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# Bank Loans

and

# Stock Exchange Speculation

BY

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# BANK LOANS AND STOCK EXCHANGE SPECULATION.

Attention has been repeatedly called to the vicious circle in which the American money market moves; how the volume of banking credit is rigidly inelastic, being determined as to circulation by bond security and as to loans and discounts by a fixed ratio to legal reserve; how the surplus funds which pile up with seasonal fluctuation in the interior flow inevitably to New York City, there to stimulate speculation at times when general economic conditions suggest quiescence, and how, conversely, when returning activity draws back funds to the interior, the recovery is impeded by the strain and cost of speculative liquidation.

This sequence, as often as it has been stated, has not been really accepted by the public mind. There has been much more disposition to invert the relation and to hold speculative manipulation responsible for monetary strain. To the extent that blind prejudice and willful ignorance figure here, nothing in the way of enlightenment is possible. But some considerable part of the prevailing sentiment is not to be so dismissed and proceeds from valid doubt. It is this condition which invites an attempt to supplement the general terms in which the argument has heretofore been phrased with a more detailed account of the relation of credit and speculation.

In the United States the money market, in the form of bank loans, may be regarded as impinging upon the stock exchange at five distinct points:

(1) Stock-exchange securities are used as collateral to secure mercantile discounts and personal loans in the insufficiency of commercial or personal credit.

(2) In the interval between original sale and ultimate absorption by investors newly issued corporate securities are used by underwriting syndicates and syndicate participants to secure bank advances.

(3) Banking institutions invest in stock-exchange securities such part of their resources as are not employed in loans and discounts in consideration of interest return and in anticipation, semispeculatively, of appreciation in market value.

(4) Bond houses and stock brokers engaged in the sale of investment securities obtain bank loans as working capital upon unsold holdings.

(5) Speculative purchases of stock-exchange securities are financed partly by time loans, but in the main by demand loans obtained from banking institutions and secured by such securities as collateral.

It is proposed to consider the nature and effect of each of such contacts from the standpoint of present banking organization and of proposed change. Such an inquiry is impeded by the paucity of statistical data and by the intimate or informal quality of many of the operations involved. But enough is ascertainable to permit a fair and reasonable judgment as to the adequacy of existing methods and as to the effect of possible amendments.

## I.

The occasion for temporary advances of credit upon adequate collateral is directly connected with the dawn of modern banking. Commercial activity is subject to varying capital requirements. Unless business operations are to be restricted within unnecessarily narrow limits or a wastefully idle reserve fund is to be kept at all times available, that quota of capital for which there is brief or exceptional business demand will find productive employment in independent investment. The same is true of individual economics. Private capital is converted, as accumulated, into productive investment—less only that part required for current requirements.

Such an economical arrangement is obviously possible only when the machinery exists for securing credit advances upon investment reserves at the time and for the period required. This is the service of the banking organization. Reserve investments take on many forms—bank deposits, real estate, staple commodities, evidences of indebtedness. The widespread extent of corporate organization and the readiness of international markets for corporate obligations, might be expected to make stocks and bonds, and, in particular, those more actively traded in and distinguished as stock exchange securities—a convenient object of such investment and a common collateral for business loans.

But as a matter of fact, credit advances upon stock exchange collateral play a relatively small part in American business life, meaning by this term ordinary industrial, commercial, and mercantile activity as distinct from corporate promotion and speculative enterprise. The average merchant or manufacturer keeps his reserve in his bank book not in his safe-deposit box, and seeks to meet the strain of sudden or increased financial requirement by further recourse to commercial loans and discounts. If he owns stock-exchange securities, his impulse will be to sell them when the occasion arises rather than to borrow upon them, and if, because of unfavorable markets or other considerations, he hesitates at accepting this loss, his banker is likely to be less reluctant. Any pressure to secure further advances upon such collateral may threaten his existing credit and result in the diversion of the securities to fortifying earlier loans rather than securing new ones. Anticipating such procedure the business man who owns securities and wishes to borrow upon them inclines to hypothecate them with a different financial institution rather than to seek further accommodation from his usual bank, unless indeed the occasion for the accommodation sought be personal rather than commercial, in which event a more cordial banking attitude may be anticipated.

