Our Defective American Banking System

A Diagnosis and a Prescription

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OUR DEFECTIVE AMERICAN BANKING SYSTEM

THE periodic recurrence in the United States of severe financial crises, from which the other great nations of the world are nearly if not quite exempt, indicates that something is fundamentally wrong with our banking system and credit machinery. It is, indeed, not uncommon to hear that system denounced as the worst now to be found in any civilized land. To this extent has a glimmering of the truth begun to penetrate our minds. A few of us are beginning to sit up and rub our eyes, and to ask whether it is creditable to our prescience as a nation, or to the acumen of our men of affairs, that such an incubus upon our prosperity should be allowed to continue.

This much fruit has come of the ups and downs of the last sixteen years, and of the active discussion of economic principles and banking science to which they have given rise. The nature of the disease from which we suffer may now be said to be fairly well understood. The amazing thing in connection therewith is the widespread inability to perceive what must be the remedy if a remedy is ever to be applied. In large measure this inability is due to deliberate shutting of the eyes. But truth is not the less vital because we are reluctant to recognize it. As the old adage puts it, "There are none so blind as those who will not see." The bankers, in particular, are resolute in their averted gaze. Their attitude may be likened to that of men afloat in badly designed and leaky craft that in stormy weather can be kept above water only with the utmost difficulty, yet who are unwilling to consider, even for a moment, anything more efficacious than some novel pump, and who repel with horror the idea of closing the seams, or of transferring their persons and property to staunch and seaworthy vessels of approved construction.

To some extent, it must be admitted, the hostility of the bankers comes from unwillingness to be thought unpractical through advocacy of measures which they believe have no chance of adoption, since legislators are too ignorant of the intricacies of finance to venture upon a complete overturning of the present system, and managers and owners of existing banking institutions may be counted upon to oppose with all their might any enactment likely to have that effect. And so, while continually complaining of the ills that need correcting, they are unable to propose any effective plan for doing away with them. If only some one could devise a reformation that would leave things as they are! That apparently is what many desire. They might with as much reason expect the art of swimming to be acquired without venturing into the water.

What, then, should be done? Is it such a simple matter? Have not many of our most experienced financiers puzzled their heads over it for years without reaching any conclusion? Are they not wise in hesitating to recommend innovations the consequences of which cannot possibly be foreseen?

The last of these questions may be answered first. The placing of our banking and financial system upon a thoroughly scientific and eminently sound basis involves no experiment whatever. There is not the slightest need of trying anything that has not been tried over and over again, that is not subject to the test of every-day use in other countries of the first rank.

Before answering the question, "What should be done?" it will be well to glance at certain things in the situation with which we have to deal.

There are in the United States about 21,400 banking institutions, national, state, and private. Theoretically, each of these stands upon its own feet, so to speak; practically, all are made mutually dependent upon each other by the practice of depositing and redepositing a large part of their reserves with one another. By this practice, which is an outgrowth of the necessity of carrying balances for exchange purposes, all are tied together in a complex credit structure inherently weak and certain to break down under any unusual strain. The consequences of this practice are most pernicious. Virtually it amounts to a pooling of the reserves, and to the making of the banks in the city of New York the final reserve agents for the banks of the entire country. And as these reserve agents do not set the reserve funds apart and hold them in cash as "special deposits," but merge them with their other deposits and pay interest upon them, they must lend as nearly as possible seventy-five per cent of the total to make the transaction profitable. Thus it will be seen, when a crisis arrives, the actual reserves of the banks of the interior consist of little more than the cash in their own vaults; for, while their balances in the hands of reserve agents are ordinarily available, they become unavailable in time of stress, as any general demand for currency to the extent of twenty-five per cent of the total of such balances would exhaust the entire amount of cash held against them by the New York banks. Experience shows that, as was the case in October, 1907, a demand for much less than this percentage may force suspension of cash payments, not only by the New York banks, but by those in the other so-called "central reserve cities." Nor, when a pinch comes, can the banks in the interior avoid making such demand. Usually it is accompanied by urgent requests for rediscounts, one inevitable consequence of the practice of redepositing reserves being that banks everywhere throughout the country, except those in the city of New York, which have nowhere to turn unless it be to Europe, are tempted to lean upon some other bank's credit to save their own. Just before the panic of 1907, 6,178 national banks not located in "reserve cities" showed balances aggregating $420,000,000 due to them from reserve agents in those cities, but only about $201,000,000 cash in their own vaults. That they could not

avoid calling upon these reserves plair
appears from their published statemer
as of December 3, 1907, which show th
they did not withdraw, or, to put it blur
ly, were unable to withdraw from th
reserve agents as much as was withdraw
from them by their own depositors.

As the balances due to other banks for
only about forty per cent of the total d
posit liabilities of the New York banks,
may be wondered why the withdrawal of
moderate portion of these balances shou
have such far-reaching effects. Ordinari
it does no more than form one of the co
tributory causes that bring about the recu
rent stringency in the "money market
that is experienced every autumn. B
when it is the result of disturbed confiden
in the financial equilibrium, the normal e
fect of the pressure for liquidation that
produces is greatly intensified, with resul
ant marked increase in the stringency, an
heightened alarm which may easily reac
the proportions of panic. In considerir
these things, it should constantly be born
in mind that any pressure upon the bank
is instantly and of necessity transferred
the business community as a whole, usual
with the effect of increasing the pressur
upon the banks and in turn upon the com
munity, in a vicious circle,—a movemer
which, when once fairly started, can only b

checked by general liquidation and very considerable curtailment in the volume of commercial transactions.

