Banking Problems

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THE PROBLEM BEFORE THE NATIONAL MONETARY COMMISSION

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About three years ago most of us found ourselves in a country where business was conducted by curious methods. It was a large and prosperous country whose people had long prided themselves upon their achievements in business and upon the superiority of their commercial and financial equipment, yet, singularly enough, in all of the leading cities of the country coin and legally authorized currency circulated at a premium, while the usual means of payment were inconvertible notes issued without any sanction of law by banks, railroads, mining companies and other firms. At the time of which I write, conditions had reached such a state of demoralization that any one who had a payment to make and felt so inclined, issued notes instead of paying cash. These notes in a majority of cases offered no promise of immediate redemption; in the case of some issues they frankly stated that they would only be repaid when the issuers deemed it advisable; in other cases they stated that due notice of redemption would be given in the daily papers; occasionally they purported to be payable to Richard Roe or John Smith, or some other fictitious character; but ordinarily they were launched with the simple statement that they would be received by their issuers and certain other affiliated firms. I made a collection at that time of nearly two hundred different varieties of this peculiar currency and as the occasion will probably never again occur when such a collection of private, illegal, irredeemable paper money can be made in any highly developed country, I anticipate that my collection will not improbably become in the future an object of curiosity and value. I have several times had occasion to show samples of the collection to European bankers, and have found that they excited much curiosity, for nothing like them has been seen elsewhere than in this country for the greater part of a century.

There were no less than twenty-five thousand banks in the country under consideration, but the majority of them had suddenly curtailed the facilities which they usually extended to the public. It was in the autumn months just as bountiful crops, vastly exceeding in amount those of any other country in the world, were being brought to market, but on account of the peculiarities of the banking system these crops could only be marketed with the greatest difficulty and at a heavy loss. The 25,000 banks were so singularly unrelated and independent of each other that the majority of them had simultaneously engaged in a life and death contest with each other, forgetting for the time being the solidarity of their mutual interests and their common responsibility to the community at large. Two-thirds of the banks of the country had entered upon an internecine struggle to obtain cash, had ceased to extend credit to their customers, had suspended cash payments and were hoarding such money as they had. What was the result? During a season when nature was offering plentiful harvests, farmers and dealers in produce were refused credit to handle their crops at the very moment when credit was indispensable, and when they had every reason to expect that it would be granted. The owners of factories which had hitherto been working overtime were now for a similar reason obliged to close them down. Railroads which had been running to their utmost capacity suddenly found themselves burdened with idle cars. Thousands of men were thrown out of work, thousands of firms went into bankruptcy, and the trade of the country came to a standstill, because the credit system of the country had ceased to operate.

Such singularly crude forms of inconvertible paper money and such general disorganization in the banking arrangements an uninformed foreigner would doubtless assume must have been the result of a disastrous war. He would imagine that such a situation could only have arisen as news of defeat after defeat had terrified men out of their reason and made them despair of the survival of law and government, but this was not the case. There was no disastrous war, nor had there been any threat of war. There was not the remotest hint of political revolution, nor were there disruptive labor troubles. There had been no conflagrations or national catastrophes. There was no explanation of the condition of the country's business in the political, industrial and physical events of the time.

Unfortunately it is not necessary to mention the name of the country whose discreditable conditions I have been describing. No property holders in America would mistake the description for a picture of conditions in Central America or the Philippines, however glad he might be to be able to do so. We do not regard the United States as still undeveloped in most respects, or as poorly equipped with the institutions and arrangements of civilization, and yet the collapse of our currency and banking arrangements which I have described was not a unique experience in this country's history. Similar conditions have occurred here before not infrequently and they have similarly been without any visible cause. In 1893, and twenty years before that, in 1873, and intermittently during the earlier phases of the country's history, as well as in 1907, a majority of the banks have suspended payments, inconvertible and illegal paper money has taken the place of coin and legal tender and the business of the country has been brought to an abrupt and disastrous halt.

