T O P I C S .

I.

THE BANKS AND THE "MARKET" - THE CHIEF MODERN SYSTEM OF BANKING.

1. The Bank as Part of the Banking Organization.

(a) The functions of the bank -

The classical grouping - discount, deposit and issue.

(b) This grouping criticised - identity of "functions".

(c) The modern view of banking - a process of obtaining credit, trading in it, and maintaining its convertibility into cash on demand.

(d) The bank of comparatively minor interest and considered as a separate unit.

(e) The real significance of the bank understood when viewed as an element in the general organization of credit and exchange.

2. The Credit Structure of Economic Society.

(a) The essential purpose of credit mechanism is that of testing, comparing and offsetting claims to wealth.

(b) These claims expressed in terms of money, and should be kept convertible into money.

(c) The duty of the banks as a whole is to perform these functions, but, at the same time, to add in their collective capacity another - that of affording a market for credit in which claims upon banks and traders may be bought and sold with the maximum of safety and under substantially uniform conditions, thereby insuring as nearly as possible uniformity of charge for banking service, and for the use of capital.

(d) A study of this market involves analysis of several distinct factors; the methods and practices of business men in creating claims to payment, the form given to such claims; the legal relationships involved in the creation of such claims and in transaction therein, the mechanism by which such claims are dealt in; the relative value of such claims and their relative cost from the standpoint of banking, the bank mechanism needed to "carry" them and offset them among themselves, and to "collect" them when due.

(e) The credit structure of today must also be studied and analyzed from the standpoint of its constituents, involving a study of, different types of banks and other financial institutions, their respective lines of business, their internal organization, their relations one to another, and their different places in the market of the country.

3. Constituents and Subdivisions of the Financial Market.

(a) The discount market.

The discount market includes the market for those forms of paper which are discountable, i. e., which are based on commercial transactions. It concerns itself with "live" commercial banking operations, and paper growing out of them. Its importance lies in the fact that commercial paper is the class of obligation next to cash in its liquid character.

(b) The investment market.

The investment market is concerned with obligations of long-term which have been created for the purpose of financing or capitalizing undertakings. It deals with obligations whose most important element is yield and safety rather than promptness of payment. It may be subdivided into various classes according to the character of the investment, the underlying conditions under which payment may be expected, and a variety of other considerations.

(c) Other divisions of "market".

Various special kinds of markets, such as that for stock, etc., must be recognized in any study of banking, both because of their own importance, and because of the influence they exert upon the elements in the market with which the banks are directly concerned because of their interest as makers and purchasers of credit instruments.

4. <u>The Discount Market</u>.

(a) The discount market is that with which banks in the proper sense of the word, are most closely concerned.

(b) Two essentials to be studied in connection with the discount market - the origin and form of paper which figures there, and the methods employed by banks to guarantee such paper and make it easily and widely recognizable.

(c) The fundamental requirement of paper in the discount market is that it be short-term and grow out of actual transactions, thus furnishing its own means of payment.

(d) Analysis and explanation of paper of such description.

(e) Process by which banks broaden salability of paper in the discount market - acceptance and endorsement.

(f) Classes of concerns participating in the discount market - makers of paper, acceptors, dealers or brokers; purchasers; speculators, or those who purchase paper as a means of insurance.

5. Systems of Banking.

(a) Meaning of "system." A banking system is that organization of or relationship between banks which exists as a result of law or custom, and which results in uniting the banks of a country under definite relationships, with a market resulting therefrom, and with definite arrangements for the holding of cash and the conversion of liabilities into cash.

(b) Principal systems of to-day - three distinct types of system - central banking system, independent charter system, and "free" banking system. Difference lies in conditions under which banks are chartered or incorporated, and in the degree of combination of resources and centralization of control.

(c) Characteristics of different systems. The central banking system provides complete mechanism for husbanding coin and currency, granting relief in time of stringency through note issue, and affording at all times a market for paper growing out of commercial banking operations. In this case actual banking relations with the public are left to various independent institutions which are united through the central banking mechanism.

(d) The independent charter system assumes that a variety of banks, each with many branches, can perform the service both of a central bank and of communication with the public in the transaction of its business.

(e) The free banking system assumes that each bank is capable of managing its own affairs without outside aid, or, that if such aid is needed, it would be still, through informal action on the part of leading members of the banking community, designed to bring about community and harmony of policy, and relief when necessary.

(f) Principles derived from experience. Experience shows that every banking system needs a mode of "mobilizing" its resources. Study of this mode of mobilization is equivalent to study of central banking principles. Need for mobilization resides in the peculiar character of the banking business, and the fact that banks can never be in position to pay cash to all who require it.

Study of financial mobilization has crystallized into analysis of principles governing note issue and reserves, together with inquiry into the question who should hold reserves.

(g) Part of United States. The United States up to 1913 was the leading example of free banking principles. By enactment of the Federal Reserve Act, principles of combined or centralized banking have been introduced, while free banking mechanism is retained. The effort is to retain free access to banking business for individuals, while at the same time providing machinery of control and cooperation of resources. The United States is thus given a peculiar status, its banking business being analogous in principle to those of the central banking countries, while largely unique in detail and adjustment.

(h) Study of American banking system. Includes two chief branches, analysis of law and custom governing organization of the system, and analysis of business practice methods in connection with operations under it. Also implies comparative study of legislation, national and State, with a view to noting defects at points at which readjustment is called for.

6. Sketch of Banking Systems of World.

(a) Chief features of English, French, German and Canadian systems, with special reference to reserves, note issue, and purchase of commercial paper.

(b) Contrast between practice in foreign countries specified, and practice in the United States, with respect to each of the chief elements in banking operation.

(c) General conclusions as to best practice of to-day on chief disputed points, and indications of countries most nearly conforming to best principles.

(d) Analysis of points at which American methods do not conform to the best practice as thus worked out.

2/9/17

11.

ORGANIZATION OF BANKS AND DIVISION OF THE FIELD AMONG INSTITUTIONS.

1. Essentials of Banking Organization.

(a) Relations between banks developed as result of law or custom; grouping of banks on legal or economic basis.

(b) Arrangements for combining resources, relieving necessity or stringency or equalizing capital.

(c) Assignment of functions to be performed on joint or common basis.

(d) These elements best studied by using our own banking system as illustrative, with comparative analysis of foreign systems, by way of contrast.thereto.

2. Outline of American Banking Organization.

(a) Three main classes of banks from the legal standpoint - national, State and private - no necessary or essential difference between them as to kind of business performed.

(b) National banks constitute compact, central "core" of banking system, partly because of more stringent general requirements, partly because of wide geographical distribution, partly because of Federal reserve organization.

(c) National banks are combined together for cooperative purposes in Federal reserve system, with such additional membership drawn from State banks as the latter may choose to add.

(d) Federal reserve system composed of twelve banking organizations, each cooperative, including all national and some State banks in the district, all such members being united under the supervision of the Federal Reserve Board.

3. <u>Function of Federal Reserve System in Organizing Banks of the Country</u>.

(a) Combined reserves. Under former legislation a loose system of combined reserves was obtained by redeposit of funds in specified cities, and at times by operation of clearing houses or, in later years, of "national currency associations." In place of this we now have compulsory deposit of specified proportion of reserves in Federal reserve banks.

(b) Note issues. Under former legislation notes were issued by national banks which deposited bonds with Treasury to protect such notes. Under the Federal reserve system notes are issued by Federal reserve banks at the instance of member banks, primarily on the basis of commercial paper or, under special conditions, of gold. Limited amounts of bond-secured notes called "Federal reserve notes," are also issued by Federal reserve banks at discretion. Notes are obtained by member banks through rediscount of their paper.

(c) Rediscounting process. As method of establishing reserves or obtaining notes from Federal reserve banks, member banks offer their paper of specified kinds, with their own endorsement, to Federal reserve banks. When such rediscount occurs a reserve deposit is created on the books of the reserve bank, or notes are issued. When paper matures the reserve bank receives the cash or its own notes, or a claim on itself (check) thus reducing liabilities or strengthening reserve holdings.

(d) Reports and examinations. Under former legislation the making of examinations and reports was in the hands of the Comptroller of the Currency. The new system provides for regular reports to reserve banks on the part of members and also examination of member banks whenever deemed necessary. Such examinations likely to be infrequent and unnecessary because of close relationship between reserve banks and member banks.

4. Membership in Federal Reserve System.

(a) As already seen, all national banks in continental United States are required by law to become members.

(b) State banks (i. e. banks organized under State law) are permitted to become members upon complying with certain conditions. System may, therefore, include not only national banks but State institutions of specified kinds.

(c) At present most State institutions remain outside, while many always will so remain because of inability to comply with requirements.

(d) Many private banks, savings banks and other financial institutions which have a direct relation to the financial market, and in many cases to the discount market, are nevertheless unlikely to become members.

5. Relation Between Reserve System and Outside Institutions.

(a) Non-national banks have in the past kept balances largely with national banks because of generally more stringent oversight and greater power of the latter. This relationship will continue to a considerable extent, and may be accentuated because of greater power of the reserve system to render relief in case of necessity.