It should also be borne in mind that in the modern financial fabric the principal function of money—actual cash that is, *which should be clearly distinguished from loanable capital in the form of credit*—is to furnish the basis for credit, and, through the medium of the banks, to make money, capital, and credit to a large extent convertible terms. The loaning power of the banks, therefore, is closely related to the percentage which the actual cash on hand bears to their deposit liabilities, all credits in open account being in American parlance spoken of as "deposits." Thus it comes about that when the banks in the interior send their surplus funds to their correspondents in New York, so that these funds may earn a little interest during the dull season of the year, when, for lack of borrowers, they cannot be employed at home, the loaning power of the New York banks is, in the aggregate, increased not merely by the amount of such cash, but by nearly four times that amount. This would not be true were the New York banks to lend to foreign borrowers who would call for the cash and take it away; but it is true to the extent that loans are represented by credits upon the books of the banks, which, when withdrawn by check, are redeposited to the credit of other customers. Whatever the experience of any individual bank, the result for all is a considerable increase in both loans and deposits.

Now, as the New York banks have established the custom of paying interest upon balances of other banks at a rate fixed for the entire year and not governed by market conditions as is customary in other countries, they must find employment for nearly all of their loanable funds if they are to avoid loss. And in forcing these funds into use at the dull season of the year, the inevitable consequence is that the funds find their way into the hands of speculators. This is true of the other reserve cities as well as of New York, the difference being chiefly one of degree. Thus it is that our banking system becomes a colossal machine for fostering speculation; a machine in which each bank is carried along by the general current, without power successfully to resist its sweep or to avert its consequences.

The banks have been severely criticised for their part in this procedure. It has been justly stigmatized as a disgrace to a civilized community, and to the banking fraternity in particular, that so large a part of the free loanable capital upon which the commerce of the country is dependent should be locked up in stock exchange or other speculations, thus fostering periodic crises, with their attendant trail of paralyzed industries, wide-spread disaster, and misery. Let us, however, be fair to the managers of the banks. As certainly as the summers come around does more or less of this loanable capital, temporarily freed from use, accumulate upon their hands. With rare exceptions, here and there, they pay interest upon it, unwillingly in the case of very many of them, but nevertheless of necessity, because their competitors do so. The country bankers, having no use at home for their accumulations, desiring to earn even a little interest upon them, and fearing to take the risk of robbery if they carry unusual sums in their vaults, send them to the cities. The banks in the smaller cities, being similarly situated as regards the plethora of loanable funds, pass their surplus along to the banks in the larger cities; and they in turn deposit theirs with the banks in New York.

What, then, should the metropolitan bankers do under the circumstances? Refuse to take this capital on deposit and pay interest upon it? That would be the sane and prudent course, but it is a course they dare not take. Self-interest interposes. The few who perceive the danger are helpless in the face of the established custom: should they turn away deposits for which their rivals clamor, they would merely injure their own business without relieving the general situation. As a matter of fact, there is but one thing they can do if they are to continue in business, and that is to take the money and lend it as best they can. This means that the capital—deposits, or credit balances in the language of the banks, or "money" as it is styled in the jargon of the street—must be forced into use regardless of the difficulty, if not the impossibility, of withdrawing it when needed for the active commerce of the autumn and winter. If, in the effort to find safe employment for the funds thus committed to their charge, the bankers play into the hands of the millionaire speculators, they are not so culpable as may seem when viewed from without. These speculators are among the very best customers of the banks; they carry the largest balances without interest; they offer what is under ordinary circumstances the most readily marketable security; they control, directly or indirectly, many of the sources from which the banks derive profitable business. Moreover, the purpose for which loans upon collateral are negotiated is not, as a rule, known to the lenders. Even the personality of the borrowers is frequently hidden, the loans being negotiated through brokers. Nor is this all: much of the borrowing is from individuals, insurance companies, trust companies, and to some extent from country banks direct. But whoever the lenders, when the autumnal activity arrives the pressure bears with most severity upon the New York banks, where the credit balances are carried.

From their intimate relation to the financial transactions that pass through their hands, the bankers cannot plead ignorance of what is going on in the field either of legitimate business or of speculation. But individually they are not free agents; the working of the system is more powerful than they are. Collectively they do not act; the number of independent rival institutions precludes concerted action except in great emergencies, whether for their own protection or that of the general public.

The truth is, that our present system — if system it can properly be called — consisting of several different kinds of banking institutions, all engaged in more or less cutthroat competition, all pushing each other into unsound practices, but pulling apart and forcing disaster when a crisis becomes imminent, and only uniting to a limited extent for mutual protection through the medium of the Clearing House Associations when, to use a convenient metaphor, they have pulled the house down upon their heads, is fundamentally and incurably weak. *The weakness is an inseparable concomitant of the large number of separate units.* Nominally independent, the relations they sustain to each other and to the community make actual independence impossible.

