The Great Debate on Banking Reform
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The movement for banking reform in the United States after the Civil War was motivated by frequent bouts of acute monetary stringency and less frequent banking panics. The financial and economic distress accompanying the disturbances was the trigger that set off a debate on banking reform that took place in three overlapping stages between 1894 and 1913, an interval just short of twenty years. The former date coincided with the so-called Baltimore Plan presented to the American Bankers Association (ABA) and the latter with the passage of the Federal Reserve Act. Proposals for an asset-based currency issued by the participating banks dominated the first stage from 1894 to 1908 that culminated in the passage of a temporary measure known as the Aldrich-Vreeland Act. The need for and viability of a U.S.-style central bank monopolized the second and third stages and ended with the creation of the Federal Reserve System in 1913.

These periodic bouts of monetary stringency and banking panics were attributed to alleged defects in the national banking system. The stock of currency did not respond to seasonal increases in demand associated with the planting of crops in May and their harvesting in October. Increased demands for currency in the interior had to be met by drawing down banker balances in New York, usually attended by varying degrees of monetary stringency, curtailment of loans to the stock market, and spikes in interest rates. Nor did the currency stock respond to panic-induced demands for currency which provoked a suspension of cash payments.

The note issue of the national banks was described as “inelastic,” a term that became embedded in the banking reform literature. The incentive to increase the supply of national bank notes depended solely on the price of eligible government bonds. Banks could issue notes up to 90 percent of the
par or market value of the bonds purchased. The higher the price, the weaker the incentive to purchase. For example, a bank purchasing an eligible bond with a par value of $1,000 and selling for $1,500 could issue $900 of bank notes. As the price rose it became increasingly more expensive for the bank to issue notes. And there was no good reason for expecting bond prices to behave in such a way to ensure seasonal and panic elasticity.

The diagnosis, if correct, led to a legislative remedy in the form of an asset-based currency. National banks should be permitted to issue notes against their general assets. The bond-secured currency of the National Banking Act was asset-based, but it was restricted to a single asset. General assets included commercial paper, railroad bonds, U.S. government bonds, and bonds of state and local governments.

What, if anything, would limit the note issue on the basis of general assets? At the one extreme were the real bills advocates, who argued that the note issue would be self-liquidating and required no constraints if confined to self-liquidating commercial paper. But legislators were more pragmatic and less doctrinaire; they recommended limiting the note issue to the amount of the issuing bank’s capital stock and made provision for a guaranty fund to protect the note holders of failed banks. When reasons were given for imposing constraints on the note issue, the fears of overissue usually came first. The smaller banks could not be trusted to exercise the proper caution and restraint.

The appeal of an asset-based currency resided in its simplicity. It did not require further intrusion by government into the banking industry. No major institutional changes were necessary. And it would impart the desired liquidity to meet seasonal and panic demands. However, it was a remedy for a double defect, the occurrence of banking panics and seasonal money market stringency. Multiple defects might require multiple solutions.

Although an asset-based currency was the preferred remedy proposed during the first stage of the debate on banking reform, other solutions were not ignored. Branch banking and deposit insurance were given thoughtful consideration. Less attention was paid to reserve pooling by the New York Clearing House banks. Frequently between 1894 and 1902 asset-based currency proposals were coupled with branch banking. Both the McClary (1898) and the Fowler (1902) bills contained branch banking provisions. Livingston (1986, p. 80) maintained that “branch banking became an integral part of the reform agenda once serious discussions of assets currency had begun.” Combining the two would presumably concentrate reserves and tend to equalize regional interest rates. European and Canadian banking experience had demonstrated the close relationship
between a highly centralized banking structure, branch banking, and banking stability. A further concentration of financial power through nationwide branch banking was, however, politically unacceptable and would remain so for another 100 years.

So much attention had been paid to making the note issue safe, scarcely any concern was shown about the safety of deposits, but that began to change after the 1907 panic. Eight states passed laws guaranteeing bank deposits. The idea was not new. An 1829 banking law required banks to contribute annually to a fund that could be used to repay the holders of notes and deposits. The Populist party revived the deposit guarantee proposals in the 1890s. The 1908 Democratic platform contained a plank establishing a deposit insurance scheme for national banks. Thereafter, the guarantee of deposits gained in popularity, but it was a rise that only strengthened the opposition of the nation's bankers.