In so far, therefore, as stock-exchange securities serve as business collateral they represent in the main: (*a*) Individual loans by those who are without commercial or personal credit or who are unwilling to use it even though they possess it; (*b*) supplementary business loans by those who have exhausted the maximum commercial credit which their customary banks have found it possible to accord, and (*c*) loans made by corporations who have been unwilling or unable to market their own obligations and are driven to use these in part to secure urgently needed borrowings.

No question has ever been raised as to the utility of this feature of our banking system. It is obviously advantageous that those engaged in business activity, or individual effort, who happen to be owners of stocks or bonds, should be able upon proper occasion to secure temporary advances of credit thereon without the waste and friction of forced sale. The banks here simply serve as pawnshops for securities. Capital is made more mobile without sacrifice of productivity, and both the business community and the investing public are benefited.

In all this speculative activity plays no part. There is some complaint that commercial banks are disposed to discriminate, either as to percentage of collateral or as to general acceptability in favor of particular securities to the detriment of others of equal intrinsic worth but of less marketability; but this is either prudence or ultra-conservatism, as the case may be, reflecting the personal equation of the bank directorate or the business temper of the particular community. In the case of "controlled" institutions this discrimination is commonly charged to be inspired by less justifiable considerations, and recent exposures have shown some startling instances in point. But for this as for the related practice of imprudent corporate loans secured by the borrowing corporation's own securities, or, indeed, for any other form of reckless commercial discounting, there is no other safeguard than rigid supervision and relentless accountability. Such unwholesome conditions might exist utterly irrespective of speculative activities, and, indeed, find their exact counterpart in small one-bank localities completely removed from monopolistic influences.

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But in another direction the use, however limited, of stock-exchange securities as business collateral brings us face to face with a signal defect of the American banking system—the hard and fast limit set upon the credit facilities of business enterprise.

The business man in the United States—merchant, manufacturer, or trader—secures his banking accommodations upon the strength of personal credit; that is, by the discount of indorsed commercial paper or of his own promissory note, if necessary, fortified by further indorsement. The amount which he can so borrow is not, as might be expected, the discounted present value of prospective payments based upon actual mercantile deliveries, but a definite maximum calculated as a multiple of his average bank balance and fixed by the bank executives with respect to the estimated resources and requirements of the borrower in relation to similar demands and resources of the bank's other customers. It takes the form of discounted notes of stated maturity and varies from month to month with business requirements, largely at the borrower's option. The bank is virtually obliged, save at the risk of exciting resentment, to grant and renew such loans if within the maximum; on the other hand, the ordinary borrower must not expect, save under circumstances of unusual stress, increased credit facilities beyond the maximum informally agreed upon.

If the maximum line of credit which a single banking institution can grant be normally insufficient, either by reason of its own limited resources relative to aggregated patrons' demands or by reason of the positive loan limitations of the national-bank act, the ordinary business man will have established analogous relations with one or more other banking institutions; but in each of these an identical policy will prevail. The borrower will be accorded a maximum line of credit, all of which he can upon occasion properly demand, but beyond which he can not hope to be accommodated.

We have here a mischief-making failure of the American banking system to respond to legitimate business requirements. It is not speculation but production that is halted and ultimately stopped by the rigidity of our obsolete credit mechanism. The experience of every other great industrial country of the world makes clear that an unlimited discount, though at rising cost, of valid commercial bills, a credit fabric based upon and varying with the volume of commercial paper, a mobilized gold reserve, and an open discount market are, from the standpoint of the producers of wealth, indispensable requisites of sound mercantile banking.

## II.

In the United States, as in the other great industrial countries of the world, the intervention of banking institutions has become an indispensable element in corporation financiering. The capital requirements of industrial enterprise can only be ultimately satisfied by the response of the investing public. That is to say, those who have accumulated capital by saving or transfer become creditors of or participants in such enterprise. When the undertaking is organized in corporate form this involves the issue and sale of certificates of ownership or evidences of indebtedness, stocks or bonds.

