkers and philosophers that each man is arrayed against his fellow man; that the gain of the one is the exact measure of the loss to the other; that competition between individuals, whether in warfare or in commerce, must ultimately mean the destruction of the weaker and the gain of the stronger. So, also, it was believed that as between sovereign nations the precise measure of the gain to one from international trade was the measure of the loss to the other.

Fortunately, however, such doctrines have not survived, and when occasionally they show their heads above the surface they are recognized as but temporary deviations from well-established rules of action. The world recognizes to-day that sympathy and cooperation are the most powerful factors in working out the social and industrial welfare of the individual, and that the same principles apply to the relations of one sovereign nation to another.

Furthermore, the fact so cogently pointed out by Adam Smith, the great economist, that both nations gain by dealings in international trade is now accepted by all nations as a guiding principle, although, to be sure, many nations have somewhat obscured the principle by the levying of customs duties upon imports far above any possible need, either for revenue or for industrial development.

It is also true that the nations to-day are beginning to recognize that they have products, whether of agriculture or manufacture, which they can create in such quantities that they are obliged to seek and obtain for them, or for a portion of them, foreign markets. They further realize that they must accept, in great measure, as payment for their exported products, goods imported from these countries purchasing their exports or from other countries for their account. In other words, speaking generally, every bale of goods exported from a country must be paid for by a bale of goods imported into the country. The actual payment may be made by the delivery of so-called "bills of exchange," but these bills of exchange, in a very large measure, are but symbols of property or are a claim for money based upon the sale of property. The merchant ships his goods abroad, but he sells the bill he draws upon the foreign purchaser to some domestic bank, and these bills, representing property, are used to offset similar bills drawn by foreign sellers against imports into the country. If the exports and imports of the country do not furnish bills of exchange enough to balance, then gold or its equivalent is used or, perhaps, loans, but these latter play a relatively minor part in international exchanges.

It would be impossible for a country to shut itself off from other countries and still hope to continue its exports, receiving payment in gold instead of in goods. If we assume—what is impossible of realization—that any country could shut off its imports and continue to export, receiving gold for its exports, within a very few years it would cripple the exchange system of all foreign countries by the

amount of gold it would take from them, but long before that point could be reached the importation of gold would so raise prices as to effectually stop its exports.

Trade, as now generally recognized, means buying as well as selling, and in so far as this conference has to do with trade and with the means and methods for increasing trade, it has to do with the increase of buying as well as with the increase of selling.

We all recognize to-day the real interdependence of nations; they are especially interdependent from the aspect of trade and commerce. The nation of large resources recognizes that in the long run it is for its own profit to strengthen this interdependence by furnishing the nation of smaller resources means to meet trade indebtedness to it. It should never be forgotten, however, that in the long run this indebtedness must be met by the shipment of goods, whether from the debtor country or from some other country, for its account, to the creditor country.

The question, however, which must be foremost in your minds is just what the United States can do in assisting other nations to finance their trade movements, both with the United States and with the other nations of the world. As to the amount of capital at present available in the United States for such purposes and the working out in detail of any specific plans or suggestions it is not my province to speak. I shall leave that field open to the delegates assembled here, and especially to my colleague, the Honorable Paul M. Warburg, who can speak with the authority of a master on every detail of international finance. [Applause.]

The message which I wish to bring to you to-day, however, is that the United States was never before in such a position as it occupies to-day to reach out and extend its trade by granting credit to those nations who wish to be its customers.

The dislocation of foreign trade caused by the present war furnishes the United States with a great opportunity, inasmuch as nations which for generations have had the relation of purchaser and seller now find these relations disrupted.

The United States also has but recently placed itself upon a sound financial foundation by enacting a new banking system, which, together with the reform laws already enacted, I believe will constitute one of the strongest systems in the world. [Applause.]

Furthermore, the new system of banking inaugurated by the Federal reserve act has provided an opportunity to our people of financing our foreign trade. It has economized the use of credit and capital. It has increased its efficiency, which will enable us, as I have said, to engage in financing trade movements with and between foreign countries, which will do much to build up our international trade exchanges, particularly with the great nations whose representatives are here assembled.

This leads naturally to consideration of the banking system which has lately been organized under the Federal reserve act. In order to understand the changes brought about by the new banking system we must briefly consider what the former system was, its defects, and how these defects have been remedied in the new system.

Prior to November 16, 1914, when the new Federal reserve banks opened their doors, we had approximately 7,500 banks in the United States chartered by the National Government, and having the sole right to issue notes known as national-bank notes. The capital and surplus of these banks was a little under 2 billions of dollars, and taken in connection with their deposits represented a banking power of over 9 billions of dollars. There were also over 20,000 State banks, trust companies, and savings banks, chartered by the respective States, representing a capital and surplus of a little over 2 billions of dollars, and including deposits, representing a banking power of over 14 billions of dollars.