A fourth solution to the banking panic problem was advanced by O. M. W. Sprague (1910), who argued that the New York Clearing House had the power, the tools, and the knowledge to prevent banking panics. Reserve pooling among the NYCH banks had successfully averted banking panics in 1860 and 1861, but had not successfully done so in 1873, for reasons I have explained elsewhere (Wicker, 2000). Thereafter the NYCH abandoned reserve pooling, and by 1893 it had all but been forgotten. Sprague's mentor at Harvard, Charles Dunbar (1891), kept alive the NYCH experience with reserve pooling.

The pace of the banking reform movement accelerated after the 1907 financial panic. Congress responded in 1908 with the Aldrich-Vreeland bill, a temporary stopgap measure until a permanent reform measure could be adopted. To expedite the transition, the Aldrich-Vreeland bill called for the appointment of a National Monetary Commission to study and make recommendations for comprehensive banking reform. While the commission was deliberating, the Aldrich-Vreeland bill would fill the gap. The bill provided for an emergency currency based on both a bond-secured and asset-based currency, mainly commercial paper. There was only one occasion in August 1914, the outset of World War I, when the provisions of the bill as amended were successfully invoked to forestall an incipient banking panic. Aldrich-Vreeland effectively brought an end to the first stage of the debate on banking reform.

Three events signaled the onset of the second stage: a New York Chamber of Commerce report in 1906, Paul Warburg's publication of a plan for a central bank in 1907, and the appointment of the National Monetary Commission in 1908. The commission was not a blue ribbon panel of experts who would study the current banking system and make recommendations for permanent banking reform. Its eighteen members
were legislators, nine of whom were from the House of Representatives and nine from the Senate, with Senator Nelson Aldrich as the chairman. He was mindful of the challenging task before him and the payoff of “enduring fame” if he were successful. His six terms in the U.S. Senate had brought him to the apex of political power. Among Republicans, he had no rival. Firmly ensconced in his leadership role, Aldrich was reluctant to share power with others. Used to getting his own way, he kept a tight rein on the agenda and proceedings of the commission. According to the commission's director of research it was a “one man show” completely dominated by Aldrich. Members of the commission played a purely ancillary role, though Aldrich was attentive to maintaining their trust and support.

One of the very best kept secrets in U.S. financial history, at least until 1930, was that the Aldrich bill was not drawn up by the Monetary Commission but by a secret cabal of New York bankers who at the invitation of Aldrich met at a Jekyll Island lodge off the coast of Georgia in November 1910 and prepared a rough draft outline of what later became the Aldrich bill for the creation of a U.S. style central bank. The participants included representatives of three of the largest Wall Street banks: Henry Davison, a Morgan partner, Frank Vanderlip a vice-president of National City Bank and a protégé of James Stillman, and Paul Warburg, partner in Kuhn, Loeb, and Co., two of whom had gone on record as advocates of a central bank. What was more irregular was the presence of A. Piatt Andrew, former assistant professor at Harvard, who had been recruited by Aldrich to serve as special assistant to the commission but who at the time of the Jekyll Island conclave was assistant secretary of the treasury. His participation was not known to his boss, Secretary of the Treasury Franklin MacVeagh, or to anyone else in the Taft administration. Only Senator Aldrich could have conceived such a daring and risky plan. Only Aldrich had the audacity and wit to carry it out knowing quite well what the consequences would be if found out.

What emerged at Jekyll Island was not a completed draft of a banking reform bill. It was presented to the commission without the knowledge of its origins as a suggested plan for monetary legislation. The plan was dated January 16, 1911 and revised subsequently in October. The final report of the commission was sent to the Senate in January 1912 without any action being taken. The Aldrich bill was the seed that eventually became the Federal Reserve Act, and that seed had been planted by Aldrich and his banker associates, a striking triumph of dynamic leadership and dogged persistence.

To establish a central bank in the United States at least three formidable obstacles had to be overcome, the first of which was the shibboleth against a central bank—a carryover from the antebellum dispute between Andrew
Jackson and Nicholas Biddle about the renewal of the charter of the Second Bank of the United States. No progress could be made toward the creation of a central bank until this nationwide prejudice was either removed or significantly moderated. The second obstacle was a banking reform measure that had gained wide appeal between 1894 and 1908, the so-called asset-based currency whereby individual banks would be allowed to issue paper currency using commercial paper as its principal backing. Deposits and notes would thereby be interconvertible. The third obstacle was the almost complete absence of strong congressional leadership of the banking reform movement before 1908. There was no dearth of banking reform proposals, none of which, however, could muster enough congressional support. The story of the origins of the Federal Reserve System can be told by explaining how each of these three obstacles was successfully removed.