(b) The reserve system is establishing definite discount market, and in this all financial institutions do and will participate. The reserve system will afford market for good paper created by outside institutions, thus enabling latter to market assets in time of necessity; and to equalize investments and rates in ordinary times.

(c) Working of the reserve system will profoundly affect international monetary and financial relations of the United States, and in so doing will alter the basis of business for larger State institutions, such as trust companies.

6. Relation Between National and Other Banks.

(a) National banks organized under National Bank Act, State banks and other institutions under State legislation.

(b) National banks inspected by Federal examiners; other institutions by State examiners.

(c) National banks allowed to keep reserves only in vault, or in Federal reserve banks, or (temporarily) with other national banks in specified cities; State banks allowed in many cases to keep reserves either with other State banks in specified cities, or with national banks; trust companies subject to same conditions where reserve requirements are fully worked out.

(d) Hence national banks may be regarded as the reserve-holding institutions of the country, the larger number of State banks depending upon them for aid in case of necessity. National banks also exercise the function of rediscount to some extent for smaller State institutions.

(e) Relations between national banks and other financial institutions, such as savings banks, insurance companies, etc., are similar to relations with State banks, but even less well defined.

7. Relations Between Other Groups of Institutions.

(a) In some States, State banks are organized on lines similar to those of the national system, with plans for the redepositing of reserves, etc.

(b) Other institutions may keep these State funds with the stronger State bank or trust companies, which thus in a certain measure act as reserve holders.

(c) Most of the non-commercial banking instutions participate in and more or less depend upon the discount market (and investment market as affected thereby) in which national banks act as the leading factors.

(d) These relationships vary considerably from State to State according to legislation prevailing there. (Analysis of State legislation).

8. Comparative Analysis of Foreign Banking Organizations.

(a) Bank of England: (1) relation with other banks largely the result of custom rather than law; (2) reserves maintained in highly concentrated form in Bank of England; (3) relations with public divided between Bank of England and other banks, but largely in hands of other banks; (4) Bank of England devotes its chief effort to headship of the discount market, regulations of international movements of specie, and other matters of similar description; (5) note issue practically in hands of Bank of England, security being Government bonds and gold in normal times, with other classes of protection in extraordinary times when bank act is suspended.

(b) Bank of France: (1) relations with other banks based on fact that Bank of France is practically a Government institution strongly fortified with gold, and transacts very conservative business; (2) other banks keep deposits with it as they see fit; (3) most important function is note issue; (4) Bank does a large business on small unit basis with individuals, thus occupying a position different from that of many other central banks; (5) Bank controls specie movements by use of its rate of discount.

(c) Reichsbank of Germany: (1) relations with other banks partly result of custom and partly of law; (2) control of note issue based on commercial paper, and adoption of methods designed to centralize control of gold stock give Reichsbank leadership in German international affairs; (3) Bank leaves dealings with public, especially of smaller varieties, to other banks.

(d) Canadian system: (1) each chartered bank is separate, independent "system," dealing with public and conserving its own funds by appropriate reserve policy; (2) each bank undertakes, therefore, both large and small transactions, issues its own notes, etc.; (3) note issue is maintained by joint guaranty fund under control of the Government; (4) Government oversight and examination furnish additional bond between banks, and informal consultations between them tend to establish uniform policies.

(e) Other banking systems. Most other banking systems are more or less closely modeled upon types already enumerated, with variations intended to suit local or national conditions.

9. Organization of the Bank as a Unit.

(a) The commercial bank: (1) organization of board of directors - interests represented - committee work - president and "chairman"; (2) officers of bank, their duties - variation in assignment of functions; (3) division of bank between "departments," - principal departments enumerated and described.

(b) The trust company: (1) banking department likely to be substantially similar to that of commercial bank; (2) other departments, number depending upon functions performed.

(c) Savings banks:

III.

MAINTENANCE OF THE LIQUID CONDITION OF THE BANK.

1. Significance of Liquid Condition:

(a) Bank's essential function, as already seen, that of insuring convertibility of cummunity's credit.

(b) This convertibility implies capacity to pay cash on demand at any time.

(c) Maintenance of liquid condition of bank, therefore, has two aspects (1) The keeping of bank reserves sufficiently high; and (2) The keeping of bank investments in form which can be used to get cash when needed.

(d) From standpoint of community as a whole, it also implies provision of some means of converting assets into cash generally, i. e., of suddenly increasing money or "currency".

2. Theory of Reserves:

(a) Reserve is that part of a bank's funds kept in form for immediate use.

(b) Strictly speaking, this means ultimate legal tender money.

(c) Actual banking practice allows it to consist in part of deposits with other banks, and in part of non legal tender forms of money.

(d) Bank theoretically starts with 100% reserve; then puts out its own obligations, payable on demand; a portion of these obligations are presented from time to time. Reserve "percentage" is the ratio of immediate resources to demand liabilities.

(e) When reserve falls, ratio may be restored (1) by getting in cash from outside; (2) by refraining from further loans and allowing old ones to mature and be paid; (3) by "rediscounting" with other banks.

(f) Purchase of coin. This may be carried out internationally when country's supply of coin is short; but domestically in periods of presure is out of the question except on limited scale. Necessity which makes purchase of coin desirable is likely to be tendency of the public to hoard.

(g) Cessation of loaning or discounting. This hazardous to community and may, if generally undertaken, accentuate bad conditions,

(h) Rediscounting. This is a process of throwing bank resources together into a common fund. May be carried on by one strong bank for weaker units. Best conducted cooperatively by banking community for all banks that desire it.

3. Theory and Practice of Rediscounting:

(a) Rediscounting bank is subject to same laws and principles as customers' bank.

(b) Difference in its position from that of other banks must be twofold (1) must limit itself to specified kinds of choice paper; (2) must practically eliminate certain sources of danger by confining its business to customers not affected by same conditions which influence customers of other banks.

(c) As rediscounting bank is primarily governed by public service considerations, must put these first, and considerations of profit second.

(d) Must be able to meet increased demands for currency by supplying acceptable medium of exchange without weakening its own money stock too much. This requirement meets provision for "elastic currency."

(e) Function of rediscounting bank is thus to check undue extension of credit by testing soundness of banking situation, and raising rates for accommodation when expansion is too active.

4. Function of Open Market.

(a) By open market is meant general market for paper.

(b) Object in ordinary times, as already seen, that of equalizing rates and supply of capital.

(c) In unusual times enables rediscounting banks to influence conditions of other banks indirectly by drawing funds off from market or putting them into market.

(d) Open market thus an adjunct of rediscounting process, and must be operated in conjunction with latter.

5. Fixed or Fluctuating Reserves.

(a) Desirable level of reserves differs greatly according to habits of community and methods of banking.

(b) Must be settled in each case on basis of highest judgment of banker.

(c) Legal requirement can be only a minimum, and is likely to be at fault.

(d) Legal fixed reserve is development of free banking system - "rule of thumb" laid down for guidance of inexperienced or reckless banker.

(e) Most scientific mode of regulating liquid condition of bank is to prescribe classes of paper to be bought so that "secondary reserve" is built up.

(f) Many variations of reserve regulations exist, including taxes on reserve-deficiencies, etc. These rendered less and less necessary when ultimate decision as to reserve policy is placed in hands of strong, central, regulating body.

6. Maintenance of "Confidence."

(a) Discussion of reserve based on existence of normal degree of "confidence."

(b) Any factor tending to destroy confidence throws strain upon banks.

(c) Maintenance of confidence is result of belief in (1) sound banking condition; (2) ability of bank to get emergency relief if necessary.

(d) Chief factor in maintaining confidence must be adoption of sound and conservative banking policy.

(e) If confidence in banking system as a whole is lost, no artificial means of restoration; when loss of confidence affects only locality or group of institutions, situation secured by substituting credit of banks as a whole for that of individual institutions.

7. Past Experience in Maintenance of "Confidence".

(a) Clearing house agreement and issue of "certificates".

(b) National currency associations (law of 1908).

(c) Issue of "emergency currency."

(d) Joint guaranty of notes or deposit of bonds.

8. Function of Reserve System in Maintaining Liquid Condition.

(a) Reserve banks' primary duty that of safeguarding reserves of community and standardizing forms of commercial paper.

(b) Secondary duty is that of relieving panics or emergencies by rediscounting.

(c) System may perform its functions by granting of deposit credits, or issue of notes.

(d) Success in every plan dependent upon ability of other banks to present paper of speedily maturing varieties, so as to enable community to liquidate itself.

(e) Success depends upon constant wisdom of management.

9. Contrast Between United States and Foreign Countries:

(a) United States far less homogeneous financially.

(b) United States lacks distinct national financial market.

(c) Foreign central banks are largely outgrowth of past commercial banks and exercise dominating control in market.

(d) Reserve banks are new cooperative organizations, and have not yet obtained strong hold on market.

(e) State banking systems and differences in legislation tend to create independent groups of institutions directly dependent upon the reserve banks.

(f) Commercial paper in United States far less standardized than in other countries.

(g) Periods of credit and open account system more lax in United States than in Europe.

10. Future Development of Liquid Condition.

(a) Basic problem that of developing sound commercial paper practice.

(b) Development by experience of accurate reserve percentage policy.

(c) Evolution of prompt efficient rediscounting, and note issue process.