In the early days of corporate financiering, both public and private, the method of open popular subscription at fixed terms was employed, the list being exposed at designated places, and the general public invited to respond. But with the tremendous increase in public and corporate borrowing and the wide fluctuations in market credit, the method of public subscription was gradually abandoned for a more certain procedure. The transition is probably to be associated with Pitt's bold financial policy in England's contest with Napoleon. In the early days of the British funding system subscription lists to public loans were posted at the Exchequer and after 1714 at the Bank of England. But Pitt's financial necessities could brook neither delay nor uncertainty, and in the war the great Chancellor of the Exchequer developed the prototype of modern underwriting syndicates—a company of "loan contractors," with whose rise, indeed, the beginnings of England as the capital center of the world are directly associated.

Modern corporate financiering makes use in the main of the loan-contracting method, ordinarily in association with underwriting guaranty. The older open-subscription practice survives in occasional examples, such as the issue of additional corporate obligations by the grant of subscription "rights" to existing security holders, the direct offering of corporate emissions to general subscription, and the flotation of public loans by sale "over the counter."

The ordinary procedure is for the borrowing corporation to enter into an engagement with a banking institution, public or private, for the guaranteed flotation, commonly at a stipulated price, of the proposed issue.

To make effective this guaranty or underwriting, or to distribute its risk, the institution in question will generally have associated with itself other institutions and individuals as a syndicate to share in designated percentages the underwriting obligation with its resultant gains or losses. Thereafter subscriptions to the issue will be invited by public tender, ordinarily by the contracting institution acting as syndicate manager. It is an unwritten law that every participant in the underwriting syndicate shall assist in the absorption of the loan by sales through its distributing agencies or by purchase on independent account. Any residue not taken will ultimately be charged to the syndicate members in proportion to respective participation.

With the great increase in resources and the wider range of connection the great banking institutions of the country, and in particular a powerful group of international banking houses, have tended to eliminate the syndicate feature of underwriting and to become their own guarantors by directly engaging to purchase the issue at contract terms. In the interval, however, between the preliminary engagement and the consummated arrangement, the purchasing institution will have secured from other institutions or individuals—"allotted" is the term more in consonance with actual practice—subscriptions to participate in the purchase covering all but such part as it may itself desire to retain. Such subscriptions will have been made to some extent by savings banks, insurance companies, and trustees for direct investment purposes, but in the main by junior banking and brokerage houses to meet customers' demands, in consideration of a brokerage arrangement and in anticipation of an early rise in the market price over the issue price.

Whether the transaction involve a syndicate underwriting or not, the banking outcome is the same in that the new securities will ultimately pass into the possession of purchasers or participants. If times be favorable and the securities popular the issue is likely to be absorbed by the public in response to the advertised offering made by the contracting house or the syndicate manager if for no other reason than to accredit the issue and reenforced by the elaborate selling organization that the ordinary bond house has developed. In such event, prompt absorption of the issue by actual investors, there will be no occasion for banking intervention. The funds requisite will be withdrawn from individual savings accounts and bank deposits and the purchased securities will find their way into strong boxes.

If, however, general economic conditions are unfavorable, either the trade purchasers or the underwriting participants, or both, will find themselves with unsold blocks of securities on hand. These may be taken up at once by those ultimately responsible, or, more likely, the unsold quota will remain under the control of the manager until with the expiration of an agreed or reasonable time—often extended and reextended—the distribution of the unsold remainder among the subscribers is consummated.

Under such circumstances prompt recourse will be had to banking institutions for advances of credit upon the unsold or undistributed securities. The business of selling investment securities is organized on essentially the same basis as any other form of merchandising. The agencies who acquire securities from the producer, in this case the issuing corporation, do so in the expectation not of keeping but of selling them. Their own resources represent working capital pure and simple, no appreciable part of which is expected to find fixed investment in the securities so bought. The profit of the transaction will therefore be very materially affected by the quickness of the turnover, or the rapidity with which the capital employed becomes reavailable.

