Measures for Banking Reform

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Measures for Banking Reform.

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Part II.


The present system of bond-secured bank note currency (government guaranteed certificates virtually not real bank notes) is safe just as the solid wooden wheels of a Mexican cart are safe. It is also just as inefficient, and should be abandoned out of hand. It should be thrown overboard absolutely and without hesitation or misgiving. Any currency reform (the bank note part of currency reform) which consists in patching up the old bond-secured system—getting something fancy in solid wheels—has had its day. A bank, under any sort of system of banks, should be allowed to use its credit just as freely in the form of circulating notes, as in that other form of bank credit, the deposit.* Its reserve should apply both to notes and deposits equally; that is, it should be a true liquid reserve or "cover" for both alike. Both sorts of liabilities should, of course, be paid over the bank’s own counter on demand, as long as the bank remains solvent. When it can no longer do that, the bank has become insolvent—it has incurred bankers’ insolvency—and its doors should be closed.

To specially safeguard the note-holders, for certain well-known reasons, a "safety fund" (not a part of the reserve, or to be called reserve)† should be established for each class of banks, to be made up by contributions from the several banks levied pro

* That is, freely within the limits imposed by appropriate general safeguards. Bank credit in neither form should be permitted to be used to purchase any form of securities other than short term business paper. A bank may properly invest its own capital and surplus in stocks and bonds, and in call loans, but not its credit. In other words, a bank’s total demand liabilities—both notes and deposits—should not be allowed to exceed its reserves together with its holdings of discounted commercial paper—that is, real commercial paper founded on wealth creating processes, not so-called accommodation paper.

† The philosophy of "reserve" and "safety fund" should not be confounded, as they often are. A "reserve" is a thing for banks which are going concerns to use; it is a thing which helps to keep them going. A "safety fund" is a thing which is of service when for any reason a bank ceases to go; it is a thing for the receiver of a failed bank to use to pay off preferred creditors without delay.
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rata according to their outstanding circulation. This fund might be properly 5 per cent. of the total circulation as in Canada. It should be managed under standing law by a committee of bankers, not by the Government; and the notes of any failed bank should be due to be paid at once out of it. The Government hereafter should govern, not bank; it should guarantee good laws and their enforcement, nothing else.

The general public, under such a plan as is set forth above, cannot possibly lose a cent on the circulating notes of failed banks. So much for that. To safeguard in addition the well-managed banks in any class from excessive assessments to maintain the "safety fund" drawn upon by reason of the misdeeds of other banks of their class, (and for this purpose at any rate they should be put into separate classes), it should be further provided that the notes after redemption by the committee in charge of the safety fund shall constitute a first lien on the total assets of the failed bank or banks. Under a system of banking provided with proper general safeguards, few, if any, failures will be so bad that the total assets will not cover at least the notes in full. These provisions respecting the establishment and administration of a "safety fund," together with the statistical data behind the suggestion, remove wholly a common objection on the part of bankers to the safety fund plan. It was a fallacious objection at best, for good banks everywhere and always suffer by reason of the sins of bad banks. You cannot get away from that moral law in any department of human life. A scheme of flexible, really credit bank note issue, thus secured as to both current redeemability and ultimate redeemability, would be perfectly safe and serviceable. It would be a financial wagon with a good, sound, civilized set of wheels; with hubs, spokes, fellies, and tires. You could haul a decent sized load on that wagon, not only without its breaking down, but with something less than ten horses to draw. But the matter of adequate real reserve for bank notes under this scheme is not to be overlooked, nor its importance minimized. Because the ultimate redeemability of credit notes must be specially provided for by means of a first lien on the "safety fund" in the interest of the general public, and on the total assets of the failed bank in the interest of the custodians of the safety fund, is no reason why the current redeemability should not be provided for just as fully as is the current payment of deposits. The expres-
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sion "asset currency," often used to designate the project of law described above, is inexact and blundering. We have in the bond-secured bank circulation an "asset" currency of a sort already. Also the "emergency currency" proposed by some to be issued against three-fourths of the value of bales of cotton lodged in Government depositories, would be an "asset" currency. This is a phase of a characteristic failing in the thought of Americans. We rely for national military defense, for example, upon an asset army.

The Essential Means for Securing the Flexibility of a Credit Bank Note Circulation.