In itself, it is well to note, speculation is not necessarily harmful to the common weal. There is no hard-and-fast line of demarcation between it and so-called legitimate business. As a matter of fact, both merge imperceptibly into one another. To an extent much greater than is commonly realized, speculation is a steadying force so far as prices are concerned. The professional speculators, sometimes known as market gamblers, are, more especially the larger operators, a remarkably astute set of men. In general, they merely anticipate normal price movements and stand to win only when they guess right, though of course their dealings may at times bring about artificial conditions with results sometimes profitable and sometimes disastrous. The real service of speculation comes through making a wide and quick market for staple food supplies, bonds, and the shares of joint-stock corporations. Without speculation the function of the stock exchanges would be far less effectively performed; listless markets and wide fluctuations in prices would almost certainly be the rule, and not the exception.

But it is just here that the harm arises, and in connection with our banking system the injury that results is of stupendous magnitude. Because of the quick market for "securities," as stocks and bonds are dubbed in the language of "the street," they have come to be regarded as the most desirable basis for loans by the banks. Nevertheless, they represent fixed capital, the fluidity being only apparent and disappearing when most desired. And it is not sound banking for institutions whose deposit liabilities are payable on demand to invest a preponderate percentage of their assets in loans upon securities representing fixed capital. Yet that is just what the banks and trust companies in New York and the larger Eastern cities commonly do. Mr. Charles A. Conant puts the truth tersely in a significant sentence, when he asserts that "there is hardly a greater menace to the security of the New York money market than the vaunted fact that it is the only strictly 'call money market' in the world."[1]

While this is true, nevertheless it is not so much the aggregate sums employed in open market speculation or in attempted

[1] "The Regulation of the Stock Exchange," Atlantic Monthly, September, 1908.

market manipulation, nor yet the failure of speculative enterprises to bear fruit as quickly as the speculators expect, as it is the financing of new issues of stocks and bonds that tie up the floating capital and put it into fixed form. When "money is cheap," or, to put it more accurately, when, because of the accumulation in the financial centers of a large part of the free loanable capital of the country, rates of interest are low,[1] is naturally the time most often selected for marketing large "blocks" of new securities. The form of such undertakings varies; but commonly the new issues are underwritten by syndicates of dealers who furnish the capital and recoup themselves as the securities are absorbed by the investing public. When the public is slow to purchase, and the securities have to be carried by the syndicates, they are said to be "undigested." Whether the members of the syndicates advance the capital from their own coffers or borrow it from the banks or other lenders makes no difference so far as the effect upon the loan market is concerned. There has been a conversion of fluid capital into fixed capital. Such conversion is going on all the time, and so long as in the

[1] Not infrequently the current "call money" rate in New York is lower than the rate allowed by the metropolitan banks upon balances of other banks.

aggregate it does not exceed the production of fluid capital, no harm ensues. But when the annual increment of fresh capital is exceeded, a condition supervenes that is necessarily fraught with grave peril to the country. Inevitably, under our system, the current loanable funds of the banks which form the final reserve against their deposit liabilities are either directly or indirectly drawn upon and made unavailable to liquidate these liabilities. "The individual institution," as Mr. Conant aptly expresses the situation, "may protect itself by the drastic sacrifice of securities when it needs cash, but it does so only at the expense of its clients, and with a disturbance to the money market and the market for securities which is abnormal and excessive." If the losses made inevitable by such forced liquidation fell only upon those who, by abstracting from the market the supply of free loanable capital that is its life-blood, were chiefly instrumental in causing them, the consequences would be bad enough. They are intensified many fold when, as inevitably happens, they fall alike upon "the just and the unjust," and an embargo is placed upon the general business of the country, making property of almost all kinds less marketable, values uncertain, and ventures of any sort ultra-hazardous. The poor borrower, who finds himself caught, and either forced to pay an extraordinarily high rate of interest or is "sold out," has, in most instances, committed no crime, economic or other, for which he should be so severely punished. The banker, on his part, may also hold himself blameless; and indeed, as has been shown, he is largely a mere cat's-paw, powerless in the grip of a bad system. Nevertheless, the bankers of the country cannot blink their obligation to take a broader and more intelligent view of their duty to the people as a whole. The prevalent notion, that all a banker is called upon to do is safely to lend the funds in his care and to pay his depositors' drafts upon demand, is untenable. Most causes in this world have dual effects—direct and reflex—and the man of affairs is as truly bound to consider the one as the other.

To eradicate the weakness in our banking system the cause must be removed. The regeneration must be radical and comprehensive. Real reformation will never come from anything else. No half-way measures will suffice. The sooner this is comprehended the better will it be for all concerned. None of the remedies that have been proposed touch the root of the difficulty; most of them would be more likely to aggravate the trouble than to ameliorate it. Of this nature is the proposition that the banks should be permitted to issue "emergency circulation," based upon bonds as security. It should be obvious upon very little reflection that if such circulation is not put out until the emergency arrives, then it serves only the purpose of "locking the stable-door after the horse is stolen." If put out in anticipation of the emergency, the most probable effect is to postpone, but not to avert, the evil day. All such measures ignore the fact that the capacity of the community to absorb fresh supplies of capital in times of speculative excitement and extravagant business ventures is absolutely unlimited. Moreover, they fail to take into account a psychological factor that should be reckoned with. Though the bankers in the United States are generally hard-headed men of affairs, they are nevertheless in some respects as timid as young gazelles. That is one of the consequences of the dangers to which our banking system exposes them. Such is their dread that their depositors may become alarmed and endeavor to transfer their funds to safety-deposit boxes, that when clouds appear upon the financial horizon their fear of seeming to be afraid is commonly greater than their fear of the impending storm. Any bank issuing emergency notes in advance of its fellows would be hoisting a danger signal not unlikely to precipitate a "run" by its depositors. The fact of such issue might be concealed for a time, but not for very long. If, in the mean time, similar issues have become general, then they may have helped to abate to some extent the eagerness of borrowers and the alarm of depositors, but if insufficient in amount to allay the stringency, then little real benefit has resulted. And in any case a violent check to business is most probable.

