The Great Debate on Banking Reform

Wicker, Elmus

Published by The Ohio State University Press


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CHAPTER SEVEN

THE ALDRICH AND GLASS-OWEN BILLS COMPARED

The failure of the Aldrich bill to make any further progress in Congress did not presage the end of the banking reform movement. Momentum was quickly rekindled with the election of Woodrow Wilson, who was an ardent advocate of banking reform. The baton passed from Nelson Aldrich to Carter Glass. Although the Democratic platform had rejected the Aldrich bill, the foundations had been laid for a U.S. style central bank, albeit one with some—though not all—objectionable features. Glass and his associate Willis could begin immediately with the task of drafting an alternative measure acceptable to the new Democratic administration, a task needless to say made easier by the work of their predecessors. With the Aldrich bill as a guide, they could incorporate the noncontroversial provisions and revise those that were objectionable, namely those dealing with governance. What emerged, as we shall shortly see, were striking resemblances between the provisions of the two bills. The similarities extended to how capital was to be raised, dividend constraints, discount operations lodged in regional and branch banks, discounts based on legitimate commercial and industrial transactions of short duration, an asset-based note issue, and federal and democratic organizational features. Warburg's (1930, Vol. 1, Chapter 8) line-for-line comparison of the provisions of the two bills revealed not only the similarities of substance but wording as well! We begin by comparing earnings provisions.

EARNINGS

One of the first problems to be resolved was the source of funds for establishing a central bank, that is, the amount of capital required. There were
at least three separate and distinct sources for raising capital: (1) funding by the participating banks, (2) funding by government, and (3) funding by the public or some combination of the three. Capital could be raised by the purchase of shares by government and the public. Both were rejected in favor of funding by the participating banks in the Aldrich and Glass-Owen bills; banks would be required to purchase shares as a proportion of their capital stock. The Aldrich bill specified a fixed amount of share capital amounting to $200 million, whereas Glass-Owen only provided for a minimum capital requirement of $4 million for each Federal Reserve Bank.

Share purchases created expectations of dividends and participation in governance as a prerogative of “ownership.” However, the prerogative of ownership was sharply curtailed; it did not extend to full participation in governance. The corporate governance analogy cannot be carried too far. Capital tied up in the central bank had an opportunity cost. The payment of dividends would compensate partially for the loss in earnings; it would also act as an incentive to participate.

The role of profit considerations in the operation of the National Reserve Association and the Federal Reserve System remained ambiguous. Profit maximization was not ruled out by legislative provision except to the extent that the payment of dividends was constrained to a fixed maximum percentage. Earnings not allocated to dividends would accrue to government in the form of a franchise tax. Neither bill provided any clear guidance about the role of earnings of the central bank. It was more or less a clearly understood interpretation of both bills that the central bank was supposed to meet current expenses out of current earnings. Shortfalls could be temporarily sustained from a contingency fund in the Aldrich bill and a surplus provision in Glass-Owen. The Aldrich bill contingency fund was not to exceed $2 million and was to act as a cushion to prevent current losses, if any, from impacting monetary policy considerations. In the 1920s some Federal Reserve Banks had insufficient earnings to pay dividends; some of them resorted to open market operations to make up the deficiency, which was not always consistent with broad policy objectives. In neither the Congressional debates nor hearings on the Glass-Owen bill was there a perception of a possible conflict between earnings and policy-related considerations. Warburg (1930, Vol. 1, p. 409) maintained that had the Federal Reserve Act allowed reasonable interest charges on checks in the process of collection, the need for Federal Reserve Banks to purchase government securities for earnings purposes would have vanished. The whole problem disappeared with the growth of earnings and never again led to potential policy conflicts.
DISCOUNTS AND OPEN MARKET OPERATIONS

Though never made explicit, one of the purposes of both the Aldrich and the Glass-Owen bills was to create a national discount market, identifying in general terms financial instruments through which the market could be accessed, thereby providing the banks with a much welcomed source of liquidity. Participating banks could request accommodation based on legitimate transactions of short maturity drawn from agricultural, industrial, or commercial purposes, terms of 28 days in the Aldrich bill and 90 days in Glass-Owen. The discount provision of the Aldrich bill was less rigid than the similar provision of the Federal Reserve Act. With the approval of the secretary of the treasury and the endorsement of the bank’s local association, any direct obligation of the borrowing bank was eligible for discount, a provision that might be particularly helpful during banking panics.