(d) Establishment of satisfactory number of branches and agencies at convenient points.

(e) Gradual growth and confirmation of general national discount market.

(f) Evolution of distinct local market in each Federal reserve district, and adaptation of paper, etc., within that district to local necessities.

IV.

BANK OBLIGATIONS AND RESERVE CONSTITUENTS - DEPOSITS AND NOTES

1. Question of Reserve Composition:

(a) Problem of reserve implies in practice question of composition of what is called reserve.

(b) As already seen, this in modern countries really includes large element of credit, although theoretically reserves consist of cash.

2. Reserve Constituents - Deposits:

(a) Next to actual cash the most immediately available resource is power to draw on another bank.

(b) Hence National Bank Act grants authority to redeposit part of reserves, counting such deposit as reserves.

(c) Hence also under Federal Reserve Act authority is granted to count balance with reserve bank as substantial part of reserves.

(d) So also in foreign countries, even where no legal reserve is specified, actual reserve requirements consist partly of credit, i. e., balances on books of central bank in favor of other banks.

3. Reserve Constituents - Notes:

(a) Notes theoretically identical with deposits, but representing credit of issuer.

(b) Hence often contended that bank notes should be allowed to figure to specified extent in reserves.

(c) Difference of practice on this point, many systems refusing to allow notes to count on ground that they may cause inflation.

(d) Essential difference between notes and deposits as reserve constituents lies in rapidity of "turnover" or rate of redemption, notes tending to have much longer life.

4. Modern View of Reserves:

(a) Real test of reserves is power to liquidate.

(b) Cash can not be maintained at sufficient figure to affect liquidation under all ordinary circumstances.

(c) Sufficiently severe shock to national credit means that joint power of the banks is attacked, just as individual power is under difficulties of more limited scope.

(d) Hence problem becomes that of maintaining succession of prompt maturities sufficiently short in duration to insure continuous flow of maturing credits, thereby providing for cancellation of claims at adequate rate.

5. Secondary Reserves:

(a) By secondary reserve is meant that portion of the assets put into shape to be readily convertible into reserves.

(b) Any paper immediately saleable figures as proper element of secondary reserves.

(c) This means that what may be secondary reserves for one concern is not for another, and what is secondary reserve for any bank may not be for all banks simultaneously.

(d) Ordinarily secondary reserves consist of paper having an unquestionable and early maturity.

(e) Banking problem as affected by reserves thus becomes that of arranging assets and liabilities in such a way as, under all ordinary conditions, to offset one another up to substantial high percentage.

(f) When this policy is successfully carried out, the question of providing a sudden currency resource is largely minimized.

6. <u>"Emergency Currency".</u>

(a) Emergency currency has been provided in some countries as a substitute for secondary reserves.

(b) Its use signifies that the banking system has partially broken down.

(c) Use of emergency currency implies a subsequent return to normal conditions, frequently preceded by suspension of specie payment.

(d) Hence use of emergency currency now considered last resort, and its employment discredits banking system when resorted to.

2/23/17.

V.

CENTRAL VS. DIFFUSED CONTROL OF BANKING - THE RELATION OF THE GOVERNMENT TO THE BANKS.

1. Problem of Control.

(a) By control of banking is meant oversight or regulation designed to prevent banks from unduly expanding loans and placing themselves in a dangerous position.

(b) Public oversight is ordinarily thought of as a means of avoiding dishonesty. This, however, is only incidental.

(c) The real problem of control is that of preventing expansion of liabilities (1) beyond the point of safety as compared with reserves; and (2) in a way that involves undue or unfair distribution of credit.

2. Methods of Public Control.

(a) Obvious means of control is that of regular bank examination and regular reports. These ordinarily made in specified form which is supposed to be uniform or standard.

(b) Inspection, however, usually aims to insure that banks are living up to legislative requirements.

(c) These legislative requirements frequently include (1) fixed reserve percentage; (2) prohibition of certain classes of loans; (3) prohibition of excessive loans to single individuals or concerns; (4) prohibition of loans intended to facilitate the operations of interested persons.

3. Fixed Reserve Requirements.

(a) First duty of public authorities in connection with reserve requirements is to ascertain extent to which observed.

(b) If requirement is violated, authorities usually armed with power to penalize the bank or compel it to suspend further operations pending restoration of reserve.

(c) Exercise of this authority always hazardous and more or less artificial except in isolated instances.

4. Excessive Loans.

(a) Books of banks show amount of loans to each borrower.

(b) Public authorities censure banks if limitation is not observed.

(c) Difficulty found in fact that many ways of evading the spirit of the requirement are easily found.

5. Loans on Improper Security, or Over-Investment.

(a) Facts of this kind ascertained by usual methods of examination, etc.

(b) Difficulty lies in fact that when commitments are once made, rectification may involve not only hardship to banks but to others.

6. Protection of Borrower by Regulating Rates of Interest.

(a) Usury laws found in most States and designed to protect borrowers.

(b) These laws difficult of enforcement and usually result in additional hardship.

(c) Application of such laws by means of legislative control never easy or adequate.

7. Criticism of Foregoing Means of Control.

(a) Remedies generally come too late to relieve evil - hence development of bad conditions which are impossible completely to rectify.

(b) Greatest danger comes from general tendencies in banking which are not revealed by examination of individual institutions.

(c) Hence Government or State oversight always unsatisfactory, and usually serviceable only in correcting dishonesty or enforcing manifest requirements of safety.

8. <u>Modern Methods of Control - Cooperative Banking.</u>

(a) In central banking countries, general restraint imposed by central bank (1) through regulation of the discount rate; (2) through determination of amount of credit to be obtained by banks on given kind of paper, (3) through constant knowledge of operations of specified banks, (4) through adjustment of general means to requirements of specified cases.

(b) When no central banking mechanism is in existence, similar results may be obtained through informal organizations, e. g., central clearing house associations of the United States which operate examination systems, regulate methods of doing business, etc.

(c) In United States central banking control now furnished by Federal reserve system (1) through establishment of standard discount rate, (2) through continuous analysis of credit of individuals and condition of banks; (3) through regular reports from member banks; (4) through special examination when necessary.

9. Relation of Government to Banking.

(a) Generally admitted that examination and inspection based on regulatory laws is necessary.

(b) Question of direct control of actual banking operations less well agreed. Nevertheless (1) prevailing practice is to give Government power to appoint either some or all of directors of central banking mechanism, or some or all of executive officers; (2) also in some cases to have the Government subscribe a portion of the stock of the central bank, thereby becoming a party in interest from the dividend standpoint; (3) or, in some cases, to have the Government own and operate a central banking institution of its own.

(c) Best consensus of opinion is that wisest control is obtained through joint management by Government and private capital; leaving to private capital the business initiative and a substantial part, or all, of the risk and profit; and to Government, exercise of conservative influence and the employment of an absolute or partial veto upon undesirable practices or policies.

10. Two Methods of Banking Control.

(a) Regulation of discount rates in such a way as to advance or restrict credit (1) generally; (2) in special cases or industries so as to equalize demand with supply.

(b) Standardization of classes of paper so as to insure maintenance of proportion of bank resources in a given form, thereby enabling community at all times to obtain necessary basic accommodation for maintenance and liquidation of current operations.

(c) Maintenance of control of directorates to such an extent as to insure nonpartisan and disinterested use of central banking funds of country.

(d) Prohibition and avoidance of operations that would tend to jeopardize the liquid condition of banks, or would tend to place commercial resources of the country at the disposal of speculative or investment operators.

(e) In general the maintenance of competition upon a legitimate basis throughout the general banking field.

11. <u>Contrast between Central and Diffused Control.</u>

(a) Diffused control, e. g., banking inspection by the several States, may result at its best in eliminating dishonesty.

(b) In applying strict regulations as to banking, such control suffers from the competition of the banking systems of the different States, it being desired to attract as many concerns to State incorporation as possible.

(c) Central control, when properly applied, goes further than diffused control by (1) applying a restrictive oversight of actual operations; (2) constantly changing the underlying conditions of banking in such a way as to maintain sound methods and eradicate any tendency to undue expansion or over development.

12. <u>Criticism of Government Control.</u>

(a) Opponents of Government control contend that banking is a competitive business, self-regulating, and not properly subject to any oversight except what is necessary to insure honesty as between banks and the public.

(b) Public takes the view that banking lies at the bottom of all commercial conditions, and the country as a whole must do what is necessary to insure maintenance of a stable and sound commercial situation.

(c) Public insists therefore, that banking is a business carried on in public interest, and hence vested with public service qualities.

(d) Refuses to grant to banks the currency function in so far as it displaces money, on the ground that circulation of money affects prices, and that profit from such circulation properly belongs to the nation at large.

(e) Public also contends that modern governments have large sums of their own which just be deposited in and handled by banks. Hence urges participation on the part of the nation in banking operations so far as based upon funds which are the property of the public.

13. <u>Status of Discussion at the Present.</u>

(a) General oversight of all banks to insure honesty and fair treatment of depositors.

(b) Joint control and sometimes joint ownership of central banking mechanism by Government and banks or individuals.

(c) Separation of note issue power and concentration of it in hands of central banking mechanism.

(d) Use of central banking mechanism as noncommercial enterprise designed as "balance wheel" of financial market.