These banks, both National and State, were independent and isolated, except as to a limited interdependence of some State institutions through stock ownership. They together constituted over 30,000 individual units, between which in times of financial stress effective cooperation was impossible.

Leaving out of consideration for the moment the State banks, there were in the United States over 7,500 independent units called national banks, each, as I before stated, having the power of note issue and each bound to keep in its vaults and with other national banks in certain cities, called reserve cities, a reserve fixed by law.

Under the national-bank act, however, these reserves were, in effect, sealed up and could not lawfully be used, even in times of financial stress. A bank whose lawful reserve was below the legal limit was bound to restore it, and if it was not restored within a specified time the Comptroller of the Currency could place a receiver in the bank.

The merchants and farmers of the country were often refused credit—the very essential of business life—and yet they could see these sealed-up reserves, ample for relief purposes, and yet denied them. They were in the position of a man weakened by hunger looking through a plate-glass window observing every kind of food which he is told is for his benefit, and yet no morsel of which can he under any circumstances be permitted to eat.

As a result, in times of financial stringency, each bank had to protect itself regardless of the condition of other banks, and had to fortify itself against its demand obligations by piling up reserves far above the prescribed limit. To do this it had to call loans or refuse to renew or make new loans during the stringency. The necessary result of this procedure was to make the stringency even more severe, and the hoarding of its resources by the individual banks quickly led to hoarding by individuals, thus throwing the whole banking system into confusion and ruining thousands of merchants who were unable to obtain the assistance to which under ordinary circumstances they would have been clearly entitled.

During the latter part of the panic of 1907 it was found that some banks which by law need carry only 15 per cent reserves were actually carrying reserves of between 40 and 50 per cent of their deposits, while in 1914 the reserves of some banks amounted to 70 per cent. It is also a most significant fact that at the height of that panic over 200 millions of dollars in cash were being carried by the banks, in their vaults and with their reserve agents, in excess of their legal requirements. If these 200 millions of resources could have been used for the common benefit, such a panic would not have taken place.

Under our old system the banks of the United States were in the position of an army entering into action as a disorganized body of individuals, without a single officer and without a single company, battalion, regiment, or brigade. That our oft-recurring panics under the old system did not involve more of our banks and their customers in general ruin is one of the wonders of financial science and is a great tribute to the marvelous recuperative powers and unrivaled resources of our people.

Under our old financial system—or, rather, lack of system—every dollar loaned by a bank on commercial paper was a dead investment, as if buried in the ground, until the day of maturity. The paper, when discounted, was lowered into the vaults of the bank with almost funereal ceremony; in fact, the national banks were but mausoleums for dead commercial paper, and if a bank president with ghoulish propensities were to open the vaults and try to dispose of any of the paper stored there, before its resurrection on the day of maturity, the act would have been looked upon with suspicion. As a result, when a bank had made all the loans it could its power to aid its customers absolutely ceased, and many a merchant of high standing and good credit had to be refused further assistance, to his injury and possible disaster.

Every bank had to arrange so that some of its resources should be invested in so-called liquid assets, so that in times of financial stress they could instantly realize upon these assets. As a result funds which otherwise might have been loaned to farmers and merchants were sent to the large financial centers of the country to be there invested in call loans upon stock exchange collateral—that is to say, upon bonds, stocks, and other securities which represented no commercial transactions, but which, in many cases, simply represented speculative activities. When, however, in times of stress these loans had to be called it was often found that what was considered to be a most liquid asset was, for the time being, no asset at all—as witness the period in the summer of 1914, when these so-called liquid assets were absolutely debarred from sale by the closing of the stock exchanges.

Furthermore, under the old system the national banks issued so-called national-bank notes, which were originally designed to constitute an elastic currency, rising and falling in response to the demands of agriculture and commerce. Unfortunately, however, these notes had no such elasticity as was thus ascribed to them, because of the fact that their issue was not controlled by or based upon business development; on the contrary, these notes were indissolubly chained to Government bonds, which had to be pledged with the Government as collateral. These Government bonds were neither issued nor regulated by the expansion or contraction of trade and commerce. They were fixed in amount and fluctuated in value in no fixed ratio to the development of those branches of business. As a fact, it was the fluctuation in value of these bonds which influenced the expansion or contraction of the national-bank notes rather than an expansion or contraction in business. When business slackened and contraction of these notes was desirable, the notes responded but feebly, and in some cases actually increased in amount; while, on the other hand, when expansion was desirable to accommodate increasing trade, the notes at times actually decreased; and at other times when they responded to the need for expansion the response was so belated as to take effect only when the necessity for the expansion had ceased.