The stage at which recourse is had to the banks and the extent to which credit advances are sought varies with the nature of the contract, the resources of the purchasing house, and the progress of the distribution. If the issuing corporation requires early payment, the obligations in temporary form, or even the purchase option, may be used by the purchaser as collateral for a bank loan. If the loan be undersubscribed, the part left over will be similarly hypothecated; or if the subscription be full but the absorption incomplete, the undigested parts, either in the custody of the syndicate manager or distributed among the separate participants, will be used as banking collateral. Ordinarily such advances are made by the banks at the rates prevailing for call money, or upon even more favorable terms in the case of underwriting syndicates having strong banking connection.

If corporate enterprise is to secure with economy the additional capital necessary from time to time for growth and expansion, if accumulated savings are to find productive employment with promptness and certainty, some such relationship between corporate borrowing and banking accommodation must necessarily exist. Practical experience in public and private financiering has made clear that, save in exceptional circumstances, direct sale in the form of public subscription is attended with uncertainty and risk. To be successful the corporation must require its money at the very moment that the saving public has reached the psychological state of investment, and such coincidence is necessarily unusual.

An intermediary is obviously desirable to bridge the interval, to supply the corporation with funds at the time needed and to make delivery to the investor at the time desired—precisely as the tradesman serves as an economically necessary middleman between producer and consumer. This is the function of the underwriter or loan contractor. Like the successful merchant, he seeks to reduce the interval between purchase and sale. He will be reluctant to enter into an engagement to take over a loan at a time when he deems the investment demand inadequate or sluggish. And, on the other hand, he will be keen to anticipate returning confidence, by offering tempting investments before his competitors have embraced the opportunity and skimmed the cream off the market.

For such transactions great resources are in any event needed. But so huge are the amounts involved in corporate borrowings that were the loan contractors dependent solely upon their own capital, any unforeseen check in the sale of the issue, indeed, the inevitable delay in its absorption, would result in congestion. The case would be exactly parallel with that of a merchant, who, having invested his own limited capital in desirable wares, would be unable to make further purchases, however favorable be the terms offered or certain the future demand, until customers had taken off his hands a sufficient amount of those things with which he was already stocked.

The existing banking organization of the United States meets this requirement of business enterprise with moderate success. Such evils as from time to time disclose themselves seem inevitably incident to the alternating fever and quiescence of modern economic organization. In flush times, when promoters abound and banks become less prudent, the availability of corporate securities as bank collateral undoubtedly serves as an artificial stimulus to evoke projects that are unnecessary or unwise. The way is opened for a perilous process of pyramiding that leads swiftly to reckless involvement.

A further criticism is that such bank loans tend to encroach upon the accommodations that can be afforded ordinary business activity. The times in which the banks are most heavily involved in syndicate underwritings are periods of business activity rather than quiet. It is then that corporate projects take amplest shape and flotation follows quickly upon flotation. During the upswing the absorption is so rapid, the profits so alluring, and the public service so plausible that banking conservatism is put to the test merely in distinguishing accommodation from excess and enterprise from venture. A bank's mercantile customers ordinarily have the first claim upon its facilities. But in periods of business calm not all of its resources will be so employed and—in lieu of the even less profitable avenue of employment in stock-exchange loans—advances upon syndicate collateral are very acceptable. Such loans are nominally payable on demand, but in reality they are much less liquid than the ordinary call loan. This is especially the case with interior banks, whose relation to the debtor broker and even to the securities involved is likely to be less impersonal than of a New York bank. The consequence is that expanding business requirements may encounter less preparedness from banks so encumbered than would otherwise occur.

These are unwelcome contingencies incident to modern business daring, from which no form of banking organization will be always and entirely immune. Greater publicity and closer supervision in operation, more direct responsibility and more certain accountability in control, with, perhaps, some legal maximum as to extent of participation, will serve as local correctives. But the real cause of the disorder is that more fundamental defect of the American banking system—the absence of an open discount market.

As long as our banks are deprived of the usual and proper investment for growing reserves, guaranteed commercial paper of international validity, we may expect to suffer periodically from undue and even unwise banking participation in corporate financiering.

## III.

The investment of a considerable proportion of loanable resources in stock-exchange securities is an almost invariable practice of American banking institutions. On September 1, 1910, the 7,173 national banks in the United States held $854,127,665 in "bonds, securities, etc.," being in the main State, county, municipal, railroad, public service, and other bonds, with a sprinkling of stocks (presumably taken for debt), warrants, and judgments, but including no part of the holdings of United States or other bonds to secure note circulation or Federal deposits.