In this connection it may be said that a truly elastic currency, responsive at all times to the needs of the commerce of the country, and automatically adjusting itself to these needs from day to day, is greatly to be desired; but, let it be clearly understood, as an every-day affair and not merely as an emergency measure. Between such a currency and a bond-secured issue kept in circulation as long as the issuing banks elect, there is a whole world of difference. In one case *daily redemption in all the leading cities* compels the issuing banks to be prepared to meet their notes on presentation, and however they strive to keep them outstanding, the adjustment to the needs of the people as a whole is automatic; whereas, in the other case, the redemption machinery being, as at present in the United States, a farcical shadow of the real thing, the volume in circulation is determined only by the cupidity or the necessities of the issuing banks. The issue of circulating notes, automatically elastic in volume, begets conservative banking: the issue of circulating notes, however secured, that may be kept out at the pleasure of the issuer, tends to unwise inflation of credit, and necessarily involves the danger of that effect.

Recent discussion of the currency question makes it evident that the term "elastic currency" is not widely understood. One banker who has read many papers opposing the idea of asset currency has repeatedly stated that in his opinion the elasticity would be chiefly in the way of expansion, and this opinion does not appear to have been openly challenged in any of the gatherings of bankers that he has addressed. It may not, therefore, be supefluous to point out that in order to be truly elastic in the sense in which the term is used by the advocates of asset currency, the adjustment must take place daily as the result of a contest in which each bank endeavors to make as wide a field as possible for its own circulation, by presenting for payment all notes of other banks coming into its possession. Thus it becomes impossible for any bank to keep more of its notes in circulation than the people have use for, and while expansion of the volume outstanding will be a normal experience during the autumn, contraction will be equally certain at other seasons. If necessary, every bank issuing such currency should be prohibited by law from paying out the notes of other banks; but self-interest should make such a law needless.

When a thoroughly sound and scientific banking system is established in the United States, such an elastic currency will be one of its important features. In time of stress it will furnish an efficient "safety-valve." At all times it will operate to equalize interest rates, and through free redemption and cancellation when business is slack, will tend to prevent the accumulation of the large amounts of loanable funds that are now such a menace to our stability.

For its economical working such a currency implies branch banking. It also implies, for the protection of the public, that the issuing banks should have large capital, be subject to stringent regulations in the interest of sound banking, with adequate penalties for their infringment,—and that government inspection should be of searching thoroughness. True elasticity could readily be imparted to our present national bank currency by establishing daily redemption in all of the reserve cities, compelling every bank having notes in circulation to maintain a redemption agent in each of these cities, and forbidding the banks to pay out the notes of other banks, but instead, requiring them to present such notes for payment just as they present checks drawn upon those banks. In this way, and in this way only, can elasticity be achieved. But elasticity would make a bond-secured currency unprofitable. Even with the full volume outstanding throughout the entire year, the increment to the issuing banks in our present national banking system is very small; and as banks are not eleemosynary institutions, some profit to them must be reckoned upon in any system they are expected to maintain.

Desirable as is a properly constituted elastic asset currency, it needs to be said most emphatically that to authorize the national banks, as at present constituted, to issue unsecured circulating notes would in all probability invite consequences appalling to contemplate. Aside from the unwisdom of allowing a multitude of small banks to emit unsecured circulation, the current practice, to which reference has been made in this paper, of the virtual pooling of reserves and the investment of the major part of these reserves in loans on the New York Stock Exchange, is alone a sufficient argument against it. But another and more serious objection lies in the fact that *the bills receivable held by the banks in the United*

States are not liquid assets. Herein lies the vital difference between banking practice in Europe and America. And this difference points clearly and unmistakably to the nature of the change in our method of making loans, which must be accomplished if we are ever to have a scientific banking system, and be even measurably free from the violent disturbances and distressing conditions to which we are now periodically subject.

A business man of high standing and wide commercial experience told the writer not long ago that when he accepted the position of director of an important bank, it was with something of a shock that he discovered, as he did very soon after taking his seat as a member of the board, that with the exception of "paper" bought from note brokers not more than fifteen per cent of the notes in the bank's portfolios could be relied upon to be paid when due. The relations existing between the bank and its clients were such as practically to compel the granting of renewals if requested. This is not an isolated experience. It is substantially true of nearly every bank in the country. Moreover, many of the larger borrowers, who under ordinary circumstances place their paper through note brokers, customarily fall back upon their banks and expect to be taken care of very liberally when the money market tightens and the brokers are unable to sell their paper. Demands of this sort must be met by the banks under penalty of the loss of valuable business, and met in general at a moderate rate of interest, thus preventing them from reaping a harvest at the high current rate, and not infrequently compelling them to become borrowers in order to grant the accommodation.