Yet in none of the leading countries of Europe during the past hundred years, except in periods of war and revolution, has there been any such general collapse of credit and general suspension of the banks as that which I have been describing. In England one has to go back to the period of the Napoleonic wars to find such a premium on money as was witnessed in this country in November and December of 1907. In Germany no such suspension of payments and premium upon money has occurred since the German Empire was founded, nor, so far as I know, among the German states for a long time before. In France, even during the troubled years from 1870 to 1873, when the country was overwhelmed with one catastrophe after another, including the war with Prussia and the Commune and the payment of the Great Indemnity, the premium on coin was only on one occasion as high as was the premium on money in New York for several months in the quiet autumn of 1907.

I do not mean to imply that there has not been in these countries an unceasing alternation of trade activity and trade relaxation. There have been fat years and lean years in every country ever since Adam delved and Eve span. Nor do I mean to imply that there have not been great failures of banks and business firms of all sorts. They will not cease to occur until human honor and human judgment and knowledge cease to have bounds. In Great

Britain powerful banks have failed, like the firm of Overend Gurney in 1866, the Bank of Glasgow in 1878, or the Baring Brothers in 1890. In France great banking firms have gone to the wall, like the Union Generale in 1882, and the Comptoir d'Escompte in 1899. In Germany there have been great financial bankruptcies like that of the Leipziger Bank in 1901. The essential and impressive fact, however, is this, that upon all of these occasions there has been leadership and the situation has been kept firmly in hand; there has been no infectious panic and no general rout in which innocent and guilty alike were crushed to earth; the failures in each of these cases have been confined for the most part to the persons and firms who had been responsible for previous excesses.

It was on account of this striking contrast between experiences here in America and conditions abroad that the National Monetary Commission, in undertaking its investigation of possible means for improving the credit arrangements of this country, began by examining the banking institutions, customs, and regulations of the leading countries of Europe. If among other people in most respects not unlike ourselves, financial panics do not occur and the credit systems maintain themselves intact in the face of stress and strain, then the reasons for that difference require examination. In the summer of 1908, shortly after the appointment of the commission, several of its representatives visited England, France and Germany, the three countries of Europe in which conditions most closely resemble our own, examining their banking systems by personal interviews with the directors and managers of the leading banks and arranging for the preparation of papers and monographs by the leading authorities of those countries. Since then representatives of the commission have also been deputed to investigate the banking systems of most of the other leading countries, including Canada, Scotland, Belgium, Sweden, Switzerland, Italy, Russia, Mexico, and Japan.

In all of these countries the liveliest interest in the work of the commission was manifested. It was borne in upon us time and again that our problem was a world problem, and that Europe and the rest of the world had suffered from the consequences of the American panic of 1907 only slightly less than America herself. I remember an interview in London during the summer of 1909 with a representative of the Bank of Sweden, who told us how even in his country, which seems to be fairly disconnected from our own, business had suffered long and heavily from the American panic of 1907, and I recall also in this connection a dispatch from Signore Luzzatti, now Prime Minister of Italy, whom we had invited to prepare a paper upon banking conditions in Italy, and who cabled back that he would be very happy to contribute to the work of the American Monetary Commission, upon which, as he believed, the monetary peace of the entire world depended.

For two years the commission has been collecting material concerning the banking systems of the more important countries. The leading financial editors, bankers, government officials and university professors in Europe and America, and even in the Orient, have contributed to the commission's publications, which constitute a library of more than forty volumes. The publications of the National Monetary Commission thus furnish an unparalleled opportunity for those who are interested in American financial problems to make a comparative study of conditions and experiences here and abroad. The public and Congress are equipped to-day as they have never been before in the case of any other great problem, with the most expert knowledge which the whole world has to offer.

No one can foresee what the commission may eventually agree to propose, but without in the remotest manner pretending to indicate what they are likely to recommend, it may not be inappropriate to direct attention to some of the respects in which the banking arrangements of European countries differ from our own. Not because any one believes that we ought to adopt, or that we could adopt in this country, the specific arrangements of any other country, but because the experiences of the older world may possibly yield some general suggestions which can be modified and adapted to our own peculiar conditions. This is easily done, and in the remaining pages I shall accordingly direct attention to certain broad and general features in which the banking practices and regulations of all European countries coincide, and in regard to which banking arrangements in America are peculiar.