Two lawmakers, one of whom we have already mentioned, played leading roles in the creation of a U.S. style central bank: Senator Nelson Aldrich of Rhode Island and Representative Carter Glass of Virginia. Aldrich and his associates were responsible for removing the first two obstacles. Glass and Aldrich shared the congressional leadership role, Aldrich between 1908 and 1912 and Glass thereafter.

As a joint sponsor of the Aldrich-Vreeland bill (1908) Aldrich reluctantly agreed to allow participating banks to issue emergency currency backed by commercial paper for the purpose of forestalling banking panics. As chairman of the National Monetary Commission, he rejected the Aldrich-Vreeland solution and opted for a central bank in a dramatic reversal.

Carter Glass, the so-called “father” of the Federal Reserve Act, and Parker Willis, his close associate, went out of their way to repudiate Aldrich’s influence, but it is now becoming increasingly clear that Aldrich deserves equal, if not top, billing with Glass as a cofounder of the Federal Reserve System. The claim that Aldrich’s contribution has been understated is based on the following considerations:

1. The Aldrich-Vreeland Act was an effective panic-preventive measure; it successfully forestalled an incipient banking panic in August 1914.
2. Aldrich was chiefly responsible for shifting the debate on banking reform from an asset-based currency to that of a central bank.
3. Aldrich alone among American politicians and statesmen had the courage, guile, and political power to disavow the deeply ingrained prejudice against a central bank.
4. The similarity in substance and wording of the Aldrich and the Glass-Owen bills was striking.
5. The nationwide educational campaign launched by Aldrich and his associates to publicize the idea of a central bank did more than perhaps anything else to increase public support for a central bank.

Although the Aldrich bill’s introduction in the Senate in January 1912 proved to be stillborn, the foundations laid by Senator Aldrich accelerated progress on a new banking reform measure. The debate no longer centered on whether or not to have a central bank but on what kind of central bank. The principal task of Carter Glass was to formulate a revised banking bill which could be steered successfully through the Congress. And that was the extent of Glass’s legislative achievement. Aldrich prepared the way by winning the debate on whether or not to have a central bank and removing the shibboleth against a central bank. The achievement of Glass can no longer be considered separately from that of Aldrich and his associates.

The reassessment of the role of Aldrich may require alternative interpretations of the origins of the Federal Reserve. The conventional wisdom has it that the Fed was created to prevent banking panics. Had panic prevention been the predominant motive, there would have been no need to go beyond the Aldrich-Vreeland bill. A close comparison of the Aldrich and the Glass-Owen bills reveals, contrary to the conventional wisdom, that they were both real bills neutral. There is nothing in either act to warrant a strong real bills interpretation, which is to say that looking after the quality of credit, the quantity will look after itself. A real bills interpretation has been inferred primarily from the views of Glass and Willis, but mainly Willis. At least three of the five persons who drafted the Aldrich bill rejected the real bills doctrine as fallacious. Nevertheless, despite the contrary interpretations of Glass and Willis and Aldrich and his associates, they were able to agree on the same discount provision in the two bills.

The central unifying theme of the book is a reconsideration, reappraisal, and revival of an old claim that Senator Nelson Aldrich deserves recognition as a cofounder of the Federal Reserve System. Each of the following chapters bears directly on that claim. The exception is Chapter 2, which provides the reader with an update on recent contributions to the origins of the Fed literature. Chapters 2 through 5 define what the Great Debate was about. A variety of asset-based currency proposals for banking reform between 1894 and 1906 are the subject of Chapter 3. A separate chapter, Chapter 4, is devoted to the Aldrich-Vreeland bill (1908), which served two purposes: it settled the debate about a preferred asset-based currency plan, and it created a National Monetary Commission to consider a permanent solution to the problem of banking reform. Chapter 5
The Great Debate: An Overview

introduces the other side of the debate between advocates of an asset-based currency and a central bank. A plan for a U.S. style central bank emerged from a clandestine meeting convened by Senator Aldrich and including a cabal of Wall Street bankers in the form of an early outline of what became known as the Aldrich bill. When introduced in Congress, the Aldrich bill went nowhere, and leadership passed to Representative Carter Glass, who almost immediately began work on a substitute bill. The Glass bill is the subject of Chapter 6. A comparison of the two bills is set out in Chapter 7. The comparison is continued in Chapter 8 with the examination of the theoretical underpinnings of the two bills in the form of the real bills doctrine. The concluding chapter, Chapter 9, sums everything up.