The Great Debate on Banking Reform

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The canonical interpretation of the origins of the Fed is that its theoretical underpinnings resided in the real bills doctrine. This attribution is usually credited to Parker Willis and Lloyd Mints. Willis as chief consultant to Carter Glass and the House Banking and Currency Committee was largely responsible for drafting the Glass-Owen bill. Not only was he a professed adherent of the real bills doctrine, he attested repeatedly to its importance in shaping the Federal Reserve Act. Mints (1945, p. 9) concluded that real bills “was the main reliance of the agitation for banking reform in the United States before 1913.” A restatement of that hypothesis appeared more recently in the works of West (1977) and Timberlake (1984). With the benefit of accumulated research and insight on the origins of the Aldrich bill and its surprisingly close relationship to the Glass-Owen bill, we can see now that the extent of that influence was probably exaggerated. The Federal Reserve Act itself, as we propose to show, was in the strong sense real bills neutral.

REAL BILLS AND THE FED’S ORIGIN

The real bills doctrine is a theory of bank liquidity that states bankers should make only short-term self-liquidating loans created for the specific purpose of providing funds for producing, purchasing, carrying, or marketing of goods. Self-liquidating loans were supposedly loans made, for example, for financing the short-term working capital needs of business where the proceeds of the sale of the final product would ensure repayment. The amount of credit would presumably adjust automatically to
quantity demanded without any harmful effects of inflation; no regulation or interference by government is warranted. There is both a strong and weak form of the doctrine. The strong form stresses automaticity; attention to quality alone is sufficient. The weak form does not require automaticity. Quality remains paramount and loans for purely speculative and long-term investment purposes are excluded. The doctrine in its strong form is fallacious. When bankers continue to make loans for whatever purpose, inflation will be the result after full resource utilization is reached.

The roots of the theory can be traced to early nineteenth-century Britain. Two opposing schools of thought differed about how or whether to control the note issue. The Banking School maintained that the note issue ought to expand and contract in response to the needs of business, which would be the case if banks confined their activities to short-term commercial and industrial purposes. The currency would adjust automatically to the ebb and flow of trade. On the other side were writers of the Currency School, who rejected the Banking School view as fallacious. They thought the note issue should vary precisely as a pure specie circulation and that the exchanges were the appropriate guide to regulating the note issue.

The evidence for what influence the real bills doctrine exerted can presumably be found in: (a) the language of the Federal Reserve Act itself, (b) the views of the framers of the act, and (c) Fed policymakers’ behavior in the formative years. We will examine each in turn. The discount provision is the relevant provision of the Federal Reserve Act in which to discern real bills influence. Section 13 authorized the Federal Reserve Banks to: “discount notes, drafts and bills of exchange arising out of actual transactions, that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes; or the proceeds of which have been used, or are to be used, for such purposes. . . .” It also gives the Federal Reserve Board the power “to determine or define the character of the paper eligible for discount, within the meaning of the Act.” Certain specific kinds of loans are excluded, namely purely speculative and long-term loans.

The term “self-liquidating” is not part of the explicit language of the act. Nor is there any statement to the effect that if attention is paid to asset quality—that is, self-liquidating loans—bank liquidity will be guaranteed. The language of the act is neutral with respect to a strong real bills interpretation. Stripped of its strong real bills interpretation, the doctrine is innocuous. Its deliberate vagueness turned out to be its strength, for rival interpretations could more easily be accommodated.

The evidence for the influence of the real bills doctrine can also be
found in the views of the framers of the act. Parker Willis, who drafted the Glass bill, was an ardent supporter of the real bills theory, as was his mentor J. Lawrence Laughlin of the University of Chicago. According to West (1977, pp. 64–67): “Willis and others viewed the Federal Reserve Act as legislating the real bills doctrine as a policy guide,” and he maintained that the “law accepts the banking theory of the note issue rather than the so-called currency theory.” Friedman and Schwartz (1963, p. 193) also stated that the real bills doctrine was incorporated in the Federal Reserve Act albeit in limited form. However, there were others who played minor roles and who were active in the banking reform movement and were followers of the real bills doctrine including Horace White (1911), Charles A. Conant (1905), J. Lawrence Laughlin (1903), and William A. Scott (1903).