This alliance of national-bank notes with Government bonds was a strange one. The national-bank notes, supposed to be a measure of the development and expansion of trade, were linked to and governed by the fluctuation in value of these bonds, which represented war, the destruction of trade, and the past dire necessities of the Government. Thus these national-bank notes, intended to represent the progress and development of trade and commerce of the twentieth century, were linked to the evidences of destruction of trade and commerce of the nineteenth century. There may have been a reason for this strange alliance in the nineteenth century owing to the necessity for finding a market for Government bonds, but in this twentieth century there is certainly no good reason for its continuance.

Furthermore, under the old system the national banks were not able to finance our foreign trade, because under the law they could not lend their credit in the form of acceptances. As a result our foreign trade had to be financed in London and on the Continent,

and the expression now so frequently heard—dollar acceptances—was merely an ideal as far removed from practical realization as the moon is distant from the earth.

For example, we buy large quantities of raw and manufactured silk from the Orient. This silk goes direct to the Pacific ports of our country; it is taken overland by special train. The bill of exchange, however, drawn for the selling price, is drawn upon a foreign bank and is sent, together with the bill of lading and other documents, east to London, or it may even pass through the United States on its way to the foreign bank upon which it is drawn, later to be returned to the United States for final discharge of the obligation of the purchasers in this country.

The lack of cooperative union or confederation between the individual banks and their reserves also weakened the ability of the banks to conserve the supply of gold, the standard of value in the United States, and as a result the movement of the precious metals from the country, even when in strict accordance with the laws of trade and of ultimate advantage to the United States, was looked upon with anxiety as a symptom of financial trouble, causing uncertainty and lack of confidence.

I have tried to show some of the defects which existed under our former system—the lack of cooperation between the individual banks, the lack of any system by which the reserves could be either used by the individual banks or consolidated into a common fund for the benefit of all the banks, the impossibility of rediscounting commercial paper once discounted by the banks, its lack of liquidity, and the consequent necessity for investment of part of the bank's assets in call loans as the most liquid investment possible, the lack of a genuine elastic currency, and, finally, the lack of power to finance our foreign trade through the loaning of credit by means of acceptances.

The question naturally arises just how the Federal reserve act has remedied these conditions, placing the United States upon a firm banking foundation. I shall try to answer this question briefly.

It should be clearly understood that the Federal reserve act does not add a dollar of money to existing stocks held by the banks or by the people, and also that, while it gives the national banks some valuable new powers and privileges, it does not change their inherent structure or their present charters.

Just what, then, has the Federal reserve act accomplished? While the act is a long one, containing much minute detail, its underlying principles are simplicity itself.

In the first place, it divides the United States into 12 districts, each district containing approximately from 500 to 700 national banks.

The national banks in each district unite in forming a new bank called the Federal reserve bank, to which each national bank contributes 6 per cent of its paid-up capital stock and surplus to provide the necessary capital.

The individual capital of these 12 Federal reserve banks varies, respectively, from a little under 5 millions to a little over 20 millions of dollars. The total capital of the 12 banks (not counting State institutions which may ultimately become members) is a little over 100 millions of dollars.

At the present time only one-half of the capital payments have been called, and the total paid in by all the national banks amounts to a little over 50 millions of dollars.

We thus have 12 Federal reserve banks with a total capital of over 50 millions of dollars paid in and about as much more subject to call by the Federal Reserve Board when and if needed. This capital, under the terms of the Federal reserve act, has been paid in gold or gold certificates.

The 12 Federal reserve districts vary greatly in area and in population. For example, the Federal reserve district of Chicago has a population of over 12 millions of people, exceeding the combined populations of Norway, Sweden, and Switzerland.

On the other hand, the area of the Federal reserve district of San Francisco (683,852 square miles) is so extensive that you could place within it England, Scotland, and Ireland, the whole of continental France, Italy, and Germany and still have left an area exceeding that of all the New England States combined, excepting only the State of Maine.

In addition to the capital payments I have before mentioned, each national member bank is obliged to pay to its Federal reserve bank a certain portion of its legal reserve, which portion, however, it still counts as part of its reserve. These payments of reserves are spread over a period of three years, and the total payments will amount to over one-third of the total reserves held by the national member banks.