The fifteen branches and the eight–twelve regional Reserve Banks were granted autonomy in the administration of the discount window. The authority to lend to member banks was vested in each of the branches and regional Reserve Banks. Application for accommodation had to be approved by a local association of banks of which it was a member under the terms of the Aldrich bill. Regional Reserve Banks had the authority and the discretion to lend to the member banks in its district. The power to change the discount rate differed between the two bills. Under the Aldrich bill the National Reserve Association set the discount rate without branch participation, whereas in the Glass-Owen bill the power resided with each Reserve Bank, with the approval of the Federal Reserve Board in Washington.

Similarly, the Aldrich bill empowered the National Reserve Association to engage in open market operations, but the Glass-Owen bill reposed that power in the individual Federal Reserve Banks. The 1913 Federal Reserve Act made no provision for coordinating the purchase and sale of securities by the individual Reserve Banks. An informal committee without legal status was organized by Governor Benjamin Strong of the Federal Reserve Bank of New York in 1923.

The technical provisions with respect to discounting and open market operations were almost identical in substance and wording. Where the two bills differed was in the authority to change the discount rate and engage in open market operations. The Reserve Banks had a greater degree of authority than the individual branches of the National Reserve Association, but the differences were matters of degree.
RESERVES

One of the alleged weaknesses of the national banking system was the pyramiding of reserves. Interbank deposits were allowed to satisfy part of the reserve requirement. For example, country banks (a reserve classification) were required to hold 15 percent of their deposits as reserves, three-fifths of which could be deposited with reserve city and central reserve city banks, the remainder being held in the banks' own vaults. Reserve city banks had to hold a 25 percent reserve, one-half of which could be deposited in central reserve city (New York, Chicago, St. Louis) banks. Central reserve city banks held a 25 percent reserve. The effect of the pyramiding of reserves was to transmit currency shocks immediately from country and reserve city banks to New York. Reserves, as a matter of fact, were not decentralized; they were highly concentrated in an exceedingly small number of New York banks holding the bulk of bankers' balances. The problem as Laughlin conceived it was the inelasticity of the stock of reserves. The remedy lay in a more flexible reserve supply mechanism through discounting and open market operations, a characteristic feature of both the Aldrich and Glass-Owen bills. Neither bill provided for discretionary changes in the reserve ratio as a policy instrument. But such changes were not ruled out in the Aldrich bill; unlike the Glass-Owen bill, there was no provision for a mandated reserve requirement ratio; the Executive Committee of the National Reserve Association had the power to fix its size.

Like the National Banking Act, the Aldrich bill permitted interbank balances to be counted as part of the reserve requirement, thereby inhibiting the concentration of bank reserves in branches of the National Reserve Association. On the other hand, the Federal Reserve Act, after calling for a 36-month transition period, concentrated reserves in the eight–twelve Reserve Banks, although vault cash could be counted as well. One of the purposes of the Federal Reserve Act was to concentrate the nation's gold reserve in a central reservoir, thereby relieving the Treasury of that responsibility.

NOTE ISSUES

The debate over an asset- versus a bond-secured currency had been resolved in the Aldrich-Vreeland Act in 1908. Participating banks were authorized to issue currency notes on the basis of commercial paper in periods of emergency. This aspect of an asset-based currency was embodied in both the Aldrich and Glass-Owen bills. The note issue privilege,
however, resided in the National Reserve Association in the Aldrich bill and in the Federal Reserve Board acting through a Federal Reserve agent in each Federal Reserve Bank in the Glass-Owen bill. The details of the note issue were left vague, presumably through the fifteen branches of the Aldrich bill. Commercial paper, bills of exchange, and gold were the basis for the note issue in the Aldrich bill. If the reserve fell below 50 percent, the National Reserve Association would be subject to a special graduated tax. In the event the ratio fell below 33½ percent, no additional notes could be issued. The total note issue was capped at $900 million. Any issue above that amount was subject to a graduated tax. All notes were fully exchangeable into gold. Federal Reserve notes were also backed by 100 percent in commercial paper and an additional 40 percent gold reserve. The Glass-Owen bill contained no cap on the amount of notes issued except the commercial paper/gold reserve constraint. Nor was there a provision that Federal Reserve notes were convertible freely into gold.