3/2/17

-VII-.

MODES OF ECONOMIZING CASH AND PROMOTING LIQUIDATION - THE CLEARING SYSTEM.

1. Theory of Clearing.

(a) Theory of clearing based on fact that if all payments made by bank check, process of liquidation would be bookkeeping.

(b) Hence, the larger the percentage of payments offset against one another, the smaller the amount of money used.

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(c) It is desirable to economize the use of money for obvious reasons.

(d) Hence, clearing is not only matter of labor-saving and convenience, but also necessary factor in maintenance of bank reserves intact.

2. Relation of Clearing to Central Banking.

(a) Clearing idea essentially involves combination or cooperation of banks in order to bring about general participation in bookkeeping process of offsetting claims.

(b) Where regularly organized clearing houses exist such offsetting may result in transfer of final balance in cash, or balance may be transferred in form of claims on cash in clearing house, or in some designated bank.

(c) Where central banking institution practically acts as clearing house, transfer of balances occurs on books of reserve or central bank.

(d) Result is to bring about economy in use of reserve cash.

3. <u>Relation of Reserves to Clearing</u>.

(a) As already seen, "reserves" are not necessarily "cash", but are a portion of bank resources put into shape to perform function of meeting and liquidating claims.

(b) "Checks" or "drafts", which are items that figure in clearing, are demand claims on banks, hence plan for liquidating them is part of reserve function.

(c) Such demand claims may likewise, to certain extent, figure in reserves of bank without causing serious danger.

(d) Consequently National Bank system has allowed balances with city banks counted as reserves, to be composed in part of uncollected checks deposited there for purpose of collection or clearance.

(e) Under Federal Reserve Act question of allowing such checks or claims to figure as part of "reserve credit" on books of reserve banks, rests with Reserve Board.

(f) Up to date Board has declined to allow such checks so to count, and has cleared them only on a time basis, giving credit when collected.

4. Problem of Uncollected Checks.

(a) Where territory embraced in a clearing system is large, time required in transmitting checks may also be large.

(b) When such time exceeds period between close of business day and beginning of another, so-called "float" is created, during which if checks are credited by receiving bank before they reach bank on which drawn, provision must be made for "carrying" them.

(c) This is equivalent to an investment in uncollected checks, but if such investments are practically equal the country over, no harm is done through immediate credit, although there may be theoretical loss to banks on account of sacrifice of interest.

(d) Such investments are not equivalent at all times, however, and hence there may be adverse currents of exchange involving eventual transfers of funds and meanwhile a considerable float.

(e) This situation may be partially corrected by national clearance.

5. Clearing System of United States.

(a) As already noted, clearing houses may exist elsewhere, and in fact exist in more or less developed form at over 160 places in United States.

(b) Each clearing house has its own set of rules, regulations, etc., governing clearance of items.

(c) Every Federal reserve bank now receives checks on all member banks, and on nonmember banks that will clear them at par, and credits the same on its books, after allowing designated time for collection.

(d) Gold Settlement Fund at Washington provides weekly telegraphic clearance for Federal reserve banks among themselves.

(e) Nucleus of national clearance system thus developed inasmuch as all national banks members of reserve system, while reserve banks are usually members of local clearing houses.

(f) Problem of completing national system of clearance depends on obtaining aid of nonmember banks not now included in system.

6. <u>Theory of Exchange Charges</u>.

(a) Two views of this problem - one that bank's obligation should be equivalent to currency and collectible at par everywhere it circulates; the other that par payment is properly to be expected only at counters of banks drawn upon.

(b) In practice, checks of a solvent bank always cashable at par in city where bank is located, and custom has made such checks so cashable at various other points as result of competition.

(c) Banks which make exchange charges do so on theory that cashing checks means expense for clerical hire, and loss of interest during time check or draft is in transit, as well as possible cost in providing funds at distant points.

(d) Those opposed to this view point out that function of bank is to provide medium of exchange, and popular agreement long ago made notes cashable at par, so that checks should be on same basis. Under normal conditions, many claim, exchange currents offset one another, and loss is only theoretical - i. e., a profit that might have been made. Cost of clerical hire, etc., is practically cost of conducting the bank.

(e) Tendency is toward establishment of par collection with either no charge, or uniform moderate service charge based on number of items.

(f) Such charge as is made to public is in theory to be placed upon drawer of check, and not on payee who is presumably receiving a flat sum to which he is entitled.

7. Relation of Clearance to American Banking.

(a) Check collection system has become closely interwoven with "redeposited reserve" plan.

(b) Abolition of latter necessarily means provision for former.

(c) Hence effort of reserve system to utilize machinery provided by it in order to take care of collections for member banks.

(d) In absence of such service, member banks would have to go on paying city banks for performance of functions now technically rendered by reserve banks.

(e) Clearing thus an integral part of reserve system, essential to smooth working of reserve institutions.

(f) Experience shows that work can be cheaply done by reserve banks, and that eventually with all banks joining in collection plan, cost would be reduced to low figure.

(g) Opposition of banks due to desire not to lose profit from exchange on checks, and feeling that reserve collection system subjects them to unnecessary oversight or an extra expense through keeping funds in cities in addition to funds held with reserve banks.

8. <u>Clearance Systems Abroad and at Home</u>.

(a) On Continent problem does not appear in same form as here owing to preponderating use of note currency and low development of check.

(b) In England situation is likewise different owing to absence of fixed reserve requirements and small area of country.

(c) Clearing system, therefore, an American problem, rendered special because of (1) extensive use of check system, (2) great size of country, (3) fixed reserve requirements, and (4) difference of view as to whether uncollected items should or should not figure in "reserve balances."

(d) In United States experience of widely diffused system of competitive institutions without central or combined banking, has until lately, rendered issue difficult of settlement.

( ) Reserve system with its arrangement for cooperation will eliminate much of this difficulty.

3/8/17.

VII.

COMMERCIAL PAPER - ITS VARIETIES AND PECULIARITIES.

1. Meaning of Commercial Paper.

(a) Commercial paper is the material in which banks deal

(b) It is the evidence of commercial transactions.

(c) Hence no rigid definition of commercial paper can be given apart from general principles on which bank is conducted - i. e., commercial paper in one country may be different from commercial paper elsewhere.

2. Significance of Commercial Paper.

(a) Terms, condition and basis of commercial paper determine liquidity of bank and ability to get its funds in hand when needed.

(b) Legal principles and practices surrounding commercial paper determine validity of bank's operations and relation to business community.

(c) Volume of commercial paper offered at any given time is index to volume of transactions of community.

3. Classes of Commercial Paper.

(a) Single-name paper - ordinary commercial note or promise to pay.

(b) Endorsed single-name paper - additional signature being merely additional evidence of goodness.

(c) Bill of exchange drawn by seller on buyer, or "two-name" paper evidencing commercial transaction.

(d) Bankers' acceptance - bill of exchange drawn on bank and accepted by latter on behalf of someone else.

(e) Endorsed acceptance - same as above, but with additional guarantee.

(f) Collateral note - single-name paper secured by evidence of value - sometimes called "commodity paper" when collateral consists of claims to staple goods. May be secured by stock, bonds, etc.

(g) Foreign or domestic bill of exchange accompanied by shipping documents, insurance receipts, etc.

(h) Miscellaneous variations of foregoing (see regulations of Federal Reserve Board attached hereto).

4. Classification of Commercial Paper.

(a) By maturities - short-term paper usually regarded as outgrowth of live or liquid commercial obligations; long-term considered less liquid, but both dependent on normal term of credit in community for validity.

(b) By protection. Two main classes of protection good in process of production, transit, delivery or sale and existing values, such as shares, bonds, real property, etc. Pure personal credit not a separate classification, but merely evidence of belief in eventual control of property.

(c) By maker or originator. This relates to the form of paper, although certain kinds or forms are closely allied with certain kinds of security or protection.

5. Modes of Testing Commercial Paper.

(a) Test of value of commercial paper is test of two elements - solvency of maker and liquid condition of his assets.

(b) Both tests applied by obtaining satisfactory "statement". Such statement calls for an underlying accounting analysis which varies somewhat from business to business.

(c) Valuation of items or property is essential, and may be effected through outside appraisement by way of checking validity of statement.

(d) Ascertainment of reliability of commercial credit involves elaborate study of variety of factors - this accomplished through credit agencies and reports of investigators.

(e) Commercial paper rating is composite product of judgment as to solvency of maker, and judgment as to promptness of payment, due to liquid condition of persons directly liable.

(f) Work of testing credit is important phase of banking and usually entrusted to separate division in charge of experts, while officers of banks spend much of their time in credit analysis.

(g) Direction of credit analysis varies according to preponderating activities of bank, whether chiefly employed in short-term commercial loans, loans on stock, or other forms of enterprise.

6. Commercial Paper and Currency.

(a) Sound theory of bank currency bases its volume on volume of transactions.

(b) Commercial paper is evidence of transaction, hence kind and quality of commercial paper has intimate relation to currency.

(c) Most modern banking systems regulate note issue by relation to commercial paper.

(d) Federal Reserve Act provides for segregation of 100% commercial paper behind notes.

(e) Absence of such protection deprives bank of steady flow of funds with which to provide for liquidation of notes when presented for redemption.