The flexibility or elasticity of a credit system of bank note issue consists in two things—first, ready expansibility; and second, automatic contractibility. The expansibility takes care of itself if the banks are left free to issue their notes as business requirements demand. The contractibility will also take care of itself in a country like Scotland or Canada (or in New England in the days of the Suffolk Bank System), where there are a few large banks, each anxious to protect its share of the field of circulation. Under these conditions there is a sufficient motive coming voluntarily into play for each bank in the system to send home promptly for redemption the notes of all other banks it receives. But where there is a system of many banks as at present in the United States, this motive of self-interest does not work with sufficient force to be effective, and a law must be enacted that no bank shall pay out the notes of any other bank. This feature of a flexible currency scheme is absolutely essential. Any plan for an elastic bank currency, whatever its other details, will fail if this feature is left out. In both the Hepburn and Fowler reports, and also in the Fowler bill, there is absolutely no mention of a rule, either compulsory or voluntary, under which the banks shall each abstain from paying out the notes of other banks. Our banker mechanics would make a hub, felly and spoke wheel, without the tire.

One the other hand, the enforcement of this simple rule of non-reissue is enough to secure full contractibility, without any further compulsory check or penalty. A tax or fine is the proper means to employ to keep banks from "staying below the reserve," but not for the purpose of insuring contractibility—as is
recommended in both the Hepburn and Fowler reports. There has been much misapprehension in many quarters on this point. There should be, it may be remarked in passing, no tax on bank note circulation for mere purposes of revenue. Why tax the people’s money? Why put any restraint upon the life blood of commerce? As evidence of what worlds away from the proposed scheme our present practice is, we have only to observe that under the existing law only a certain fixed amount of notes (an absolute, not proportional amount) may be retired in any one month.

To facilitate the working of the contractibility side of an elastic currency, Assorting Houses should be established at convenient points; that is, the principle of “central redemption” should be applied. Through these last named institutions, the whole mass of bank credit, as well as that of each individual bank, circulating in the form of notes, would be constantly, day by day, put to the test of redemption, just as now the general mass of bank credit in the form of deposits, and that of each bank in particular, circulating by check, is constantly put to the test of payment by the settlement of balances at the Clearing House. Of course each individual bank would pay both its notes and its deposits over its own counter, if cash is demanded, as at present. Under the new plan notes would expand at crop-moving time; would find their way presently into the tills of the merchants; before long would be turned into the banks where the merchants keep their accounts; and then would be sent home, either to the issuing bank or to the nearest Assorting House, and presented for redemption. They would disappear from circulation after having performed their function by a rather ephemeral existence, just as now is the case with checks, and the individual expanding and contracting deposit accounts behind the checks.

Such flexible credit currency would not be, as the term is commonly understood, an “emergency currency”: it would be for daily use. The emergency-meeting power of the system proposed consists in both flexible deposit creation and flexible note issue, together with the provision of an elastic limit as to reserve in place of the present dead-line. Little emergencies should be met automatically and quickly in the ordinary course of business, and the big ones should never come at all. There has been much inconsequential talk about “emergency currency.” One seems to take
it for granted that every now and then the horse will be stolen from the stable, and that consequently there should be some up-to-date device for sending promptly for the police. Under the general scheme set forth in this paper, or any other scheme containing the essential elements of soundness, there would be no “emergencies” such as in the past Americans have regarded as a part of the natural order of things. But while it indicates some degree of error in attitude of mind to talk of “emergencies” and “emergency currency,” it is a downright blunder in principle to propose, as is done by some, to tax a so-called emergency credit note issue “progressively” as to its amount. Not the amount to which banks “go below the reserve,” but the length of time they “stay below” should be taxed or fined progressively. It is not desirable that the banks should be timid about taking relief measures when such are needed, and they alone can be the judges both as to occasion and quantity. If there is need to act at all they should be free to act with decision and with full amplitude of power, because it frequently happens in all departments of affairs (as for example, in the case of the first Cleveland bond issues) that “small measures do not produce small effects; they produce no effect at all.”

Under the plan of credit bank currency here proposed, moreover, there need be no fear of inflation. There cannot be such a thing as an inflation of the currency of any country by bank credit, as long as there is ample reserve and the unremitting test of current redeemability.* At the time of the Parliamentary Committee investigation which led to the famous “Bullion Report” of 1810, the bankers under examination said, that there could be no inflation of the currency (depreciation of bank notes) as long as the managers of the issue were very careful (as they themselves had always been) to discount prime commercial paper only. Theirs was an “asset currency” idea; and there was a depreciation of the bank note even at that moment. Bagehot quotes from the testimony of the governors and directors of the Bank of England before this committee and makes the comment: “Very few persons perhaps could have managed to commit so many blunders in so few words.”† Others, better informed, maintained

* It is wholly illogical and unnecessary, although there is the precedent of Canada, to limit the notes of a bank by the amount of its capital. Such a limitation distracts attention from the principle.
in connection with this controversy, that bank notes should be kept at par with gold by a very careful regulation of the quantity of paper issued, using the rate of foreign exchange and the paper price of bullion as indices; that is, by taking anxious care in such ways as might very properly be taken to guard against the depreciation of an convertible government issue. Neither set of advisers to the government saw, as the authors of the Bullion Report did see very clearly, that the avoidance of inflation and a premium on foreign exchange, and the attainment of immediate banking solvency as well, is a state or condition which “cometh without observation” provided there is maintained an ample reserve and constant exchangeability of bank notes for the standard coin of the realm.