From these disabilities and disadvantages the European banks are exempt. It is not their custom to discount the simple promissory notes of their clients, and then, having held these notes until maturity, to take in satisfaction of them similar notes made by the same parties. The practice, so common in the United States as to be almost the general rule, for banks to furnish their clients with what amounts to fixed capital through a series of renewals running, it may be, for years, would be regarded as the height of bad banking, and absolutely indefensible from any point of view. The legitimate function of banks is to lend temporary capital in the shape of credit, not to enter into quasi-partnerships in which either the capital of the banks or the funds intrusted to their custody are embarked in manufacturing, merchandizing, farming, warehousing, or in any other business enterprise, taking all the risks of the business, but gaining only ordinary interest in return. To assert that it is only temporary capital that the banks lend, when they habitually grant renewal after renewal, and that, if they have used good judgment in making the loans, they can always require payment at maturity, is merely to beg the question. Every banker in the United States knows that in the majority of instances there are circumstances that would make such a course inexpedient if not impracticable; and in time of stress the burden of "carrying" the clients with whom such relations have been established is usually imperative.

The European method of making loans is in every way better and safer, and is in strict conformity with sound banking principles. It is not only safer for the lenders, but the borrowers, considered en masse, are served far better and more equitably than they are with us. This difference in the method of making loans is the fundamental difference between banking in Europe and in the United States. It goes to the very root of all the questions involved in the reformation and modernizing of our banking system and banking practices. Even the currency question is secondary to it and is largely bound up in it. It is not because they have elastic currency in some European countries that Europe weathers financial crises without the phenomena of panics, sudden collapse of credit, loss of confidence, violent contraction of the volume of business, and all the attendant distressing circumstances that we know so well. *The real reason why these things are avoided is that the bills receivable, which with us are a fixed, immovable mass, are with the European banks scarcely less liquid than the cash in their vaults.*

Although cash advances by the European banks are not entirely unknown, they are usually for small amounts. In general, when a line of credit is granted, it means that the bank agrees to accept the bills of exchange of the client with whom the arrangement is made, running not longer than a specified time, — ninety days being the usual limit. These bills, duly accepted by the bank, are placed with a bill broker for sale in the open market. As all the European banks except the central banks make a practice of accepting such paper, based upon collateral security, or reliable guaranty, or thorough knowledge of the financial condition, habits, and ability of the makers, the market is thus supplied with bills of the highest class. To some extent the standing of the makers influences the rate at which the paper sells, but in general the standing of the accepting bank determines its salability, and the question of individual credit is largely eliminated. But to the bank the preservation of its credit is of vital importance. It is incumbent that sound judgment be exercised at all times in accepting bills. The amount of paper which any borrower can place upon the market at any time is therefore limited by the sum which his bank is willing to accept. The bank on its part cannot prudently lend its credit except upon the condition that its client does not enter into similar relations with any other bank. Furthermore, it is customary to withdraw the credit, wholly or in part, whenever it appears that the financial strength of the borrower is declining.[1] Over-extension of credit is thus, for the most part, effectively checked, and the whole course of business made safer in consequence.

Such is the character of the paper held by the European banks. There are, of course, many varieties in the bills themselves, and there, as here, there are bills drawn by merchants and manufacturers upon their customers, against goods sold. But all are readily marketable at any time, and no stigma attaches to a bank when it sees fit to dispose of any part of its holdings,

[1] As for renewals, it is usual for the banks to require that maturing acceptances be met by the makers before other acceptances are given in their place.

either because it needs cash or because it can reinvest the funds to advantage; as, for example, by selling bills that are about to fall due and buying others having two or three months to run. For such paper the market is not merely local; it is as wide as the whole world. It is the rate of discount that governs. For instance, when business is active in England and the open market rate in London is higher than that in Paris, the French banks buy English bills. They may not know much about the makers, but they do know the standing of the accepting banks. In this way conditions are equalized for borrowers all over Europe. To-day Austrian bankers may be investing in Italian paper; six months hence the conditions may be reversed. Only the United States is out of the running, having no modern bills to offer, save such as grow out of foreign transactions, and which, being payable abroad, and bearing the acceptance of European banks, are not strictly in point.

It will be observed that under the European system the borrower is not affected, as in the United States, by the ability or inability of his bank to make him a cash advance. If the bank feels that it can prudently lend its credit by accepting his paper, all the borrower has to consider is whether he can sell it and at what rate.

The banks, on the other hand, owe their clients nothing that need cause the least embarrassment. When they have already loaned all that they should loan, they are not subject to being called upon, as our banks are, to make further advances that they cannot avoid if they desire to retain the business of the applicant. Moreover, they have no relations to the makers, acceptors, or indorsers of the bills in their portfolios that need deter them from reselling the bills at any time they may desire, either at home or abroad. And should they find that they can get a better rate by adding their indorsement, no loss of prestige thereby ensues. Far otherwise is it in the United States. Our banks sometimes have to borrow, but all sorts of shifts are resorted to to avoid showing rediscounts in published statements, lest they be interpreted as indicating weakness.