It was certainly clear that a central bank had never been demonstrated to be a superior mechanism for the issue of bank notes compared to an asset-based currency. With an asset-based currency the initiative to increase the bank note circulation rested solely with the national bank suffering the currency drain; its response was predictable. The bank may have had no other option. The response of a central bank was less predictable, especially if it was not properly organized and managed, resulting in delays in recognition and undertaking action. Nor would the issue of notes be any safer. Bankers Magazine (1907, p. 315) concluded on the basis of the available evidence that an asset-based currency issued by national banks would be perfectly safe, and the establishment of a central bank could scarcely be defended as any safer. If removing bank note inelasticity was the sole purpose of banking reform, then an asset-based currency might be preferable. The debate about an asset-based currency did not focus on whether or not the note issue was a responsibility of the government or private banks. It did play an important role in the decision about what functions to grant a U.S. style central bank.

One other difference remained, but it was without practical significance. National Reserve Association notes were obligations of the National Reserve Association, whereas Federal Reserve notes were obligations of the U.S. government at William Jennings Bryan's insistence. Wilson and Glass agreed to go along with this residue of the old populist currency wars of an earlier time. Safety of the note issue remained a preoccupation of the formulators of both bills. Equal consideration was not given to the safety of checking account deposits.
ORGANIZATIONAL STRUCTURE

Both the Aldrich and the Glass-Owen bills provided for a decentralized operating structure. The Aldrich bill divided the country into fifteen districts with a branch in each district. The Glass-Owen bill created no less than eight nor more than twelve districts with a Reserve Bank in each district. Each district branch of the National Reserve Association and each Reserve Bank had its own board of directors, which as we have seen had the authority to administer the discount mechanism. Reserve Banks had the additional authority to set the discount rate and to engage in open market operations. The principal operating functions of a central bank were performed by the branches and the Reserve Banks. The idea of a regional system of quasi-autonomous reserve banks did not originate with the Federal Reserve Act. Embodied in the Aldrich bill was a system of fifteen separate districts with a branch bank in each district. The word “branch” was unfortunate, for it did not have the same connotation as when applied to the Bank of France, the Bank of England, and the Reichsbank. There were 11 branches of the Bank of England, 188 branches of the Bank of France, and 93 so-called head branches of the Reichsbank. At the Bank of France and the Bank of England the local branch management had full control of discounts, not including the rate of discount. Assisting the manager of a Bank of France branch was a local board of directors from “the best qualified commercial, industrial, and agricultural representatives in the region.” Managers of the branches of the Bank of France were named by the chief of state on the report of the minister of finance upon presentations made to him of three candidates by the governor of the Bank. Managers of the Bank of England were named by the Court of Directors of the Bank.

Not only did the two bills differ about the degree of autonomy of the district banks, there were differences concerning compulsory or voluntary membership of the participating banks. Membership was purely voluntary for national and state banks and trust companies in the Aldrich bill and compulsory only for national banks in Glass-Owen. Another minor difference arose over the designated fiscal agent of the Treasury. Under the Aldrich bill the National Reserve Association was the mandated fiscal agent of the Treasury. Glass-Owen made it obligatory for the Reserve Banks to act as fiscal agents when required by the Secretary of the Treasury, but he retained the discretion to deposit funds outside the Reserve System.

The National Reserve Association and the Federal Reserve Board were entrusted with purely supervisory functions. But these powers were specifically constrained in the Glass-Owen bill. There were no similar constraints in the Aldrich bill. Both bills were silent on the broad objectives of monetary policy, but preservation of the gold standard was implicit.
GOVERNANCE STRUCTURE

The similarity of wording and substance between the two bills is striking, but we do not wish to obscure the differences. Nowhere are those differences more glaring than in the provisions defining governance of the central bank. The one question that attracted the greatest controversy was: Who was going to control the central banking system, the bankers or government appointed officials? The Aldrich bill provided for a scheme of governance at every level where banker control was dominant. Participating banks were, first, members of a local association. In the final version of the bill, these local associations were organized into fifteen districts with a branch in each district having a board of directors elected from the affiliated banks. The fifteen branches were united into a National Reserve Association with a board of forty-six directors: fifteen from the branches (one from each branch); an additional fifteen who were supposed to represent agriculture, commercial, industrial, and other interests; nine chosen by the branches on the principle that the number of votes was to equal the number of shares; and ex-officio members including the governor of the National Reserve Association, two deputy governors, the secretaries of the treasury, agriculture, commerce, and labor, and the comptroller of the currency. The governor was to be selected by the president of the United States from a list submitted by the board of directors. An executive committee, or policy committee, was composed of nine members, the governor, two deputy governors, the comptroller of the currency, and five directors representing the participating banks. By omitting cabinet members, their influence was muted.