7. Rediscount of Commercial Paper.

(a) Reliability of paper increases as number of sound endorsements increases.

(b) Best form of commercial paper is that growing out of business transactions with guarantee of strong financial institutions.

(c) Rediscounted paper is paper discounted by one financial institution for another. Such paper constitutes best protection of notes.

(d) Bank rediscounting primarily concerned with solvency of concerns presenting paper - only indirectly with that of maker - work of judging, as well as that of carrying, responsibility, is thus divided.

8. Purchase of Commercial Paper.

(a) Different from rediscounting in that it must be paid for, while in rediscounting proceeds are credited.

(b) Moreover, in purchase, paper may be bought with or without recourse.

(c) Such open market purchases are, therefore, a secondary field of operation after rediscounting has been resorted to and fails to supply the volume needed.

(d) Purchase of paper necessary as expedient of market in which bills and notes are freely offered for sale, and in which interest rates are fixed as the result of competition.

9. Principles of Development of "Portfolio".

(a) Careful selection of paper with view to maturity.

(b) Selection of paper with view to diffusion of liability.

(c) Selection of paper with view to division of makers between different industries.

(d) Selection of paper with view to geographic distribution.

(e) Selection of paper with view to equalization of sizes of units.

(f) Main object is to secure compensating or balanced holding of paper in which risks offset one another.

3/15/17.

VIII.

TESTING THE CONDITION OF THE BORROWER - HIS BUSINESS ELIGIBILITY.

1. Significance of Borrower's Condition.

(a) From the preceding discussion it is evident that bank depends upon borrower for maintenance or convertibility, of credit. Bank guarantees convertibility, but guarantee can not be fulfilled unless average judgment of condition of borrower is sound.

(b) Ascertainment of actual condition of borrower is, therefore, essential factor in bank's operations.

(c) Borrower's analysis of his own condition and observance of sound principles necessary in order to enable him to meet obligations.

(d) Two-fold problem thus presented (1) What is "soundness" in condition of borrower, and (2) What method can best be used by bank to protect itself against deceit and imposition.

(e) Questions thus raised partly those of accounting and partly those of obtaining quick information.

2. Analysis of Borrower's Condition.

(a) Question of solvency. Bank is, of course, primarily interested to know that borrower is sound, but solvency is only one fundamental. It must be ascertained by usual methods - correct accounting, proper valuation of assets, suitable allowance for depreciation, etc.

(b) Banker declines ordinarily to have any relation with concern which is either insolvent or on verge of insolvency.

(c) Assuming solvency, banker's primary interest is in question of liquidity - he wishes to know whether concern is asking for fixed capital or current accommodation

(d) If concern wants capital practically on permanent loan, amount banker is willing to extend would be much smaller, if what is desired is liquifying of short term commercial claims, banker is willing to go practically to extent of his resources.

(e) Basis of analysis is relation between turn over of capital and investment, amount of outstanding obligations, as compared with incoming or accruing claims; "goodness" or liquidity of claims, and current activities of business which mean salability of producer's own goods. These factors differ from industry to industry in significance and relative importance.

(f) Question of commercial policy. Sound business policy essential factor, if concern is large but business sapped by excessive dividends or withdrawals, or if expense of carrying on business is unduly high, banker will hesitate as to extent of loan. His effort is to obtain details as to policy as accurate as possible.

3. Criteria of Banker's Choice.

(a) As already stated, solvency essential, although bank may at times find it wise policy to help a concern technically insolvent.

(b) Assuming solvency, banker's effort is to discriminate between long term loans which are liquid and short term, or strictly commercial loans.

(c) In long term loans, banker is willing to go to extent permitted by probability of safety and ultimate liquidation if forced. Regards such loans as undesirable and to be made only for encouragement of more satisfactory business.

(d) In all applications for loans beyond this basic element of long term investment, banker anxious to expand his operations so far as resources will permit.

(e) Limitation on operations furnished by desire not to expand beyond point of safety as indicated by capital and reserves of institutions, also not to enlarge risk in any one case beyond point of safety, also not to become involved too closely with affairs of any one concern or type of business.

(f) Desire of banker is to supply credit to dealers who are most successful in rapidly turning over capital, not only because of capacity to earn profits, and consequent safety, but also because they are most profitable customers for banks both as to volume and character of accommodation sought. Banker makes profit from rapid turn over of funds, not from long term loans.

4. Relation of Bank to Accounting System.

(a) As already seen, correct accounting is essential.

(b) Further, uniform accounting is urgent.

(c) In addition, standardized accounting is desirable.

(d) Business practice in United States is loose as to accounting methods.

(e) Hence reliance upon sound firms of accountants who examine books, criticize methods and reduce results to a somewhat uniform basis, thus permitting of rough standardization and comparison.

(f) Banker calls first for statement of condition, and if this is unsatisfactory or incomplete, obtains audit or analysis, through accounting firm which advises him of condition of affairs, as well as policy as shown by books.

5. <u>Relation of Banker to Credit Agencies.</u>

(a) Function of credit agency is to ascertain full facts as to conduct of business man in connection with settlement of claims against him, state of his business as reported by himself, and tested by outside criteria, and other matters.

(b) Result is body of data indicating general trustworthiness of business man.

(c) Banker relies on data thus furnished in making his loans.

(d) Credit agency data, however, not usually sufficiently complete, and consequently banker supplements them by data obtained through unofficial or private credit agencies. These are compiled from a great variety of sources with remarks indicating relative value of items of information.

6. <u>Organization of Credit Department.</u>

(a) Credit department necessary feature of modern bank.

(b) In large banks consists of elaborate system of files in which are embodied all credit data together with analyses of borrowers' capacity in regard to accommodation and general financing of business.

(c) Effort of credit department is to furnish on short notice tabulated, condensed view of situation of prospective borrower, showing particularly liabilities and their maturities, relation of liabilities to quick assets, and contingent liabilities, if any, and general status of borrower.

(d) Credit department also includes outside staff of regularly or sporadically employed individuals who furnish data likely to be useful.

3/22/17.

IX.

BANK ORGANIZATION AND RELATIONSHIP IN INTERNATIONAL BUSINESS.

1. <u>Function of "Foreign Exchange"</u>.

(a) As already seen, bank performs function of providing means of payment at a distance and collection of resulting documents. This is fundamental service in foreign exchange operations.

(b) As further seen, bank furnishes credit for the purpose of "carrying" goods, and this process may imply the furnishing of credit during a productive period or during a period when the goods are in transit, hence commercially out of reach. Latter phase of this function is that performed by bank in foreign exchange relationship.

(c) Function of supplying capital for investment is performed by many banks, and when undertaken by one country for another must be carried out through banking mechanism which can make use of foreign exchange methods.

(d) These functions are the same when performed internationally as when performed domestically, except in two particulars (1) Conversion of values from one currency to another, and (2) Transference of funds from one more or less isolated market to another. "International trade" and "foreign exchange" between Maine and Canada are conducted on the same principles as "domestic trade" between Maine and California.

2. Effect of Variation in Money Standard.

(a) Money standard of different nations may differ as to (1) basic material, or (2) unit value of coin, or (3) both.

(b) Where material is identical but unit value is different as, e. g., dollar and pound sterling, fundamental function of bank is to convert coined money or its representatives into one or the other kind of money, buying and selling, according to demand.

(c) Where basic metal is different, as, e. g., American dollar (gold) and Chinese dollar (silver), function of bank is to deal in gold value expressed in silver, and vice versa, and at times to supply gold or silver, as the case may be, for export, or to receive and sell it.

(d) Where both elements enter, function of bank is same as last stated.

3. Organization of International Banking.

(a) If no established relationship between banks of one country and banks of another, owing to fact that they belong to different systems, international work of bank is merely that of buying and selling foreign currency and claims to credit.

(b) If relationship established, basis for systematic trading is laid and credit begins to enter in.

(c) In this case, bank here may act as agent or correspondent for a foreign bank, or foreign bank may establish actual branch office here, or may arrange to control a local institution.

(d) In every case fundamental change is introduction of credit into relationship of bank in international dealing, which means that payment may be postponed, and that bank becomes merchant in international credit instead of merchant in gold and silver.

(e) From internal standpoint this necessitates opening of "foreign exchange department" in bank.

(f) Foreign department is usually organized on separate basis with separate set of records designed to permit of statement of relationship in terms of foreign currency, i. e., bank account is altered to permit change in basic unit of value, and periodical "conversion" must take place. Sometimes also definite portion of bank's resources is sot apart for trading in foreign exchange. Where foreign branch is established given "balance" is usually assigned to such branch; and transfers made from time to time to increase its resources as occasion requires. Where foreign bank is is designated as correspondent, balance is placed on its books to credit of home institution. This balance carried in terms of currency of country where foreign institution is located.

4. Dealing in Coin and Bullion.

(a) Simplest "foreign" operation is purchase of coin of foreign country composed of metal same as domestic standard.

(b) If metal unit of foreign country contains, say, 4.8666 times as much gold as home unit, bank may purchase title to a unit of such gold actually located in foreign country. In such case, exchange is at "par" when bank is willing to pay exact gold equivalent of foreign unit - in this case $4.8666 for one pound sterling.