The authors of the Fowler Report, unlike the authors of the Bullion Report, are evidently haunted by the fear of bank note inflation and hence the reason (in part at least) for their illogical restrictions on the “emergency” part of the credit circulation they propose, and also the absolute limit on the total note issue under their plan which would be almost reached at the outset.* If one is apprehensive of danger from “inflation” he had better look in another quarter—to the increase of non-convertible bond-secured notes, under some hasty, ill-considered, patch-work scheme. That involves, in any form, precisely the old “greenback” fallacy over again. The issuing of bond-secured currency is virtually “coining” a specific form of the credit of the Government (its bonds), similar to the coining of “the general faith and credit of the people of the United States,” about which the Greenbackers used to prate.†

**Advantages of a Flexible Credit Bank Note Currency.**

Real credit bank notes expanded freely by the banks (under adequate “general safeguards” and provision for maintenance of reserve) and contracted automatically by means of a proper standing rule prohibiting any bank from paying out the notes of other banks, would have many direct and indirect advantages. The circulation of banks would then fluctuate month by month and seasonally, according to the needs of business, instead of

* Most of the complicated limitations as to the amount of circulation of the Fowler report are absent from the Fowler bill.

† The above was written before the bringing forward of the proposals to coin several kinds of bonds embodied in the Aldrich bill. I did not suppose that anything as bad as that would receive serious consideration.
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going up or down in semi-geological age-long variations depending upon the price and supply of bonds. The advantage of our getting rid of the ever-recurring autumnal "moving-the-crops" blow upon the angle of the jaw of our financial system, is well understood and calls for no demonstration here. It should be remarked in passing, however, that the influence of the present inflexible currency in producing this particular evil is much exaggerated. The cause of the crop-moving stringency is, in the main, the pyramiding of reserves. And to this last may be added, the drawing into Eastern financial centers of interior funds in general. But whether the chief cause or not, the inflexible currency is certainly a contributing cause of the regularly recurring minor crisis each autumn, and its removal would be a decided gain.

There are other advantages of a flexible credit currency, however, that are not so well understood. One evil of our present system discovered a few years ago by Professor O. M. W. Sprague—then of Harvard, now of the Imperial University of Tokio—may be briefly set forth as follows:

In normal, good times when the spirit of enterprise is buoyant and bank reserves are still ample, the banks assist new enterprises to establish themselves and old ones to increase their operations, through making loans—through discounting commercial and industrial paper—the proceeds of which are placed for the most part to the credit of the customers on the books of the banks (credit created deposits). Such checking accounts afford command of a conventional means of payment, and straightway through purchases of all sorts, the large business of the country, both manufacturing and merchandising, expands apace. Also, concurrently with expansion, prices rise in the realm of the larger capital-creating undertakings. Presently, furthermore, there is an increase of wages and a rise of prices in the domain of the business of final consumption. All the working people of the country require (or rather have) more pocket-money, and all the retail merchants require (or rather have) more till-money. But there is within the country only one place that this additional pocket-money and till-money can come from, provided the Government is not inflating the currency just then with greenbacks or certificates issued in payment of purchases of silver. Inasmuch as such a period is an era of rising prices, the
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"exchanges" will be against us and no gold will be imported. There is only one place, then, that the new money adapted for general circulation can come from, and that is, from the reserves of the banks. Being drawn from the reserves, it makes the whole credit superstructure upon which the general business of the country rests, and on which prosperity itself rests, totter from its foundations. For this serious defect in our present system, credit bank note currency, having free expansibility and issued in all denominations, is the appropriate remedy. The banks could then supply retail money as well as wholesale money, concurrently with expanding business and rising prices, up to the time when gold is forced abroad and a slow and easy recession sets in. That is, a slow and easy recession would take place if the banks have been doing a proper banking business, discounting real business paper based upon wealth-creating processes, but not if they have blown up a great bubble of speculation by means of loans based on stock market quotations. The "general safeguards" will need to be especially well looked to under a regime of free use of bank credit.