To make commercial paper always a liquid asset, it is essential that the market for prime bills should never fail. In all the countries of the world having modern banking systems this certain market is insured through the medium of a central bank. *The primary function of these central banks is solely to provide such a market.* The other functions that they may perform, such, for instance, as the handling of the government funds, and the issue of circulating notes, are merely incidental, and must be kept so, if the organization is upon a right basis. The usual provision by which these banks are kept from doing an ordinary commercial business is their restriction, in buying paper, to bills bearing the names, as acceptors or endorsers, of at least two banks or bankers in high standing. If, in addition to this regulation, the power to give acceptances be denied, the central bank becomes, as it should be, chiefly a bank for other banks, that use it to rediscount bankers' acceptances, with their indorsement added, thus bringing the paper within the requirement that it must bear the names of two banks or bankers. Through the power to issue circulating notes, the ability of the central bank to rediscount for them is made sufficiently elastic to safeguard all emergencies.

Of all these central banks the German Reichsbank is without doubt the most perfect in its organization and the most efficient as a working machine. And in spite of the fact that a part of its stock is owned by the government, it demonstrates, beyond cavil, that it is possible to keep such a bank quite free from political influence. The fact is, that the restriction of its functions to those which it should properly perform removes all reason for the bank being "in politics." To describe in detail the working of the Reichsbank or any other of the European central banks would unduly extend this paper. The question may, however, be asked, how does the Reichsbank get a supply of bills at times when the money market is easy? The answer is, that in ordinary times, as the Reichsbank has branches in all the important towns in Germany, the other banks find it a most convenient collection agent. The custom is to rediscount all bills payable at a distance. For this service the Reichsbank deducts interest, for five or ten days according to circumstances, at its published rate, which is usually from one half to one per cent above the open market rate, but makes no collection or exchange charge. As the money market hardens, bills having longer time to run are offered for rediscount, and when the offerings become so abundant that the bank thinks its note issues need to be restricted, a check is interposed by raising the published rate of discount. This published rate has an incidental use of great value, as the rates allowed or charged upon current accounts by the commercial banks follow its fluctuations and are regulated by them. For such a regulator, it may be said, in passing, there is a crying need in the United States.

When almost all of the banks' assets are liquid, fixed requirements in the way of cash reserves are obviously needless. Nevertheless, the advantage of keeping the volume of cash in the country in due proportion to the credit fabric erected thereon is also obvious, and so, when loanable capital is abundant and rates of interest are low in any country having a modern banking system, the raising of the published rate affords a check upon the tendency of the capital to find employment in other lands, with gold exports as a consequence. Up to a certain point such exports are of no importance, and efforts to prevent them would do more harm than good. Beyond that point the raising of the rate becomes effective. Thus does a central bank act as a regulator in more ways than one. And if it have, as it should have, very large powers as a bank of issue, it should also operate, as it does in Germany, to prevent all danger of a money squeeze such as we in the United States experience almost every autumn.

We may now, it would seem, address ourselves with some clarity of vision to the solution of the problem of what should be done to reform our unwieldy and unstable banking system.

The chief defects of the system may be summarized as:

1. That the assets held by the banks are not sufficiently liquid.

2. That the necessity for carrying balances with other domestic banks for exchange purposes ties up too large a percentage of the cash resources of all of the banks, brings about the artificial multiplication of deposit liabilities, and, through the counting of these balances as a part of the required legal reserves, results in virtual pooling of these reserves and their investment in loans upon stock exchange collateral, thus fostering speculation and inducing recurrent periods of financial distress.

3. That when these periods of financial distress come about, the banks are compelled to assume a hostile attitude toward each other, thus greatly aggravating the distress.

The remedy for these defects is to adopt the only known method by which the assets of the banks can be made liquid, and by which the necessity for carrying balances with other domestic banks can be avoided. Briefly stated, it implies the establishment of a branch banking system, for which in its main features that of Canada may well be taken as a model, and also the organization of a central bank of issue, closely following the lines of the German Reichsbank, and having at least one branch and a local board of directors in every state in the Union. Whether the central bank should have a monopoly of the note-issuing function is perhaps open to question, but in the opinion of the writer of this paper it would be unwise so to restrict it. One important reason is, that through the use of their own circulating notes as till money in their branch offices, the commercial banks would be enabled to maintain branches in smaller places than would be profitable under other circumstances. As in Germany, the profits of the central bank should be restricted; and other details, such as the provision that the management must be in the hands of trained bankers, may well be adopted.

With the inauguration of this system, the organization of national banks under the present law should be brought to an end, and all the banks, old as well as new, should be required to provide for the daily redemption of their circulating notes in all of the commercial centers. In founding such a system, great care should be taken to avoid introducing features that would nullify its efficacy. Only banks with large capital should be authorized to establish branches, or to issue unsecured circulating notes. Specific authority given to extend credit by accepting time bills having a limited time to run, coupled with stringent restrictions upon the power of the banks to invest more than a small percentage of their loans in paper not bearing the acceptance or endorsement of other banks or bankers, should — and doubtless would — suffice to introduce the European method of making loans. Once introduced, it may be depended upon to take care of itself as against any other form.

So, too, with branch banking. Under a properly organized system the service would be far more efficient than anything the people of the United States have ever known. Not only would there be a larger volume of loanable funds from the same amount of resources, but these loanable funds would be equally available in all parts of the country at all times. The banks would be stronger and safer, and not being tied together by depositing their reserves with one another, they would in fact be independent. At the same time, being comparatively few in number, there would be more possibility of concerted action in time of need than can ever be hoped for under our present system.