(c) Modification in problem seen when pound sterling is located here and not abroad. In this case purchasing value may be $4.8666 less cost of conversion into coin, if any, loss of interest due to time metal is idle, etc. Assuming existence of such par exchange in two countries simultaneously - England and America - theoretical price to be charged by bank for supplying individual with title to pound sterling is gold equivalent plus cost of transportation, plus interest in transit, plus insurance and other charges, because individual would have to incur these expenses if he shipped local gold and then sold it to English banks at par. In same way theoretical amount home bank will give for title to gold in England is gold equivalent less amount equal to transportation, insurance, interest, etc., coming in opposite direction.

(d) Points above and below gold equivalent of par which will cover shipping and other costs, known as "gold points".

(e) If exchange were at gold point, individual would not need to rely on bank, but could effect his own dealings.

(f) Practical foreign exchange operations, therefore, are concerned with fixing actual ratio of exchange at some point intermediate between "gold points".

(g) Problem in foreign exchange is to adjust supply and demand in such a way as to avoid shipment of gold.

(h) Real function of bank is thus seen in offsetting or clearing international claims with shipment (and conversion) of as little gold as possible.

5. Interchange of Gold and Silver.

(a) Foreign exchange operations between gold and silver may be simply purchase of silver against gold and vice versa.

(b) Or, where credit relationships established, as above explained, may be clearance or cancellation of series of credits and debits resulting in net balance which is converted from silver into gold and vice versa.

(c) Bank's profits or losses during continuance of operation consist of charges based not merely on regular exchange service, but also on conversion of gold into silver units according to market variations of one metal stated in terms of the other.

(d) In all such operations interchange of metals does not necessarily take place in fact, but liability for interchange, in case payment is demanded, is assumed by bank.

6. Supply and Demand in International Exchange.

(a) Establishment of selling or buying point for one currency in terms of another evidently dependent on comparison of volume of claims on one country, as compared with demand for remittances.

(b) Volume of remittances dependent on quantity of goods purchased and requiring payment, while volume of claims dependent on quantity of goods sold and to be paid for.

(c) "Goods" as here used include commodities, services, interest and dividends, travelers funds, and variety of minor factors - anything giving rise to an indebtedness.

(d) When such demand or supply is one-sided, artificial resources may be availed of by arranging to create credit balances abroad.

(e) This done through ordinary loan arrangements, establishing loans or credits in favor of foreign banks.

(f) Therefore, arrangements giving rise to artificial credits suffice to bridge over period until payment made in "goods", or "goods" received. Exports and imports eventually equal.

3/28/17.

IX
(Continued)

CLASSES OF PAPER IN INTERNATIONAL TRADE.

1. Fundamental Types of Paper.

(a) "Bill" or "bill of exchange" is the underlying type of document.

(b) This represents paper drawn against actual shipments of goods from one country to another.

(c) "Bill" in foreign, as in domestic trade, is order to pay specified sum at sight or at maturity.

(d) Differs from domestic bill chiefly in requiring more careful protection and frequently in being stated in terms of a foreign currency.

2. Documents.

(a) Foreign bills usually protected by "documents", including bills of lading, properly drawn, certificates of issuance, hypothecation powers, invoices, consular and other certificates, etc.

(b) These documents must be made in accordance with local law and administrative regulations, and must give to the bank power to facilitate movements of goods, and to retain control of them until released.

(c) "Complete set" of documents practically places in hands of bank control over goods constituting basis of credit extended.

3. Clean Bills.

(a) By "clean bills" are meant bills without documents attached.

(b) Protection of banker purchasing clean bills dependent entirely on credit standing of persons against whom drawn, and eventual liability of drawer.

(c) In case of accommodation based on clean bills, advance is practically a loan on two-name paper.

(d) Documented bill becomes identical with clean bill when banker releases the documents to consignee of the merchandise, though he may protect himself by so-called "trust receipts" which establish different legal status for borrower.

4. Finance Bills.

(a) By finance bill is meant bill drawn for purpose of providing funds to meet requirements, independent of actual shipments of goods.

(b) Finance bills may be drawn for the purpose of offsetting difference between exports and imports, or for any other purpose requiring immediate funds.

(c) Such bills are really drafts against loans negotiated with foreign bankers.

(d) Protection for finance bills may be collatoral of any kind placed with concern agreeing to make payment of bills which are thus drawn.

5. Commercial Letters of Credit.

(a) By commercial letter of credit is meant authorization issued to importer in order to enable him to obtain goods abroad to be paid for by bank in foreign country, which in turn collects from bank at home extending credit.

(b) This enables purchase of merchandise on cash basis.

(c) Banker who furnishes the credit does not ask for payment until maturity of draft and arrival of goods.

(d) Banker is thus protected by ownership of goods until their arrival and release to importer.

(e) Confirmed letter of credit is one that can not be revoked without consent of payee.

6. Types of Paper in International Trade.

(a) From foregoing it is seen that loans or advances in international trade are same as in domestic trade.

(b) Form, however, is different owing to closer adherence to commercial movements of goods as basis for business.

(c) Protection is more thoroughly worked out than in most bank loans at home, partly owing to varying legal requirements of different countries, and partly owing to uncertainty as to exact financial or business conditions surrounding each transaction.

(d) Technique of management of paper also differs, inasmuch as complex relation between banks is introduced, and hence the necessity for some provision protecting such banks' interests against one another, as well as against borrower.

(e) Foreign trade also implies continuous maintenance of given sum of banking capital in financing trade in given district, and effort so far as possible to have movements of goods and operations for financing such movements offset one another so as to have credits, as well as shipments of goods, cancel as nearly as possible.

4/5/17.

X

THE FOREIGN EXCHANGE MARKET - ITS ORGANIZATION AND METHODS.

1. Idea of "Market".

(a) General conception is same as that of any other market, i. e., aggregate of buyers and sellers who deal with one another.

(b) Analysis of market thus becomes analysis of supply of bills drawn in foreign transactions, and analysis of demand for such bills or remittances growing out of them.

(c) Associated with this analysis of demand and supply is analysis of agencies for performing work, including both the methods of dealers and of middlemen and speculators.

2. Origin of Bills.

(a) Supply of foreign exchange is supply of instruments of value growing out of all those transactions which give rise to claims by one country on another.

(b) As already seen these are claims originating chiefly as follows: (1) raw or manufactured products purchased; (2) securities bought; (3) interest upon capital invested abroad; (4) money borrowed; (5) expenses of travelers; (6) freight and insurance.

(c) Demand for remittances is converse of above, i. e., is due to the need of meeting obligations growing out of transactions based on these same elements.

(d) Distribution of control of foreign exchange naturally adjusts itself according to character of operations, one class of remittances originating with customers of given kind of institution, another with another.

3. Commercial Banks and Their Operations.

(a) As seen in former analysis, foreign exchange function of commercial bank is that of opening credits for payment of goods, and making transfers - latter function grows out of or is dependent on former.

(b) Customers of commercial banks are exporters and importers who want to have bank finance movement of goods. Such operations give rise to balance in favor of or against banks abroad, and to some extent "clear" on books.

(c) Remittances called for may be necessitated in order to offset or liquidate balances, or to enable individual simply to sell or transfer funds.

(d) Commercial banks may purchase and sell bills or remittances in this way, waiting for maturity of obligations and paying and offestting them then, or they may buy and sell drafts or claims of different maturities, engaging in exchange business with other banks in domestic field or abroad. This trading process may be intended either as a means of making earnings or as a means of insurance against loss.

4. Private Banker and "International Banker".

(a) Operations of private and international bankers are usually either brokerage or finance operations.

(b) Concerns of this kind have connections or branches abroad, and find a profit in transfers of funds in order to take advantage of varying rates of interest to purchase or carry securities abroad, or to use foreign funds in home market.

(c) Such operations give rise to "finance bills" which do not grow out of any distinct commercial operations, although eventually liquidated by movement of specie or goods.

(d) Bankers' acceptances may be used in international trade to create balances for the purposes before mentioned, or they may grow out of actual commercial transactions, and may then be marketed through private or international bankers.

5. Brokers and Middlemen.

(a) Inasmuch as no definitely established market for foreign exchange exists, there is field for service of broker or middleman.

(b) This service may be merely conveying of information from bank to bank and carrying through of transactions necessary for interchange of claims. Or it may consist in actual purchase of bills and sale to someone else, in which case broker or middleman approximates to private banker.

(c) Some houses engaged in international trade conduct foreign exchange departments which operate not only in exchange growing out of business of the concerns, but also out of other business, thus becoming practically foreign exchange brokers in addition to other functions.

6. Work of Commercial Houses.

(a) Normally commercial house merely opens credit with necessary, or disposes of drafts as case may be.

(b) Commercial house may, however, foresee fluctuations of exchange market, and hence contract with bank for purchase or delivery of exchange at future dates in specified amounts at contract rates.

(c) Commercial house may actually purchase bills and hold them in order to supply itself with remittances at future time.

(d) In all such cases commercial house becomes speculative factor in exchange market.

7. <u>Mechanism of Market.</u>

(a) As just seen, market contains several classes of factors differently organized.

(b) No definite meeting place or basis of interchange.