The Glass-Owen bill in its final version sharply curtailed the representation of banker interests at both the district and national levels. Each district reserve bank had a nine-member board of directors, only three of whom were bankers; three were required to be engaged in commerce, agriculture, or some other industrial pursuit. The remaining three were “public” members appointed by the Federal Reserve Board in Washington. Nevertheless, there was banker representation, albeit not controlling, at the district level. But banker representation was completely eliminated at the national level. The central controlling agency, the Federal Reserve Board, included two ex-officio members, the secretary of the treasury and the comptroller of the currency, and five members appointed by the president with the consent of the Senate.

Central banks are by their very nature political institutions that impact the well-being of the public for good or ill. When central banks act to curb inflation, reduce unemployment, and promote economic growth, some are harmed; there are political consequences that cannot be
ignored; policymakers must assess the political consequences of their actions; central banks must be accountable to the public. Nor can the process ever be free of “politics” in the above sense.

What supporters of the Aldrich bill feared was the injection of political considerations into central bank decision making. What they intended, to be free of “politics,” meant to be free from political party influence. These same supporters could not conceive of presidential appointees not governed by partisan politics. Supporters of the Glass-Owen bill equally could not fathom how banker control and banker self-interest would always coincide with the wider public interest. The rejection of the Aldrich bill and its replacement by the Glass-Owen may be viewed, not incorrectly, as a political accident, the accident, that is, of the Wilson presidency and his undaunted insistence on government control of the central banking system.

These differences about governance of the central bank were not simply ideological. Granted there were deeply entrenched views about the role of government in economic affairs. Supporters of the Aldrich bill associated government intervention with the threat that purely partisan political considerations would be decisive. For example, giving the president the authority to appoint Federal Reserve Board members was an invitation to inject “politics” into central bank management. “Politics” meant partisan bias, which was unacceptable. And the only way to keep the central bank free of politics in the partisan sense was to legislate banker control.

There were provisions of the Aldrich bill that recognized the public interest aspects of central banks. The president appointed the governor, but only from a preferred list submitted by the forty-five directors of the National Reserve Association. Moreover, secretaries of the treasury, agriculture, commerce and labor and the comptroller of the currency were made ex-officio members of the board of directors, but did not serve on the nine-man executive committee. Representation of public officials was token at best. As we know, President Wilson was not inclined to support a bill in the absence of government control. His position was even stronger than that of Carter Glass, who had no problem with accepting banker representation on the Federal Reserve Board. In fact banker representation was included in an earlier version of the Glass bill. To a group of bankers Wilson allegedly quipped: “Who would place a representative of the railroads on the Interstate Commerce Commission?”

Central banks, to repeat, by their very nature cannot be free of politics in the sense their actions impact the well-being of the public. There are benefits and costs distributed unequally when the central bank acts to restrain inflation, curb stock market speculation, or foster economic growth. Some people benefit, others are harmed, from which political con-
sequences ensue. The central bank is a political institution which can act with various degrees of autonomy from the conventional political arena. The question is the extent and degree of central bank accountability to the public.

The process of selecting sites for the location of Reserve Association branches and Federal Reserve Banks was the same. Both bills provided for the appointment of an Organization Committee whose task it was to determine district locations. The membership of the two committees was almost identical: the secretary of the treasury and agriculture together with the comptroller of the currency were members of both committees. The secretary of commerce and labor was included in the Aldrich bill but omitted in the Glass-Owen bill. The two bills shared the same criterion for the selection of districts. They would be drawn with “due regard to the convenience and customary course of business and not necessarily along state lines.”