First of all, the American observer is sure to be impressed by the fact that the banks of European countries form parts of a coherent system, subject in a greater or less degree to common leadership. No matter what country you have in mind, whether a monarchy or a republic, you will invariably find some sort of an institution which, on account of its preponderant capital, its peculiar privileges, its relations to the government, or on account of the recognized disinterestedness of its policy, is able to exert a controlling influence over the other banking institutions. Its officers are recognized guardians of the country's credit. They survey conditions with an eye cast beyond the immediate future, and with a regard directed not merely to the prosperity of one section, but to the growth and development of all sections of the country. If credit seems to be expanding feverishly at certain times or in certain lines, their influence is directed to impede excessive advance. If a safely managed and solvent bank finds itself in temporary difficulties owing to conditions which it could not have foreseen or guarded against they will render assistance until the strain is relaxed, and if, because of an unexpected catastrophe the confidence of the community tends to be unsettled, they are able to prevent the disorder from spreading. Such leading and influential institutions, organized not with the primary object of obtaining dividends for their stockholders, but organized and managed to support the public credit and the common interests of the country, play a predominant rôle in the banking organization of every European nation. Their functions and the details of their organization differ from one country to another, but they coincide in the facilities which they extend to other banks and the preponderant influence which they exert over them, and in the fact that their officers and directors recognize an unusual measure of public responsibility.

No phase of recent American banking is more striking than the groping of our 25,000 independent banks toward some coherent organization and leadership. This is shown not merely in the consolidation of great city banks and the affiliation of banks and trust companies, but in the development of association and joint control through the clearing houses, and the absorption on the part of these institutions of new and far-reaching functions. The adoption of methods of mutual supervision through clearing house bank examinations which has been so much in evidence in western and middle western cities during recent years is one step in this direction. The more careful regulations governing the conduct of firms which are admitted to membership in the clearing house, and with regard to the non-member institutions which clear through members, about which so much controversy has centered during recent years in New York, is another instance of the same tendency. Above all, the resort to clearing house loan certificates in times of unsettlement which became so surprisingly general throughout the country in 1907 is the best illustration of the way in which our banks are forced at times to act together under common leadership. It shows, too, how an ingenious people can improvise a needed institution if it does not already exist. The operations of the clearing house associations during the panic of 1907 were essentially akin to the ordinary functions of the Bank of England, the Reichsbank, and the Bank of France. With the banks as customers, these clearing house associations made loans on collateral, rediscounted notes, and made the reserves of all of the banks available for each other in practically the same way as do the great national banks of Europe. The operations were of an identical nature, but there were two essential differences in form and in measure of effectiveness. First, the arrangements had to be devised in the stress of an emergency, and only began to operate after the panic had become acute, and it was no longer possible to forestall the general collapse. Second, there was no general clearing house association for the country as a whole, and even though the banks of each locality were able by a belated expedient to pool their reserves and transform their commercial paper into available, liquid assets, there was no arrangement for a similar settlement of accounts as between different cities. Hence the struggle which was witnessed of each locality endeavoring to fortify itself at the expense of every other locality—a spectacle which could not have occurred in any European country and which we ought to make impossible of recurrence here.

Another respect in which the banking arrangements of other countries differ from those of our own lies in the greater mobility of their reserves. This is partly due to the absence of any requirement that a proportionate minimum of actual cash be maintained inviolate against all deposits,—a requirement which exists in our national banking law and has been copied to some extent in the banking laws of most of the states, but which has no counterpart, so far as I am aware, in the legislation of any other country in the world. With us it fixes an uncompromising limit to the expansion of loans and discounts and prevents the reserves of our banks from really serving as reserves. From the instant that the required reserve has been touched, no matter how critical the need, if the law is strictly enforced, no further accommodation can be granted. There are no such restrictions in other important countries where most of the reserves are pooled in the central institution and where the usual practice in periods of unsettlement is to lend and discount freely to all who have legitimate requirements. Thus panics are suppressed elsewhere as gypsy moths or other pests are suppressed, while they are still in embryo. The requirement of an unusable cash reserve against deposits is peculiar to our system alone. One of the German bankers whom we interviewed last year, described the American reserve system very aptly by comparing it to the regulations with regard to cab-stands in the city of Berlin, where the law demands that there shall always be at least one vehicle at each of the appointed stands. Under this law, a man returning home in the course of a wet and windy night and finding a cab on the street corner may be unable to employ the cab because the law provides that there must always be a reserve of one cab at each of the appointed stands. So, no matter what the exigency, no matter how insistently a precarious situation in the financial world demands a liberal extension of accommodation on the part of the banks, our institutions, unlike those of any other banking system in the world, are prevented from responding to these demands by this uncompromising restriction of deposits to an untrespassable maximum proportioned to the cash reserves.