Against branch banking it is often urged that borrowers in the smaller places in Canada do not fare as well as if they were served by independent local institutions. This criticism is not well founded; though, as Mr. Herbert B. Walker, manager of the Canadian Bank of Commerce, Montreal, says in a letter to the writer, "It is probable that instances could be cited that would seem to substantiate the statement that the smaller towns do not always obtain all the borrowing facilities to which they imagine themselves entitled.'' Pertinent also are Mr. Walker's further remarks. He says: ''It is one of the advantages of the branch system that we are able to gather deposits in the quiet and unenterprising localities, and lend the money in the more active and enterprising places; in effect, therefore, it is not necessary to have an equilibrium of deposits and loans at each branch in order to conduct a profitable banking business. As an illustration of this, we have a number of branches where the deposits are in excess of the loans, and also many other branches where the loans are greater in amount than the deposits. In the main, this distribution of capital is effected with the best of results to the country at large. I am not prepared to say that it always works perfectly and without in any case causing injustice to some borrowers whose claims for banking credit might possibly receive more favorable attention from a local institution, the directors and management of which would have a greater personal knowledge of and interest in the applicant for credit. These cases, however, are of slight importance as weighed against the fact that the smaller towns and cities are provided with banking facilities of a high order, such as few of them could possibly have if they were obliged to depend upon the sort of local banking concerns that would spring up with insufficient capital and inexperienced management. As it is, there is keen competition for country business by the chartered banks, and each local manager is anxious to make as good a showing as possible for his branch, and is, therefore, not likely to slight the claims of his own customers for accommodation."

Naturally, the possible introduction of branch banking is regarded with dismay by many bankers throughout the country, through fear of its effect upon their personal fortunes. It cannot be doubted that in competition with well-equipped branch banks many of the existing institutions would find it unprofitable to continue in business. But the change would not take place overnight. Normally, it may be expected to be a slow process, a gradual evolution, requiring many years for its accomplishment. Here and there an independent institution would maintain itself, as the experience of Canada and other countries proves. But also it cannot be doubted that the bankers of the United States would soon perceive the clear advantage to themselves of amalgamating their separate institutions into larger ones, branch offices taking the place of unrelated establishments, and that in the end they would be gainers, and not losers, by the change.

Under such a scientific system as is proposed, the changes in current banking practices would in many respects be little less than revolutionary. Many of the ills the bankers now combat with only indifferent success would be things of the past. For instance, the competition of the note brokers, of which many of our metropolitan bankers have just reason to complain, would be quite at an end. Under the revised system the bill broker would be not the rival but the indispensable adjunct of the banks. The vicious practice of carrying unsecured loans along from year to year would become only a memory. Lines of credit would be granted only after full and careful consideration, and not, as too often at present, upon nothing more substantial than brief oral statements. The granting of credit to and the acceptance of paper made by firms or corporations in which the officers of the bank are interested should be prohibited; but even if not forbidden by statute, the effect upon the credit of the bank in the open market, as reflected by the discount rate for paper bearing its acceptance, would soon operate to reduce the practice to very moderate limits.

In addition to the normal check upon the present tendency of the surplus capital of the country to gravitate to the New York Stock Exchange, which a scientific system would afford, only a definitely limited proportion of any bank's total loans should be permitted to rest upon the pledge of stocks or bonds. In the case of the central bank, it should be provided that, as in the case of the Reichsbank, all loans upon collateral should be made at one per cent above the published discount rate, with strict limitations as to the kind of collateral acceptable and the percentage of the market price that may be advanced. The reason for this is, that the central bank should not ordinarily make loans upon collateral, but only in times of emergency when it might be desirable for the public good that it should be permitted to do so. The primary function of the bank being to insure the liquidity of the bills discounted by the commercial banks, its loaning power should in general be scrupulously reserved to that end.

That the present Sub-Treasury system should be abolished and the central bank should be constituted the fiscal agent of the United States and made the depositary of its funds, excepting only the reserve against the legal-tender notes and the coin represented by the gold certificates and silver certificates, is highly desirable, but not an essential feature of the proposed scheme. It is, however, essential that the central bank should be effectively divorced from political interference and political power. It is not necessary that the government should own all or any part of the stock,[1] or that it should exercise any supervision or regulation other than to see that in the conduct of its affairs the mandates of the Bank Act should be strictly obeyed. In this connection the writer would suggest that the Comptroller of the Currency or the Superintendent of the Banks, as he might more appropriately be designated, should be given authority summarily to remove from office any bank officer within his jurisdiction whom he might find violating the provisions of the bank act, and it should be his duty to make such removal upon a proper showing of culpability, the official so removed having the right of appeal to a trial board or court, which, however, should have power to reinstate him only upon clear showing that he had not been guilty of any infraction of the law. To make technical compliance with the statutory provisions more certain, any bank officer so deposed should be disqualified from hold-

[1]Though not necessary, still for the sake of the prestige it would give, government ownership of a part of the stock, not, however, exceeding one fourth of the whole, is, in the opinion of the writer of this paper, highly desirable.

ing any official position in any other national bank, and be personally liable for any loss caused by his misconduct. This may sound severe; but if restrictions upon banking practices are demanded in the interest of the public welfare, the punishment of those who offend cannot be made too drastic.