The extent of such investments is subject to seasonal fluctuation, and, even more, to the irregular variation of general economic and financial conditions. Here and there particular banks have abstained from such investments, and in some cases this restraint has become an avowed policy. But the ordinary practice is as described.

The motives leading to such investments are in some cases specific and obvious. The financial institutions of Baltimore find it profitable to invest largely in Baltimore City bonds, because such securities are not only exempt from State and local taxation but, by a curious series of implied agreements, administrative rulings, and legal enactments, carry with them a corresponding tax-deducting power, to the extent of largely relieving some of the institutions from capital taxation. More common is a bank's investment in a particular State's or municipality's bonds in the hope, or even as the condition of becoming its public depositary or of securing some public or semipublic account. This may even extend to a private corporation, whose profitable banking account can be more certainly retained by participation in its financing. Finally, some part of a bank's securities represent the foreclosure of hypothecated securities, acquired by the institution for its own ultimate protection.

But these instances explain only a fractional part of the aggregate holdings and do not touch the essential consideration, which is—that a bank buys securities because it can find no other profitable investment during recurring periods when business is quiescent for such of its surplus funds as it would otherwise employ in its regular channels.

When reserves become congested and the local demand for money is exhausted, neither the call money market in New York nor the masked rediscount of country bank paper nor the availability through brokerage houses of the promissory paper of a limited number of widely known mercantile and industrial establishments will absorb the excess, and recourse is had to the bond market.

From whatever point of view regarded this apparent necessity under which American banks now labor of tying up large parts of their loanable funds in stock-exchange securities is unfortunate. It offers an unhealthy stimulus to corporate financiering by supplying a temporary and fictitious market for investment securities. It invites speculative gains and losses by the fluctuation in market price in the interval between purchase and liquidation. It curtails mercantile accommodation by the bank's reluctance to liquidate such securities in a declining market, and it injects an additional element of risk into banking stability in the temptation to invest in less seasoned and more productive bonds.

In making such investments under existing conditions the banks, however, obey a perfectly sound economic impulse. Idle funds are as unhealthy for the community as they are unprofitable to the banks. It is probably better in the long run that investment be made in securities, with all attendant uncertainties, than that unemployed funds accumulate as swollen reserves or be applied to questionable credits. But such a necessary alternative is lamentable, and one with which the banking institutions of no other industrial country of the world are confronted. Everywhere else the banking surplus of one community relieves the credit strain of another, and in so doing finds safe and convenient investment for itself. Here again we have the prime defect of our banking system—the two-faced evil of localized commercial paper—driving the banks on the one hand to inconvenient and uncertain investment of unemployed funds, and lessening, by wasteful isolation of reserve, the maximum banking accommodation which the mercantile interest of the country might enjoy. Finally, it is questionable whether the practice of investing in securities ordinarily results in profit to the banks. A not uncommon experience is for bonds to be bought at the higher level incident to an easy money market and to be disposed of when there is competitive selling and prices have weakened. Even when a profit might have been realized, bonds so bought are likely to be held until a loss is shown, then to be carried over and written off, and finally to be sold at original cost when the next easy money period begins.

## IV.

The modern stockbroker is engaged in two kinds of activity—the purchase and sale of investment securities, and the conduct of speculative operations for principals or in personal behalf. Ordinarily both classes of business are conducted by the same house, but there are many bond houses who do not invite speculative accounts and, on the other hand, many commission houses figure inappreciably in the investment market.

In connection with each class of business large banking accommodations are involved. Such bank advances take the form either of time or of call loans, according to the prudence of the broker, the state of the money market, and the disposition of the lending banks. The purpose of a sagacious broker, as of a cautious merchant, is to make sure of having at all times that amount, and no more, of borrowed capital that he requires, and to pay for it the lowest price for which it can be obtained at any time during the period of its use. This end can never be completely attained. If money be cheap and the prospect for any stringency unlikely, there is yet reluctance to rely entirely on demand loans because of the ever-present possibility of an abrupt change in the general financial situation, certain to send the call rate bounding, and to make further or even continued advances impossible. On the other hand, time money ordinarily commands higher rates than call money, and borrowers are unwilling in periods of easy credit to tie themselves up, so as to be unable to profit in the even easier money market likely to prevail in the future, by call loans and by the sale of securities. When the situation is reversed and the money market restricted, there is nevertheless the same reluctance to use call money exclusively, for conditions may easily become prohibitive; while, on the contrary, the exclusive use of time money, even were it practicable, is checked by the hope of improving markets and lower rates.