Up to the present time about 295 millions of reserve money has been thus paid to the 12 Federal reserve banks, and at the end of three years over 400 millions will have been paid in, which latter amount will be, of course, greatly increased by the admission of State banks and trust companies. At that time all the reserves of the member banks must be held in their vaults or with the Federal reserve bank, the privilege of keeping their reserves in part in approved banks in reserve cities ceasing at the end of that period. This will necessarily largely increase the amount of money deposited by the member banks in the Federal reserve banks.

In addition the Secretary of the Treasury may deposit the general funds of the Treasury—excepting only certain trust funds—with the Federal reserve banks, and disbursements of the Government may be made by checks drawn against such deposits.

The national banks in the 12 respective districts (and State banks which may join the system later) are the only stockholders of the Federal reserve banks, and their stock can not be transferred or hypothecated. The stock is entitled to a 6 per cent annual cumulative dividend, and one-half the net earnings of the Federal reserve banks may be paid into a surplus fund until it amounts to 40 per cent of the paid-up capital stock.

All net earnings over and above this dividend and surplus are paid to the United States as a franchise tax.

Each Federal reserve bank is managed by a board of directors, consisting of nine members, of which three are appointed by the Federal Reserve Board and six are elected by the member banks, three of the six directors representing the banks and three consisting of members who at the time of their election were actively engaged in commerce, agriculture, or some other industrial pursuit.

These 12 Federal reserve banks are under the control and direction of the Federal Reserve Board, consisting of the Secretary of the Treasury and the Comptroller of the Currency, ex officio, and of five other members appointed by the President and confirmed by the Senate.

The Federal Reserve Board sits in Washington, D. C. It appoints, as I before said, three directors on the board of each Federal reserve bank; it has general powers of supervision and examination of the Federal reserve banks and the member banks; it may suspend or remove, for cause, any director or officer of the Federal reserve banks; it may suspend the operation of any Federal reserve bank and liquidate or reorganize such bank; it defines the paper which may be rediscounted by Federal reserve banks; it has power to review and determine the rates of discount established from time to time by the Federal reserve banks for the discount of commercial paper offered by the member banks; it regulates the open-market powers of the Federal reserve banks; it has power to suspend every reserve requirement of the act if it deems such course necessary; and it has many other specific powers which I need not mention here.

Each Federal reserve bank is independent of every other. They are empowered, however, with the permission of the Federal Reserve Board, and at rates fixed by the board, to rediscount the discounted paper of any of the other Federal reserve banks, and can be required to do so by the affirmative vote of at least five members of the Federal Reserve Board.

The act also creates a body known as the Federal Advisory Council, one member of which is elected by each Federal reserve bank. The duties of the council are to confer with the Federal Reserve Board and to advise it as to matters connected with discount rates, note issues, reserve conditions, open-market powers, and similar questions.

I have thus given a skeleton outline of the Federal reserve system. Many details I have had to omit for fear this address would take on the quality and length of a treatise or textbook. I think, however, that what I have outlined will give a fair understanding of the scope of the system.

The question remains as to how the Federal reserve act remedies the defects which I have outlined as characteristic of the old system.

The first fundamental defect of the old system pointed out by me was that each national bank was independent, and that as a result we had 7,500 independent banks and 7,500 scattered reserves, no effective cooperation being possible, nor could the individual reserves even be drawn upon legally by the very banks which owned them.

This defect is remedied under the Federal reserve act through the capital and reserve deposits placed by each member bank with its reserve bank. These payments constitute a substantial fund—already about 350 millions of dollars, and constantly growing—which must be used by the Federal reserve banks for the benefit of the member banks and their customers—the people of the United States.

These funds are held for use in discounting commercial paper offered by the banks for discounting acceptances and for certain open market investments which I shall not undertake to enumerate to-day. Any bank desiring funds can take its commercial paper to the Federal reserve bank and obtain gold or lawful money in exchange. This privilege enables a bank to loan freely in times of commercial stress and to draw down its available resources far below what would have been considered prudent under the old system, for the commercial paper discounted by the banks under the new system is as good as gold, as it can be turned into cash or a cash credit at once at the Federal reserve bank upon request. This privilege also makes commercial paper a genuinely liquid investment, whereas under the old system such investments were absolutely dead until the day of maturity. Such commercial paper is far more liquid than a loan upon investment securities, for the loan upon commercial paper presumably liquidates itself, as the borrower receives from the consummation of the commercial transaction—to assist which the note was originally discounted—the money with which to pay it.

It should, moreover, be pointed out that every dollar paid into the Federal reserve banks by the member banks—including all deposits

made by the United States Government—is impressed with a trust, in that it must be used (excepting as to certain open-market investments) only for the discount of paper issued or drawn for agricultural, industrial, or commercial purposes, whether in the domestic or foreign trade, and can never be invested in or loaned upon speculative securities or even upon real estate transactions.