The evidence of the influence of the real bills doctrine derives less from an interpretation of the provisions of the Federal Reserve Act and more from the behavior of Fed policymakers in the system’s formative years. Policymakers in the early years may have been strongly influenced by real bills in at least two important episodes: the reluctance to raise discount rates in 1919 to curb inflation and a similar reluctance to raise rates to forestall stock market speculation in 1928 and 1929. Emphasis was directed at the quality of credit and not the quantity. The famous Tenth Annual Report of the Federal Reserve Board has also been interpreted as a real bills manifesto. It was probably drafted by Board member Adolph Miller, who had been a colleague of Laughlin’s at the University of Chicago.

The report proposed both a qualitative and a quantitative test for an excess supply of credit. The real bills influence is apparent in the exposition of the qualitative test (Tenth Annual Report, p. 145):

The Federal Reserve System is a system of productive credit. It is not a system of credit for either investment or speculative purposes. Credit in the service of agriculture, industry, and trade may be described comprehensively as credit for productive use. The exclusion of the use of Federal Reserve credit for speculative and industrial purposes and its limitation to agricultural, industrial, or commercial purposes thus clearly indicates the nature of the tests which are appropriate as guides in the extension of Federal reserve credit.

The report also proposed an alternative test—a quantitative test—that justified an increase in the amount of credit if it was accompanied by a commensurate increase in the nation’s aggregate productivity (output). Given the availability of production indices, it was fairly simple to administer.
Mints (1945, pp. 266–67) described the two tests but dismissed the second on the mistaken grounds that the Board thought the first would be sufficient. The significance of both tests is emphasized in its Annual Report (1924, pp. 33–34).

The Board is fully aware of the fact that the problem of credit extension involves the question of amount or volume as well as the question of kind or character; otherwise stated involves a quantitative as well as a qualitative determination. But it is the view of the Board that it is not necessary to go outside the Federal reserve act to find suitable methods of estimating the adjustment of the volume of credit provided by the Federal Reserve banks to the volume of credit needs. The Federal Reserve Act itself suggests the nature of the tests, guides, or indicators, whatever they may be called to be used in gauging the need for and the adequacy of Federal Reserve credit.

The quantitative test revealed that the Board was aware that price inflation might ensue if credit expansion continued that was not accompanied by a commensurate increase in output. Effective applications of the quantitative test were made in 1922–23 (Wicker, 1966, chapter 5). The behavior of Fed policymakers in the formative years is not consistent with the claim that they were committed to the strong form of the real bills doctrine.

Our sole concern in this chapter is the language of the Glass-Owen and Aldrich bills and what can be inferred about real bills influence. Briefly, our conclusion is that the language of the Federal Reserve Act is neutral, that is, consistent with either the acceptance or repudiation of the real bills doctrine. A comparison of the Aldrich and Glass-Owen bills has revealed a similarity of wording in the discount provision that was not accidental. However, the implications of this striking parallelism have been overlooked. According to West (1977, p. 155) the real bills doctrine was the cornerstone of the Federal Reserve Act. But the Aldrich bill was free from such an association and did not evoke the same criterion. Carter Glass and Parker Willis were proponents of real bills, but at least two, if not three, of the five Jekyll Island participants specifically repudiated it. Neither bill contained language explicitly related to the strongest form of that doctrine. Banking theory considerations may have influenced Willis, but the discount provisions of the Aldrich bill were drawn from the practice of the Reichsbank. Therefore, the language of the two bills was real bills neutral, though their underpinning may have differed substantially.

We know what it means to claim that those who drafted the Federal Reserve Act accepted the theories of the banking school, but what did
Willis mean when he said the law accepts the banking school theory of the note issue? How can the law accept a particular banking theory? Suppose that all of our sources concerning the origins of the Federal Reserve Act were suddenly destroyed and the only thing that remained was the text of the act itself. What can we infer from reading and interpreting the act about how the real bills doctrine influenced specific provisions of the act, namely those dealing with discounting and the issue of notes?