Another of the advantages in doing away with our present shackled system of bond-secured note issue, and getting a proper system of free trade in banking credit in its place, would be that we should thereby remove one of the chief sources of popular misunderstanding of and hostility to our banks. That part of the general mass of voters that knows and cares something about finance understands just enough so that it seems to them that great favoritism is now being shown the banks by the Government. Under the present system, a bank buys bonds and continues to own the bonds (although deposited in the keeping of the Government) and therefore as a bond-owner draws interest upon them: and then it receives back from the Government the face value of the bonds in a peculiar form of currency guaranteed by the Government (a sort of Government certificate for which the banks have no further very evident responsibility) which last so-called "notes" the bank, as a banker, lends out and so makes a second profit. This looks to the average man in the street, and on the farm, as if it were a most cunningly devised scheme of graft—graft the Government makes legal and respectable. The truth of the matter is that the bond-secured-currency tangle of laws, instead of being a permission, is a requirement; far from being a "favor," it is a most burdensome restriction. Hostility to the
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banks in one particular begets hostility in other particulars—even a general attitude of suspicion. This considerable political nuisance and menace, always making Congress in currency matters very timid, could be almost entirely gotten rid of by a stroke of the pen. Pure bank credit—real bank notes—if they are made secure, the masses will never much interest themselves about; any more than they now bother their heads about deposits. In France the people no more think of interfering with the regular, free expansion and contraction of circulation by the Bank of France, than a child thinks of interfering with his father when he winds up the clock Saturday night. If a watchful people are suspicious of "favoritism" let them look elsewhere—to the existing connivance of the Government with "window dressing" by banks. Reference is made here not merely to particular features of our present practice but to the existing system as a whole. Under existing dual legal conditions, with many financial institutions carried on under the State governments, the present scheme of five "called" reports each year for the national banks is itself nothing but "window dressing." It is as if a king wishing a general inspection and census of his army were to allow the review to take place department by department, and with plenty of notice when it was coming. What would happen with respect to departmental commanders borrowing from each other to make a fine "showing" of equipment complete and ranks full, is obvious.

Still again the burdensome restrictions on our present system of national banks, as regards their natural and proper function of note issue, prevents the system from spreading equally into all parts of the country in proportion to the amount of business to be done. To serve adequately the business needs of their customers, the banks situated in rural, sparsely settled regions need to employ for obvious reasons a larger proportion of their credit in the form of circulation than do city banks or those located in a country district where population is dense. Many city banks get along very well with no circulation at all. The two sorts of banks have different industries to deal with and are governed by different circumstances in every way. A country bank cannot force its customers to make use of deposit banking (it cannot develop check banking in place of note banking) beyond a certain point, although there may yet remain business which the bank could do,
and which the economic needs of the community itself require should be done. Beginning with the initial blunder of the Civil War times of an absolute limit on national bank note circulation, which total was largely grabbed up by the East (notwithstanding a rule of apportionment in the statute), from that day to this our national banking system has been largely a territorial monopoly. The benefits of the system have been largely denied to the country districts in the West and South; and hence in those regions the multiplication of weak state banks. Lately, in partial, blundering mitigation of the situation, the national banking law has itself been changed, so as to allow the establishment of national banks of insufficient capital. Considerable communities have been, and still are, notwithstanding the diluting of the system, without banking facilities; and at times (other than panic times, too) whole regions experience a scarcity of currency. This state of affairs has been, in turn, one of the leading contributing causes of fiat money and silver purchase crazes.

Finally it may be mentioned in this connection that freely issued credit bank notes are essential to the carrying out of any plan for a system of large banks with branches. The expense to the head bank of furnishing "lawful money" as till-money for its branches would swamp the carrying out of the scheme, unless the head bank's own notes may be substituted for lawful money for that purpose.

(To be continued.)

Accountants are reminded to make arrangements for their annual vacations so as to fit in with the twenty-first annual meeting of The American Association of Public Accountants—October 20-22, 1908, at Atlantic City.

Herbert Foster, New Haven, Conn., has been appointed lecturer on the problems of business management in the Sheffield Scientific School of Yale University.

Mr. Theo. J. Friedleben is delivering a series of lectures before the New York Society of Accountants and Bookkeepers on Factory Cost Accounting. The meetings are held on alternate Tuesdays in the new quarters of the Society, 29 W. 39th St.

Prof. J. A. Bexell, formerly head of the School of Commerce of the Agricultural College of Utah, has accepted the Deanship of the School of Commerce of the Oregon Agricultural College, Cornwallis, Oregon.