One striking feature of such loans, whether time or demand, is to be noted. The merchant or manufacturer is able to secure banking accommodations up to a certain point upon his own personal credit—that is, by the discounting of his own promissory note or single-name paper, unsecured by pledge of collateral. Such is never the case with the bond dealer or stockbroker. However ample his resources or unquestioned his credit, the broker can only obtain loans upon collateral securities. Any attempt to secure credit on other terms is a confession of financial weakness and is never resorted to save in straits. The explanation of this seeming anomaly appears to lie partly in the greater amounts, relative to resources, involved in brokers' transactions as compared with mercantile business, but even more in the fact that the wares of the merchant and the unfinished products of the manufacturer, which serve as the ultimate basis of mercantile loans, are either immobile or inchoate, whereas the securities which represent the stock in trade of the broker are capable of easy and convenient removal and possess immediate marketable value, thus readily lending themselves to the cautious impulse of the banker to protect his advances. Even in those branches of mercantile activity where the stock in trade is capable of reduction to marketable and movable form by warehouse storage—cotton, grain, canned goods—bank advances are ordinarily limited to collateral-secured loans.

In so far as the activities of the stockbroker relate to the purchase and outright sale of investment securities, he is a dealer in merchandise. He buys securities of such kinds as will appeal to the varying desires of his customers, at prices which will permit sale at usual business profits. Accordingly, his vaults, like the shelves of the merchant or the warehouse of the manufacturer, are at all times stocked with investment wares awaiting the demands of his investing clientele.

It is true that a considerable part of the stockbroker's wares will consist of undistributed syndicate holdings or unabsorbed underwriting participation, upon which credit advances have been made in the manner already discussed in a preceding section. But over and above such holdings the ordinary bond house is the owner, by actual purchase and payment, of blocks of securities acquired for purposes of sale at profit, and the actual distribution of which is pressed with all the energy and skill of commercial vending.

Advances of credit upon the unsold part of this stock in trade are sought from the banks in supplement of the broker's own working capital. The relation of the stockbroker to the banks is, in this particular, like that of any other business man. He conducts a certain kind of business and has a certain amount of capital of his own with which to conduct it. Restricted within these limits, not only will his operations be meager and unprofitable, but the facilities which he can offer the investing public in variety and readiness of investment securities and the advantage which corporate seekers of capital can obtain from such middlemen, will be correspondingly curtailed. To press the analogy, such restriction would find exact parallel in the case of a merchant denied credit upon unsold wares or a manufacturer upon undistributed produce.

This service is rendered with reasonable adequacy by our present banking system. Bond houses suffer something in common with all mercantile enterprise from the inelasticity of bank credits in periods of economic expansion, but the treatment accorded is often preferential and the discomfort on the whole less acute.

## V.

There has been much controversy as to the function of speculation in modern economic life. Those directly engaged therein have insisted upon its respectability and dignity as a form of business enterprise. Radical attack has denounced speculation as a parasitic activity, the effect of which is legalized plunder and demoralization of wholesome business method. The consensus of qualified opinion is, however, that this latter sweeping condemnation can be applied, if at all, only to the extravagant excesses of speculative fever and that the intelligent discounting of economic developments—the essence of speculation—serves as a balance wheel of industrial life.

Such a discussion, however, smacks of the academic. Whatever drastic measures may be taken to eliminate speculative abuses, it is reasonably certain that large play will still be left for those adventurous spirits who, by forsight, daring, or blind hazard, seek to gauge the course of coming events and who reap profits or suffer losses according to the accuracy of their forecast or the accident of their guess.