The reserves of the banks in European countries are more mobile than our own for another and more important reason. In England, or France, or Germany, or in any of the other important countries, the banks are accustomed to consider as equivalent to cash actually held in their own vaults, the balances held for them by their great central institutions. If because of the seasonal recurrence of increasing credit demands, or on account of temporary unsettlement of confidence, the reserves of the banks need to be strengthened, such increases can always be effected by the individual banks by transferring to the central institution some of their bills-receivable, or commercial paper, and receiving in exchange through the direct or indirect process of rediscount, an increased balance upon the books of the central institution. As these balances are regarded and treated as identical in every way with cash, the reserves of European banks are widely flexible, and the banks are able at any time within reasonable limits, to transform their solvent assets into available reserve funds. At the same time the pooling of a large part of the reserves of the individual banks in the central institution makes it possible to supply without disturbance unusual demands for cash arising in any particular part of the country as well as at particular seasons of the year. The lack of any such flexible and easily mobilized reserve power in America forms one of the most conspicuous contrasts between American and European banking arrangements.

A third respect in which the drift of the world's banking is in a different direction from that of this country concerns the matter of note issue. The tendency of note issue regulations in every other country is manifestly toward concentration in its control. When the great act of Sir Robert Peel in 1844 established the English system of note issue upon the basis on which it stands to-day there were 279 banks in England issuing notes. The act provided for the gradual absorption of all of these issues by the Bank of England, and at the present time there remain less than thirty note issuing banks outside of the Bank of England, with a total issue amounting to less than £500,000, or only one per cent of the total issue. In Germany when the bank act of 1875 was adopted thirty-two other banks throughout the empire were issuing notes to the extent of 135,000,000 marks, but that act, like the English act of 1844, provided that as these banks forfeited their rights to circulation the Reichsbank should be allowed to absorb their note issuing privileges. To-day there remain in Germany only four note issuing banks aside from the Reichsbank with a total note issue averaging less than twelve per cent of the whole. In France the Bank of France has been the sole source of circulation for more than sixty years, or since its reorganization in 1848.

In quite recent years a number of other countries have brought their bank note issue system into line with those just mentioned. In Italy, beginning in 1893, the government entered upon a course of legislation tending toward the concentration of note issue in the Bank of Italy, and already of the six banks which at that time were issuing notes, only three remain—the Bank of Naples and the Bank of Sicily, with minor privileges, and the Bank of Italy, sponsor for three-quarters of the total circulation of the country. When Japan, emerging from feudalism, reorganized her banking system early in the seventies, she adopted the American system of decentralized issue, but after an experience of only a few years she turned to Europe for her models and adopted a system of centralized issue patterned after that of the Bank of Belgium. In Sweden, one of the last countries to change, down to 1900 there were no less than twenty-seven separate enskildabanks endowed with the privilege of issuing notes, but by legislation of that year, a centralization of issue was arranged for, and since January 1, 1904, the Bank of Sweden alone has had the privilege. Most recently of all in Switzerland, where for generations notes have been issued by a system of cantonal banks, the Swiss National Bank, organized by the act of 1905, has taken over the authorized circulation of the eleven other institutions which up to that time had enjoyed the privilege of note issue. The fundamental reason for the drift of the world toward centralization in the control of note issue is not altogether clear, but the main advantage probably lies in the possibility of concentrating its control under a single body of men who are conscious of public ends and the opportunity which ensues for better adaptation of currency supply to currency demand, for stronger control over credit expansion and for wiser and more immediate relief in times of emergency and incipient distrust.

The importance of the question of note issue arrangements has been very much exaggerated by writers upon currency reform in this country. In the course of the last half century it has become the custom of banks throughout the world, and more particularly of banks in the Anglo-Saxon countries, to lend their credit in the form of deposit accounts rather than in the form of notes; on this account the matter of the issue privileges, which was formerly the principal feature in banking legislation and the main subject of discussion in banking literature, is ceasing to have the importance which it used to command. The thought of the world moves slowly, and it only recognizes essential changes in conditions reluctantly and long after they have occurred. The banking problem as it still presents itself to many financial writers is limited to the search for improvements in the regulation of note issues, but in reality this question has for decades only concerned a minor phase of credit organization.