THE ALDRICH-GLASS LEGACY

A series of necessary steps had to be taken before a central bank could be established in the United States. The historical prejudice against a central bank dating from the antebellum period and the Jackson-Biddle feud had to be dispelled and a nationwide educational campaign conducted to demonstrate the feasibility of a U.S. style central bank. Moreover, the protagonists of an asset-based currency issued by national banks had to be convinced of the superiority of a central bank. What this meant in fact was the abandonment of the principle of an asset-based currency that had dominated all of the measures for banking reform between 1894 and 1908.

By 1910 Aldrich and his associates could claim a modicum of success. The central bank shibboleth no longer was an obstacle to the creation of a central bank. Proponents of an asset-based currency had been silenced, and public opinion tilted in favor of a central bank. But the Aldrich bill when introduced in the Senate in 1912 was stillborn, a casualty of Democratic opposition and divisiveness within the Republican ranks. Aldrich’s efforts, however, had not been in vain. Carter Glass and his associate H. Parker Willis, as we have shown, relied heavily on the Aldrich bill in drafting the Federal Reserve Act.

The argument we have been making is that Senator Aldrich deserves equal billing with Carter Glass as a founder of the Federal Reserve System once we remove the ambiguity about the term “founder.” Founder of the Federal Reserve in a strictly narrow sense may refer to the person or persons directly responsible for the Federal Reserve Act and who steered it
successfully through Congress. There is no ambiguity about who that person was—Carter Glass, chairman of the House Banking and Currency Committee. In a broader sense, though, founder may also refer to the person or persons responsible for making a central bank the focus of banking reform and drafting a bill that served as the basis both in substance and wording for the Federal Reserve Act. The groundwork was laid by Senator Aldrich and his associates between 1908 and 1912.

The debt of the Glass-Owen bill to its precursor the Aldrich bill was not only not acknowledged but also repudiated by Glass and Willis because of an unfortunate set of circumstances. Glass and Willis exaggerated their claims that the Glass-Owen bill owed nothing to the Aldrich bill. Aldrich himself was not entirely blameless; he launched a scathing denunciation of the Glass-Owen bill. Emotions were running high, and a sober assessment could not be expected from either of the interested parties. Glass (1927, p. 239) concluded: “the Federal Reserve has no relationship to the Aldrich plan beyond a common use in some cases of indispensable banking technique and nomenclature.” And Willis’ (1923, pp. 523–24) repudiation was even stronger: “1) The Federal Reserve Act was not a copy or derivative of any other bill; 2) It had little relationship in principle to the so-called Aldrich bill, although in various places made use of the language of the Aldrich bill on matters relating to technique; and 3) It was not derived from, or modified after or influenced even in the most remote way by other bills or proposals currently put forward from private sources but, on the contrary, it was itself the pattern from which a host of imitators sought to copy.” Glass and Willis’ reluctance to acknowledge any influence of the Aldrich bill may have stemmed from a plank in the Democratic party platform which specifically opposed “the Aldrich bill or a central bank.” It may also explain why Glass denied that the Federal Reserve constituted a central bank. Glass’ approach to the Aldrich bill, however, went much deeper. Like Wilson he favored government control rather than banker control of the central bank, but unlike Wilson he did not oppose banker representation on the supervisory board.

One may ask, does it really matter whether there were one or two founders of the Fed? Absent the role of Senator Aldrich we get an exaggerated picture of the Glass achievement. He did little to bring business, banker, and public opinion around to focus on the desirability of a central bank instead of an asset-based currency. The Glass contribution was essentially legislative. He did what no other politician had been able to do, namely steer legislation successfully through the House and the Senate. But it was Aldrich, not Glass, who paved the way for the transition to a U.S. style central bank.
Moreover, absent the role of Aldrich, we seriously underestimate the contribution that the New York bankers, especially Paul Warburg, played in the design of a U.S. central bank. It was the Jekyll Island cabal that applied the principles of federalism and democracy to the problem of organization and governance of the central bank, principles later incorporated into the Glass-Owen bill. The New York bankers got all they wanted, with the single exception of banker control.

There is a striking parallelism between the wording and substance of the discount provision of both the Aldrich and Glass-Owen bills. Yet each has been subject to conflicting interpretations. According to West (1977, p. 158) the real bills doctrine was the cornerstone of the Federal Reserve Act. We will have more to say about this in the next chapter, which continues our comparison of the provisions of both bills.