(c) Nevertheless stable quotations established through action of large dealers in fixing their rates.

(d) Competition then results in "shading" of rates with modification for various transactions because of special conditions influencing them.

(e) Government interference with movement of specie, or Government action for supplying or withholding remittances establishes artificial conditions, and either introduces new factor in market, or sets limit to fluctuations, as case may be.

4/12/17.

XI.

INTERNATIONAL DISTRIBUTION OF CAPITAL.

1. <u>Character of Demand for Capital</u>.

(a) Rate of interest a payment for capital not money.

(b) Rates to be earned determine rates that will be offered.

(c) International competition the same in theory as competition between individuals or localities.

2. <u>Form of Foreign Loans.</u>

(a) When short in form; merely give rise to bankers' balances carried on books; or short term paper of ordinary "finance" varieties.

(b) When longer; are represented by bonds as in case of other loans.

(c) In either case require to be placed with investor or holder.

3. <u>Mode of Payment of Foreign Loans</u>.

(a) This best approached by considering purpose of such loans.

(b) Such purpose is not that of getting control of <u>money</u> except in rare instances.

(c) It is rather the getting control of goods either for consumption or production.

(d) Foreign loans are thus essentially transfers of goods (although sometimes of money) in exchange for obligations.

4. Effect of Foreign Loans on International Balance of Trade.

(a) Creates permanent item of interest.

(b) To the extent or amount of such items it becomes no longer necessary to ship goods to make up full merchandize balance.

(c) Loan operations affect exchange market directly by leading to necessity of supply of exchange to meet obligations.

5. Control of Exchange and Monetary Movements.

(a) Method is to supply exchange or withhold it.

(b) This method practiced on short term basis by bankers in order to equalize temporary differences in supply of bills growing out of commercial shipments.

(c) When movement of specie is continuously against a country, Government may undertake to supply exchange through the placing of public obligations or through other artificial methods of meeting demands (illustration afforded by "gold pool" established in the United States at opening of European war).

(d) At times the practice of artificially furnishing exchange may be adopted as regular basis of control of monetary relationships by Government, as seen in the case of India and the Philippine Islands.

6. Effect of Specie Movement.

(a) Eventually it is necessary to liquidate trade balance which is continuously unfavorable by shipment of specie due to fact that conditions of sale of securities are likely to be unfavorable if plan of such sale is carried too far.

(b) When specie moves from one country to another it usually goes into bank reserves.

(c) Effect is to increase lending power of banks, hence to reduce rates of interest.

(d) Effect of this reduction is to supply buying power and to raise prices, while through influence on the investment of capital the tendency is to cut rates of interest.

(e) In consequence country tends to increase in cost of production and loses its competitive advantage.

(f) Under ordinary conditions this results in gradually restoring balance of trade.

7. Debtor and Creditor Countries.

(a) Creditor countries are those in which process of saving and investing capital has resulted in more or less complete utilization of domestic resources leaving investment surplus for use abroad.

(b) Debtor countries are those in which funds have been needed for local use, and because ordinary interest returns have been higher.

(c) Creditor countries are able to maintain their hold on trade of debtors by dictating form in which remittances shall be made, and by offering satisfactory financial market for disposal of bills.

(d) This ordinarily means that creditor countries are bankers for others.

8. International Position of United States.

(a) Before war - borrower not engaged in financing foreign trade - in debt about 2 billions.

(b) Since war - lender and financier of foreign trade.

(c) Future - depends on intensity of desire to develop own country as against operations in foreign countries.

4/19/17

XII.

RATES AND COMPETITION FOR CAPITAL.

1. Distinction Between Long Term and Short Term Competition.

(a) Long term capital is supplied through mechanism already studied, and distribution depends upon conditions governing investments.

(b) Short term capital is supplied for temporary or short term operations, and may not require or presuppose any long term investment.

(c) International money market may, therefore, be afforded by country which has no surplus capital for investment, although ordinarily country which is large lender of capital also develops banking machinery for short term operations.

(d) Short term competition primarily a matter of discount rates and banking facilities; long term is matter of investment and financing.

2. Mechanism of International Money Market.

(a) Essential factor is rate of discount which can be allowed on the use of banking funds for facilitating movement of goods.

(b) Second essential factor is ability to furnish actual banking conveniences for collections, opening of credits, etc.

(c) Third essential is ability to operate banks under most economical method and with approved types of paper.

(d) Fourth escential is satisfactory trade relations with foreign countries so that "market" is not disturbed by undue difficulties with trade balance.

3. Methods of International Payments.

(a) These are selected by agreement or contract.

(b) Effort of bankers connected with given market is to have merchants settle balances by "bills" drawn on market with which such bankers are connected.

(c) In times past "sterling bill" was standard method of settlement because of facilities held out by England.

(d) Selection of money unit in which to draw bills is determined by conditions governing sale of such bills.

(e) Bills drawn usually distributed by currency unit according to market on which they are drawn in first instance, while bills which would ordinarily be drawn on minor markets are shifted to major markets according to facilities for sale or disposition as already indicated.

. Conditions Determining Location of Financing.

(a) Fundamental consideration is level of discount rates for first class commercial paper.

(b) Development of banking with branches and agencies and other international connections, has important influence.

(c) Extent of country's financial interests abroad, investments in foreign countries, etc., has underlying influence in directing business to home market.

(d) Character of country's foreign business and degree of permanence tend to influence permanence of foreign financing which comes to it.

5. <u>International Competition Among Bankers.</u>

(a) Bank which has abundance of funds desires to have bills drawn on it and thus keep its funds employed.

(b) When funds are fully occupied, banker endeavors to secure assistance of some intermediary country by arranging to draw bills on it (illustrated by present position of United States and Great Britain).

(c) Selection of intermediary country depends on cost of establishing bankers' balances there. This depends somewhat on international arrangements, and somewhat on prevailing rates of interest.

(d) One determining influence at any given time may be condition of balance of trade which affects exchange rates, and so alters basic cost of providing remittances.

6. Influence of Balance of Trade.

(a) In general, in order to carry on financial relations with any country, basis must be laid by establishment of good commercial relations.

(b) This means that extension of banking business abroad is associated with extension of sale of goods.

(c) Financial facilities also react, as already seen, upon development of commercial business.

(d) Summary: - Basic considerations influencing short term financing and current sale of goods found in relative discount levels of trading countries and in conditions surrounding export of capital.

4/27/17

XIII.

MONEY PRICES, AND CREDIT.

1. Definition of Money Value.

(a) Price a statement of relationship between goods and money.

(b) Money not a final good in itself, but a means of transition to some other good.

(c) Hence price really a mode of expressing the value of any one good or article in terms of all other goods or articles.

(d) "Value of money" is converse of other expressions of value which state such value in terms of money.

2. Theory of Prices.

(a) Theory of prices is analysis of factors governing relationship between money and goods.

(b) If "money" were an abstract purchasing power or unit representing control over an aggregate of different goods, theory of prices would be theory of values in general.

(c) When money is introduced, peculiarity of the analysis is seen in fact that it is narrowed so as to bear specially upon elements relating to the exchange power of the money-article.

(d) Most discussions of prices thus tend to become special discussions of factors directly influencing the value of money itself. While factors of value which are common to all classes of goods are taken for granted.

3. Conflicting Views of Prices:

(a) Original "quantitative" theory of money states that prices vary according to variations in supply of money.

(b) As economic activities became more complex, this necessitated various refinements upon definition of "quantity of money."

(c) Eventually there was developed the so-called "credit theory of prices," which regarded price as outcome of aggregate of factors representing purchasing power.

(d) Principal difference between conflicting theories found in definition assigned to term money, and in analysis of factors influencing its supply.

4. Nature of Credit..

(a) Various definitions but two chiefly in opposition: (1) That credit is a "short sale of money", i. e., merely a deferred agreement to deliver money. (2) That credit is purchasing power based on the possession of goods and merely stated in terms of money. The latter idea the correct one.

(b) Object of using credit to dispense with use of money (1) because of expense of using it, (2) because of greater speed and convenience without it.

5. Effect of Use of Credit.

(a) Two primary or original views on the topic. (1) That use of credit is equivalent in effect to use of money and affects prices in same way. (2) That credit acts as substitute for money, and relieves money of demand which would otherwise fall on it, prices being simply transferred to credit exchanges from the money exchange.

(b) Electric view more recently developed is combination of foregoing and is that credit and money normally operate together as media of demand for commodities; relation between money and commodities being established by comparison of demand and supply in exchange system of which credit forms integral part.

6. Relation of Credit to Prices.

(a) Under any given conditions if new volume of goods comes into existence they lead to creation of credit at banks and elsewhere sufficient to effect their exchange. In such case no influence on prices, but some strain which would have fallen on money is lifted off.

(b) In certain cases credit may be granted out of proportion to real values created or exchange work to be done. Such exchange of credit may lead to undue amount of purchasing power in certain hands, and this tends to increase demand for commodities, hence causes rise of prices.

(c) In either case over-conservatism or "panic" may lead to withholding of credit which would otherwise have been granted. This may lead to lessening of demand for commodities, hence fall of prices.

(d) In some cases derangement of normal credit arrangements may result in unusual call for money to settle with; prices, however, remaining unchanged.