This is not the occasion to present the details of the banking systems of other countries. I have only intended here to sketch in broadest outlines some of the features that are common to the banking systems of practically all of the other countries of the world—features which we in America lack, and which perhaps may have enabled other countries to meet the fluctuating exigencies of business more effectively than we have been able to do. I have not sketched the peculiar features of any single country; I have merely gathered together what is common to them all. I have no idea and no member of the commission has any idea that the detailed arrangements and regulations governing banking in any other country are applicable to the United States. I do believe, however, that some of these features which are common to all other banking systems should be carefully examined before we make any attempt at domestic reform, and, as I have endeavored to explain, the most distinctive characteristics of European banking, in my opinion, are the greater unity and coherence of their organization, the greater mobility of their reserves and the greater concentration of control in their note circulation.

The history of currency legislation in the United States during the last forty years has not presented a story to which any well-informed and intelligent American can point with pride. At the end of the Civil War we found ourselves encumbered with an inconvertible paper currency issued to defray the expenses of that great war, and for fourteen years thereafter this currency circulated at a discount while successive legislatures proposed varying plans for its retirement and for the resumption of specie payments, only to modify and repeal them. It was not in fact until 1879, or nearly a generation after the issue of the greenbacks, that the government fulfilled its obligation and undertook their redemption. From that date for another generation successive Congresses dealt with the problem of silver coinage with equally inapt vacillation, and it was not until the year 1900 that the world was finally assured that this country would continue to use as its monetary standard the metal which had been the undisputed standard of all the other leading nations for a quarter of a century. We are confronted to-day with the third great currency problem of the last fifty years. We are looking for the means of improving our banking system so that we may avoid for the future the wide-ranging catastrophes with which American business has been periodically distressed, and through which the respect for this country abroad has been impaired. Having established our standard of value on the world's basis, we are now trying to devise a banking system more worthy of our position in the world and better adapted to further the uninterrupted development of our great resources.

Fortunately in this great task we are presented with a means of resolving the complexities of the problem such as has not existed with regard to any other problem in our history. We have a commission of distinguished membership which is devoting itself with deliberation to a scientific study of banking difficulties at home and banking experience in the rest of the world. The commission includes representatives of all sections of the country, from states as widely separated as Maine, Louisiana, Texas, Pennsylvania, Virginia, Colorado, and California. At its head is a masterful leader, clear thinking, unvisionary and thorough, whose one ambition is to crown a long career with a great constructive law. The outcome I am confident will show that the members of this commission, whether Republicans or Democrats, realize that the questions before them are vital to the development of the common country, and that the issues are of far too wide a scope to be treated from the viewpoint of sectional interests or partisan politics.

The problem before the National Monetary Commission is well suggested by its analogy with the problem of providing protection against certain kinds of physical catastrophes, such as fire. There are at least three ways to protect one's self and belongings against loss by fire. One may equip a house with fire-escapes and in case of a blaze make one's way out as best one can, saving one's self but leaving home and possessions to destruction. A better method is to equip one's house with fire extinguishers, so that if an incipient blaze occurs one has the means to combat the flames and to prevent the complete destruction of one's property. The best method, however, of protecting self and home is by fire-proofing the entire structure; then there remains no real need for anxiety, for only under conditions of extreme carelessness can any considerable damage be accomplished by fire.

In the financial structure of this country we have seldom provided any method of protection against possible disaster beyond the means of escape, and even these we have generally left to be improvised after a catastrophe was under way. Under the so-called Aldrich-Vreeland act of May 30, 1908, provision was made for equipping our financial edifice with something akin to extinguishers in the shape of currency associations and emergency currency to which the banks could run for relief in case of impending destruction. But these extinguishers are only of limited usefulness. They can only be employed after emergencies are under way, and the law only gave them a period of effectiveness of six years. The act of 1908 provided, however, that during these six years experts should be engaged to examine into the methods of panic-proofing employed in other countries in order that means may be devised by which our own financial system may be panic-proofed and panic risks for the future eliminated. This is the problem before the National Monetary Commission.