We reproduced in part Section 13 of the Federal Reserve Act a few pages earlier. To reveal evidences of real bills in Section 13 we need to review the characteristic features of that doctrine:

1. Short-term commercial paper is the desired asset in the portfolios of both the commercial banks and the central bank.
2. The property that makes it desirable is its alleged self-liquidating feature.
3. Purely speculative loans and long-term loans for investment purposes are excluded.
4. The note issue is self-regulating.

Points one and three are included in Section 13. The emphasis accorded short-term commercial paper is a necessary but not sufficient condition for the validity of the strong form of the real bills doctrine. The self-liquidating feature does not appear in the language of the act, nor is there any statement to the effect that the note issue is self-regulating. There is no internal evidence that the real bills doctrine in its fallacious form appears in the original act.

In a purely hypothetical real bills model where individual banks issued paper currency, there is no role for a central bank. The problem of bank liquidity does not arise since liquidity allegedly is guaranteed, if, that is, bank lending is confined to self-liquidating commercial paper. Moreover, currency notes issued by the banks are self-regulating. Ergo, in such a strict real bills model there would be no banking panics. The solution to the bank instability problem therefore was to constrain asset quality of the commercial banks. Nevertheless, advocates of real bills were not deterred from advocating a central bank. They simply were not prepared to push the purely hypothetical real bills model to its limits. The proposal to allow banks to create an asset-based currency had been rejected, as well as a bond-secured currency established by the National Banking Act. In its place the banking reformers substituted an asset-based paper currency issued by a central bank backed 100 percent by commercial paper. The central bank did not intend to control the amount of currency supplied. Presumably it would be demand determined.
The absence of specific policy guides like the money stock and prices in the Federal Reserve Act has puzzled historians of the Fed. A purely passive stance with respect to these variables is at least consistent with such an omission. The framers of the act took it for granted that the gold standard was the long-run determinant of the money stock.

Nor does the Federal Reserve Act spell out the circumstances when the discount rate should be changed. Real bills had nothing to say about discount rate behavior. Both the congressional hearings and the debates show an awareness that discount rate changes should influence gold flows and the level of economic activity.

The criterion to access the discount window was the availability of eligible paper. According to Harris (1933, p. 297) eligibility criteria were framed with a view to stimulating the use of self-liquidating paper of a commercial type. However, by 1925 no clearly defined criteria of eligibility had emerged, which led Willis (1923, p. 905) to conclude that it was “almost impossible to lay down any definite standard of ‘eligibility’ which should be universally applied in all districts.” Reliance on the discretion of Reserve Bank officials in the absence of any instrument necessarily introduced a note of uncertainty with respect to the availability of reserves and never provided the sense of absolute security characteristic of the German discount market with its standardized financial instrument. The sense of insecurity was greatest during the period of direct pressure during 1928–29 when officials attempted to control the flow of credit to the stock market. By 1933, Harris (1933, Vol. 1, p. 286) noted that member banks in financial centers obtained most of their advances by borrowing on their own notes instead of commercial paper.

REAL BILLS AND THE ALDRICH PLAN

Section 26 of the Aldrich bill reads as follows: “The National Reserve Association may through a branch rediscount for and with the endorsement of any bank having a deposit with it, notes and bills of exchange arising out of commercial transaction, that is, notes and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, and not including notes of bills issued or drawn for the purpose of carrying stocks, bonds, or other investment securities.” This section of the Aldrich bills is almost identical in wording to Section 13 of the Federal Reserve Act.

The discount provision of the Aldrich bill was identical to Glass-Owen, but the underpinnings were radically different. The Aldrich bill’s discount provision was modeled after the German prototype as understood by Paul
Warburg and grounded in his banking experience in Germany before his move to the United States in 1902. At the center of the German system was a highly organized discount market almost totally absent in this country, where bills of exchange were freely traded in an open market among the different issuers, the Credit Banks and the Reichsbank. The bill of exchange was a standardized financial instrument whose main characteristics were: (1) it bore the endorsement or acceptance by a well-established bank; (2) it was highly liquid and of short maturity, saleable at any time in an organized market; and (3) it was subject to uniform laws governing such paper. The bill of exchange was self-liquidating, though not automatically in the classical real bills sense. Emphasis was placed upon bills of short maturity where the expected proceeds of the sale of the goods would be used to repay the loan. Quality alone was never the sole criterion for judging safety. Of equal importance was the reputation of the endorsers and acceptors, and the existence of a robust market for commercial paper. According to Warburg (1930, Vol. 2, p. 223) it was Germany’s highly developed discount system that averted banking panics “with as much certainty as we may expect their occurrence with us.”