To prevent the control of the central bank falling into the hands of any one man, or small group of men, it should be provided that no one person should hold more than say one-twentieth of the entire capital stock, also that no certificates of stock should issue, but instead that the ownership, which should vest absolutely in the nominal owner, should be registered upon books always open to public inspection at the head office of the bank, and hypothecation should be specifically prohibited,—the purpose of these provisions, which might well apply to the stock of all of the national banks, being to prevent men from holding shares in names other than their own, and to obviate the possibility of borrowing upon the stock of one bank to secure funds to buy up a controlling interest in another. But whether such a provision be incorporated in the bank act or not, there can be no doubt that national banks should be prohibited from loaning upon the shares of other banks.

With the establishment of such a system as is here outlined, the bankers of the United States would be weaned from several infantile notions to which they cling with great pertinacity. One of these is the horror with which they contemplate the acceptance of time bills; another is reluctance to sell unmatured bills receivable. It is true that under the present law the national banks may not incur liability as acceptor or endorser save to an extent so limited as to be practically prohibitive. It is also true that there is now neither occasion for the acceptances nor a market for the bills; but the attitude of mind goes farther than these considerations, and the quicker it is changed to a more cosmopolitan point of view the easier will it be to compass the reform we so greatly need.

Another of these crude notions is the absurd worship of deposits that our present system engenders. Under a modern scientific system the relative value of deposits would be much less than it is in the United States at present. In far less degree than now would they be created by book credits against credit loaned, or in other words, by discounting clients' notes and adding the proceeds to their deposit accounts. Perhaps, also, the useful distinction between "current accounts" and "deposit accounts," commonly made in other countries, would come into vogue. Cash deposited in one bank would not be passed along from one bank to another until, before reaching its final resting-place in New York, it would, as is now often the case, have swelled the deposits of three or four banks. Banks' balances with other banks would be confined to the accounts of the few independent local institutions that might survive, and would be limited to the needs of these institutions for facilities for selling demand exchange. They would have no object in keeping large balances with correspondents for the sake of interest, since the rates would always be regulated by the official rate of the central bank, and the idle funds might with equal availability and more profit be invested in commercial paper.

Theoretically, under such a system as is proposed, the banks should not be required to carry any fixed reserve, arbitrary regulations in that regard being calculated to hamper the smooth working of the system. Practically, however, some minimum should be specified. This would not need to be more than fifteen per cent, except for the central bank. Experience shows that the percentage of cash reserve that safety prescribes is far higher under our present halting and inflexible system than under one properly constituted. In Canada the banks get along comfortably and safely with a fifteen per cent reserve, and they do not have the advantage of a central bank and of having their portfolios filled with modern accepted bankers' bills, which would make their position far more secure.

Only the more salient features of the proposed system can be considered in this paper. All of the details would require careful thought in drafting an enabling act. For any insurance fund to protect depositors there would be no need. A provision in the Bank Act that any institution having its capital impaired, in however small degree must at once make good the deficiency or close up its affairs and retire from the field, would be sufficient. Granting, however, for the sake of argument, the necessity for or the desirability of such guaranty, then to be equitable the banks as a whole should be given autocratic and plenary powers to supervise and regulate the business and practices of their fellows; they should not be charged with responsibility without at the same time being clothed with authority.

It remains to be said that to graft a central bank upon our national bank system as it is now would be the height of folly. There is no place in the system for such a bank, no function that it can safely or properly perform. Desirable as is such a bank in a sound, well-considered, and thoroughly scientific system, it would be worse than useless as an adjunct to the nondescript system under which we are working.

To the establishment of the better order of things, ignorance and supposed self-interest are the chief obstacles. Let us hope the day is not far distant when they will be overcome. One difficulty, however, arises from the division of our nation into separate states, each with its own code of laws. To work effectively, a central bank should not be hampered by usury statutes. The effect of the establishment of a system of branch banks, and a great central bank as here outlined, would almost certainly be to lower the average rates of interest, and to equalize them throughout the country. But in time of stress the central bank should have power to mark up its published rate as high as might be necessary. Restrictions upon the rates that may be charged by pawnbrokers and others making advances upon chattels may perhaps be justified, but in business transactions incalculable harm may result, as every bank knows.

So utterly futile are usury statutes to accomplish the end aimed at, that it passes comprehension that belief in their efficiency should still persist and find expression in statutory enactments. In New York the prohibition of time loans at a rate above six per cent compels borrowers to have recourse to the "call money" market, which in time of urgent demand is sometimes bid up to ruinous figures, and even after paying the high rate, the borrower is liable to be required to meet the obligation at an hour's notice. Only those familiar with the effects upon the New York money market can have any conception of the wide-spread damage that results from the restriction upon interest rates imposed by the state law. Unless the law should be repealed in the event of a central bank being established, that institution would be shorn of a large measure of its utility. As the only object it could have in raising its published rate would be the protection of the nation's reserve stock of gold, it would be a pity if this resource should be denied through the persistence of an unsound and antiquated notion.

Since we must eat and drink, and must supply ourselves with clothing and shelter, we may defy all the principles of finance and still continue to exist; we may even, in a country so liberally endowed by nature as is this land of ours, manage to endure the shocks and losses which such defiance entails, and by ravishing the natural resources of the land bring prosperity intermittently to our doors: nevertheless the defiance is crass stupidity, for which we pay a heavy price.

We may struggle along for generations yet with our wretched apology for a banking system; but when at last we supplant it by a system based upon scientific principles, we shall all be amazed that we were so long in seeing the light.

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