The second fundamental defect in the old system which I have pointed out was the lack of a really elastic currency. The Federal reserve act remedies this defect by providing for the gradual payment and cancellation of the national-bank notes, and, further, by giving authority to the Federal Reserve Board to issue to Federal reserve banks applying therefor obligations of the United States known as Federal reserve notes. The bank obtaining such notes must deposit with one of the Government directors, known as the Federal reserve agent, as collateral commercial paper approved by the regulations of the Federal Reserve Board up to the face value of the notes thus issued, and in addition must maintain a gold reserve of 40 per cent against such notes. These notes will constitute a truly elastic currency, rising and falling with the rising and falling of agriculture, trade, and commerce. No limit is imposed upon their issue. Such a note could conceivably be issued against every commercial or agricultural transaction represented by commercial paper which has been discounted by member banks. When, however, the commercial paper liquidates itself, and the maker uses the funds received from the transaction to pay off the note, the Federal reserve notes issued against that paper must be returned and canceled, or the amount of the notes thus paid must be retained by the Federal reserve agent against the Federal reserve notes until they are returned and canceled.

The Federal reserve notes will also serve to protect the gold supply of the United States, for much of it, sooner or later, will go into the vaults of the Federal reserve banks and Federal reserve notes will be issued in its place.

The Federal reserve act also authorizes national banks, for the first time, to accept bills of exchange growing out of the import and export trade under certain reasonable regulations, and the Federal reserve banks are also authorized to discount such acceptances. This grant of power is a most valuable one and will enable our banks to finance our foreign trade by loaning their credit upon these acceptances. By this grant of power the so-called "dollar acceptance" is made for the first time possible, and this means much for the future development of our trade, especially with the great nations of Central and South America, and will add much to our ability to assist them in financing their sales to and purchases from the United States.

The Federal reserve act, however, has done much more to help make possible closer trade relations with foreign countries. The Federal Reserve Board is given power to permit national banks to establish branches in foreign countries, and it is at once apparent what a great assistance this will be, not only to the United States but likewise to the great nations who are trading with the United States, especially those whose delegates are assembled here. Branches of national banks have already been authorized in Argentina, Brazil, Panama, and other countries, and it is confidently expected that a great development in our trade relations with such countries will result. [Applause.]

The Federal Reserve Board is also authorized to permit the Federal reserve banks to open and maintain banking accounts, appoint correspondents, and establish agencies in foreign countries, for the purpose of purchasing and selling bills of exchange arising out of commercial transactions; these banks are also authorized to deal in gold coin and bullion at home and abroad. It is easy to see what power the Federal Reserve Board, through the Federal reserve banks, will thereby have, in connection with its power over discount rates, over the movement of the precious metals into and from the United States.

These great powers can and will be exercised in such a manner as to encourage and assist in every way the growth of the volume of trade between the United States and foreign countries.

I think it will be realized, as I have before stated, that, growing out of this new banking act, the time has come for a marvelous development in our foreign trade, especially with South America, and that an opportunity is given to finance that trade such as has never been possible before. [Applause.]

The resources of the Federal reserve system will also be greatly augmented in the future by the addition of large resources contributed by State banks and trust companies, which the act permits to join the Federal reserve system under reasonable regulations. I venture to express the hope that within the near future the majority of the strong State banks and trust companies doing a commercial business will join this system.

The Federal reserve act economizes the use of capital; it makes its use more effective than under the old system; by lowering the prescribed reserve requirements it has released hundreds of millions of capital which will provide additional credit; by its rediscount provisions and by the powers given to the Federal Reserve Board to suspend reserve requirements in cases of necessity it has practically made a financial panic of the type we went through in 1907 an impossibility.

The banks have been greatly strengthened by these reforms and have enlarged their power to grant discounts to their customers both in domestic and international trade.

I believe the result will be of lasting advantage and benefit, not only to the people of the United States but to the people of all nations which engage in trade with us.

I have tried briefly to outline just what the Federal reserve act has done for us, and to show how, incidentally, it may be of great advantage to all nations that trade with us. There remains only to consider the practical application of the principles of the act to the great problems of commerce, transportation, and finance which you are called together to consider, and these problems will be considered by you in conjunction with our own delegates, who are, it is needless to add, chosen men, representing the highest ability in practical banking, and who represent as well the highest type of our citizenship.

I am sure that it will be the earnest prayer of all the people of our country, and of the great nations whose delegates are here assembled, that our deliberations shall be crowned with successful achievement. [Prolonged applause.]

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