The alleged success of the German discount system can be attributed to a combination of circumstances: (1) the existence of a uniform and standardized financial instrument; (2) an efficient discount market; (3) a central bank; (4) a highly concentrated banking structure with numerous decentralized branches; and (5) the proportion of cash-using to deposit-using transactions was still relatively large compared with the United States and Britain. Warburg tended to stress points 1–3 to account for the absence of banking panics in Germany, but he ignored 4 and 5. He was well aware of the importance of the highly concentrated branch banking system in Germany. Item five, particularly, has not been sufficiently emphasized. The proportion of cash- to deposit-using transactions was still very large in Germany, certainly much larger, for example, than in the United States and Great Britain. Savings deposits were concentrated in specialized banks known as Sparkassen where deposits were guaranteed and notice of withdrawal could be requested. Cash-using transactions were concentrated among the holders of savings deposits. The conclusion we might draw is deposits in the Sparkassen were not a likely source of unexpected deposit withdrawals in time of uncertainty.

Deposits of Berlin Credit Banks were estimated in 1908 to be between 3 and 3.5 billion marks ($8.8 million). There were also Cooperative Banks with more than 2.3 billion marks. In all of Germany deposits may have totaled more than 8 billion marks, or $2 billion. By way of comparison deposits in New York banks amounted to $10 billion. Deposits of the large Credit Banks were mainly deposits of large industrial establishments, and
the Reichsbank transferred claims among the Credit Banks by means of book credits, thereby reducing the business demand for check-using transactions.

Unanticipated deposit withdrawals of excited small depositors of the Sparkassen were less likely than in the United States to ignite bank contagion. Moreover, the size, composition, and distribution of deposits payable on demand made German banks less prone to unexpected deposit withdrawals. German banks were not as vulnerable to deposit shocks as U.S. banks. And deposit guarantees at the Sparkassen may have contributed to relative deposit stability in periods of nascent banking unrest.

The real bills doctrine was not the source for the role accorded commercial paper in the Aldrich bill. Warburg was a practical banker with only a peripheral interest in banking theory. Although he never referred directly to the real bills doctrine, he disparaged those who treated bank credit or the note issue as self-regulating or automatic in its ebb and flow. Employing the metaphor of water flows, Warburg (1930, Vol. 2, p. 128) regarded as the duty of the central bank to supply legitimate credit demands. He added: “No automation—no tax or fixed regulator—can perform it, but the best judgment of the best experts must indicate the policy to be pursued from time to time.” Similarly he argued that currency notes should expand and contract in accord with the requirements of trade: “However, this is not a merely automatic process when those entrusted with the management of the central bank see the necessity of exercising a restraining influence on the business community, they raise the rate at which the bank will discount . . .”

A. Piatt Andrew, who also attended the Jekyll Island meeting, regarded the real bills doctrine in its strictest form as fallacious. He (1904, p. 16) maintained that it was “preposterous then to assume that credit can be issued indefinitely upon the basis of goods without any regard whatever to the quantity of available money in which it is likely from time to time to be expected for redemption.” He also recognized that as prices rose, the demand for credit would lead to a race between credit expansion and prices.

The discount provisions of the Aldrich and Glass-Owen bills were identical. Yet at least two if not three of the framers of the Aldrich bill had rejected the real bills doctrine as fallacious.

West (1977, p. 150) concluded that it was remarkable that the two sides could agree on the same discount provisions with such strong contrasting views on the validity of the real bills doctrine. A comparison of the discount provisions of the two bills reveals that the Federal Reserve Act was neutral with respect to the strong form of real bills. There was noth-
ing within the act itself to discriminate between a Warburg-Andrew and a Glass-Willis interpretation of that same provision.

We are perhaps in a better position to answer our initial question: What did Willis mean when he said the law accepts the banking school theory of the note issue? The law neither accepted nor rejected the banking school theory; it was consistent with both its acceptance and its rejection, that is, it was neutral!