During the calendar year ending December 31, 1910, there were bought and sold on the New York Stock Exchange 164,051,061 shares of stock of an approximate value of $14,124,875,879. Dealings on the stock exchanges of Boston, Philadelphia, Chicago, and Baltimore, aggregated 21,179,574 shares. Allowing for trading in other cities and in the outside markets of New York, it is probably a conservative estimate to place the total number of shares dealt in the United States at 225,000,000 of an approximate value of $20,000,000,000.

A substantial proportion of this trading consists of outright purchases for investment purposes by corporations, institutions, trustees, and individuals. But the overwhelming part of it, as well as an appreciable amount of trading in active bonds, represents speculative commitments for the rise or fall by stockbrokers acting as agents or trading for themselves.

Such operations are financed in the main by bank advances. The ordinary procedure is for the operator to supply 20 per cent of the purchase price—or if acting through a broker 10 per cent and the broker another 10—and the banks to advance the remaining 80 per cent on a demand loan upon a pledge of the securities purchased, or their equivalent, as collateral. The quota advanced by the broker will be drawn from existing bank deposits created largely by time loans negotiated to guard against possible market stringency, but likewise secured by collateral.

The ready availability of banking funds for such speculative operations is, as has so often been pointed out, the direct consequence of unwholesome elements in the banking system of the United States. Under the provisions of the national-bank act interior banks are permitted to deposit three-fifths of their legal (15 per cent) reserves with correspondents in reserve and central reserve cities, and reserve city banks in turn, up to the extent of one-half of their legal (25 per cent) reserves, may count their deposits with central reserve banks as a part of such reserves.

The original motive of such provision was probably the greater and more regular mercantile requirements of the central reserve cities, notably New York, in contrast with the seasonal fluctuations of banking needs in the interior cities.

To insure such remittance, the New York banks are in the habit of allowing 2 per cent interest upon country bank deposits subject to call. The consequence is that the interior banks, failing any other avenue of profitable short-time employment, remit to New York not only the authorized quota of their reserves, but also the surplus funds which accumulate with recurring business inactivity.

It is not possible for the New York banks to employ all of such deposits in mercantile loans and discounts, even were it sound banking to lend call money on time loans. The only method of profitable use is demand loans, and the only large market is offered by speculative operators on the stock and produce exchanges.

We have here all the conditions favorable to artificial stimulation of stock exchange speculation. At periods of seasonal dullness, and, even more, at times of business reaction, the irresistible lure of payment for idle money attracts the surplus funds of the interior banks to New York, there to be pressed upon the call money market for what it will bring, and, finding regular employment only in stock exchange operations, to encourage speculative commitments at the very time when quiescence is in order. As there is unwholesome stimulation, so there is sudden and wasteful liquidation. When reviving business leads the interior banks to reduce their New York balances, the depositary banks meet the strain by calling loans, with the result that the speculative movement for the rise is reversed and a repressive influence cast upon general business.

The primary cause of this unwholesome sequence is obviously again the inability of the interior banks to find profitable employment for idle funds during recurring periods of business calm. A part of the capital so disengaged is put, by the stronger or bolder banks, as has been noted, into stock exchange securities; but that more considerable part, likely to be required upon earlier or more abrupt occasion, and all balances of many banks reluctant to tie up any part of their resources in semi-speculative investment, flow irresistibly to New York depositaries.

It is certain that a measure of stock speculation would persist, even if the resources of the New York banks were alone available for financing it, but the extent of such accommodation, even when supplemented by the demand loans made available by individual capitalists, would be limited and the cost of securing it would be greater. Individual speculation would be less in amount and narrower in distribution. Most of all, the periods of speculation, in so far as determined by the cheapness of money, would vary logically with the movement of general business, instead of, as at present, running in vicious opposition thereto.

Any reform in our banking system which will create a logical form of investment for temporarily idle banking resources may therefore be expected to discourage instead of to promote speculative excesses. The banking experience of every other industrial country of the world shows that guaranteed bills of short maturity constitute such proper investment. Over and above all other advantages which would attend the acceptance of commercial paper, whether by a new central banking agency or by powerful existing institutions, there would surely follow through the diversion of periodically accumulating banking funds into this more healthful channel a marked arrest of the wild course of American speculation.

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