7. <u>The Bank and the Money Supply</u>.

(a) Two views regarding the function of bank in relation to money, (1) one treats it as a means of providing a substitute for money. (2) the other as a means of effecting transactions without the necessity of any reference to money.

(b) First effect of banking operations is to provide means of exchange which economize or reduce necessary use of money.

(c) Secondary effect is to render circulation of money much more rapid, thereby enabling a given quantity of money to perform larger number of exchanges.

(d) Incidental effect of banking is to equalize stocks of money, and hence to bring about equilibrium of prices both locally and internationally.

8. Relation of Banking to Price Level.

(a) Banking comes into existence on basis of established price level. Relation of bank to this existing price level is one of steady and constant modification.

(b) Effect of bank operations is to stimulate exchange and production, while encouraging use of money stock as banking reserve.

(c) Rise or fall of reserve tends to affect supply of credit, hence to increase or decrease means of transferring goods.

(d) Fluctuation in supply of bank credit also tends to influence direct payment for goods, hence to affect prices.

(e) Such influence on prices tends to bring about readjustment of money domestically or internationally, hence to establish similar relationships between money and goods throughout world.

(f) Banking is thus direct influence through which price level is altered (1) by reflecting change in activity of the process of exchange and in the conditions of supply of credit, (2) by directly affecting the supply of bank credit itself through changes in reserves, and hence in the volume of credit which can be extended by bank at given time.

9. Ultimate Problem of Prices as Influenced by Banking Credit.

(a) If bank credit merely eliminates certain transactions from entering into money exchange, effect of banking upon price problem is negligible from long-range standpoint although significant temporarily, and prices are basically established in that range of operations which are conducted on a money basis.

(b) If bank credit is merely a substitute for money, foregoing conclusion must hold generally good.

(c) If bank credit is regarded as one element among factors of demand, coordinate with money, fluctuations in bank credit are real fluctuations in demand for goods, hence bank credit may be regarded as playing the same part as additional "money" supply, and prices may be considered with bank credit treated as an essential element in equation.

(d) From this standpoint, analysis of price becomes largely analysis of all factors tending to influence activities of exchange, and convertibility of goods into purchasing power.

5/3/17.

XIV.

BANKING AND ITS RELATION TO MONEY AND PRICES
(Continued)

1. Mechanism of Money and Banking.

(a) Under conditions where money is used as medium of exchange, but no banking or credit system in operation, assume creation of banking mechanism.

(b) Immediate effect is to withdraw portion of circulating medium and simultaneously provide a credit mechanism capable of supplying a means of effecting exchanges as needed, up to much larger amount.

(c) Banks stand ready to provide this circulating medium by converting claims upon wealth into means of payment, or, in other words, "extending credit."

(d) This system enables owner of wealth to make direct payment for other wealth in form acceptable to owner thereof.

(e) Process does not create new wealth, but renders process of exchange more active and simple, than would be true without it.

(f) Process makes a demand for a given sum of money in the first instance for use as "reserve", but also facilitates transactions which might otherwise have required use of money, and at the same time renders possible or brings into existence transactions that otherwise would probably not have been undertaken.

(g) Credit mechanism thus both constitutes demand for money and influences supply of it, by obviating the necessity for as large a coinage as would otherwise occur.

2. <u>Adjustment of Level of Money Supply</u>.

(a) Banking system undertakes to place money where it will yield largest returns, in convenience as measured by interest rate.

(b) Hence if bank reserve has been unduly lessened in any country, owing to growth of credit structure with resulting increase in discount rate, banking mechanism shifts specie to that point.

(c) Effect is to prevent undue increase in price level resulting from cost of bank credit as element in cost of production, or from temporary curtailment of demand due to inability or indisposition of local bank to provide additional amounts of credit on books.

(d) Process of readjustment of specie supply thus carried out establishes stable relationship between credit system of world and underlying money basis.

3. <u>Relation of Reserve to Amount of Credit</u>.

(a) This relationship not constant either geographically or chronologically.

(b) Amount of credit which can be safely sustained by a given reserve varies widely in accordance with several factors.

(c) Hence no positive statement to be made concerning extent to which credit is "substitute" for money.

(d) Credit instruments as medium of exchange also vary in ability to satisfy wishes of community, public being at some times more ready to employ credit instruments than at others.

4. Relation of Credit System to "Rapidity of Circulation".

(a) Rapidity of circulation recognized by all economists as factor in real money "supply."

(b) Must likewise be recognized as factor in credit supply, since efficiency and availability of credit are rendered greater when given amount of credit is rendered more able to exchange goods, through improved methods.

(c) Hence variation in activity of credit mechanism implies variation in extent and effectiveness of current or immediate demand for goods.

5. Credit System and Prices.

(a) Credit system is thus seen as an arrangement or mechanism which operates to affect the strength of every factor entering into the determination of prices.

(b) May correctly be regarded as affording means of providing a "substitute for money" at times, or as rendering money more efficient.

(c) This, however, is only incidental effect of its operation.

(d) Credit system affords entirely new medium within which different factors influencing demand and supply of goods and money act upon one another.

(e) Even if conceded that change in quantity of money propuces an exactly corresponding change in prices, this could be true only under stable or assumed condition as to use of credit, because change in such condition changes relationship between other factors in price equation.

(f) Credit itself, as already seen, does not constitute "demand for goods"; but demand is, at least potentially, present in some form before credit is extended.

(g) Money must be included among goods, not only because of circulation power, but because constituent metal has a value of its own.

(h) Money, however, not to be regarded as a medium through which all exchange must ultimately or theoretically be effected, but as simply an element entering into the general equation of demand and supply.

6. General Summary.

Banking and bank credit are to be regarded as processes or means whereby exchange system of the world is facilitated and demand for goods is rendered more steady and effective. Inasmuch as extension of bank credit, and credit system as a whole, are processes without any eventual value in themselves, they are not substitutes for money, but are means of creating a condition of exchange in which money occupies a place different from that otherwise to be assigned to it. Prices can not be discussed without reference to credit situation since this tends to influence them both absolutely and relatively because it affects the conditions under which demand is exerted. Money is one element in a great aggregate of goods. It has a value dependent upon a variety of different elements of use. Prices can not be regarded as based upon a theoretical comparison of the total valume of money in existence with a given total of goods to be exchanged. Neither element in such an equation is stable at any moment, but both are variable.

5/10/17.

XV.

CURRENT BANKING PROBLEMS OF THE UNITED STATES.

1. Problem of a Combined Gold Reserve.

(a) Effect of Federal Reserve Act (1) Establishment of partial and incomplete system of organization shared in by about one-half banking capital and surplus of country. (2) Creation of a partial combination or concentration of gold reserve. (3) Inauguration of system of Federal oversight which, however, has no means of direct cooperation with State authorities.

(b) New system has shown itself effective as stabilizer of credit in peaceful times Not tested as yet by panic or international pressure or by severe government financing.

(c) Question now to be met in this connection is the means of securing organization of complete system able to carry the load of public demands and maintain convertibility of whole credit structure.

2. Problem of Elastic and Sound Currency.

(a) Coexistence of variety of different kinds of note issues, including three classes of bank note.

(b) Difficulty of eliminating bond security behind notes, and putting issues upon a basis of sound commercial paper.

(c) Failure to recognize bank note as form of credit, hence tendency to include it as bank reserve in State institutions.

(d) Difficulty of securing note issue based solely on commercial paper instead of on bonds or long term investments.

3. Problem of Introducing Sound Method of Financing Business With Commercial Paper.

(a) Prevalence of single name paper type of loan.

(b) Obstacles to introduction of trade acceptance and bankers acceptance.

(c) Special conditions under which discount market must be developed.

(d) Federal Reserve system provides for several technically separate discount markets, connected by the Federal Reserve system of oversight. This is a new mode of dealing with the banking question and requires the application of new methods.

4. Problem of Relation of Government to Banking System.

(a) Federal Reserve system, though technically fiscal agent of Government, not yet performing more than routine functions.

(b) With peace maintained, problem would have been that of gradually taking over subtreasury duties.

(c) In view of condition of war, chief problem becomes that of aiding in flotation of loans and in keeping banking system as sound and liquid as possible as outstanding obligations increase.

(d) In modern government loans, public obligations tend to become a staple banking paper, and hence the basis of advances. Problem of reserve system is to prevent dangerous inflation based on such advances.

5. Problem of Uniform Collection and Clearance System.

(a) Maintenance of erroneous collection system by considerable number of banks based on faulty reserve plan has continued down to date.

(b) Retention of deposits of country bank funds in cities where they are loaned on call leads to a desire to use these funds to "carry" the collections.

(c) Opposition to prompt and cheap collection owing to existence of large number of artificially created institutions, likely to persevere.

6. Problem of Uniform Management, or Oversight, of All Classes of Banks.

(a) Conflicting State laws and regulations differing from those of national Government.

(b) Lack of any accepted principle of classifying different kinds of banking operations and dividing them among different (and mutually exclusive) types of institutions.

(c) Lack of uniform policy regarding loans, discount rates, and banking policy throughout country.

(d) Competition for retention of institutions under State supervision, resulting in concessions regarding reserves, management and other details of operation.

5/14/17