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MODES OF FINANCIAL DEVELOPMENT:  
AMERICAN BANKING DYNAMICS AND WORLD FINANCIAL  
CRISES

by

Marcello de Cecco

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## MODES OF FINANCIAL DEVELOPMENT:

### AMERICAN BANKING DYNAMICS AND WORLD FINANCIAL CRISES

Introductory remarks. In this paper I try to suggest that, from a largely homogeneous theoretical and practical banking tradition, the different interaction of political and economic forces led the British and American banking systems to develop according to different modes. The American banking system, after a start which followed British lines, radically changed course in the Jacksonian era, and it has increased its differences from it, and from other major banking systems, as time has passed. The non-existence, in the U.S., of a strong coalition of lenders, and the structural bias of the country towards using more savings than it generated, blended with a banking theory and a legal tradition totally similar to the British ones, have modelled the U.S. banking system in a way which, if it has favored the fast growth of the American economy, has also given it a tendency to deep financial instability.

The structural imbalance of the American financial system has been a most important generator of crises of the international financial system in the last 150 years. In this paper I have given a rapid sketch of how American financial instability has recurred throughout the period and spread to the rest of the world financial system. In a short piece like the present one, many questions are left unanswered and many links are missing. But the field is now being extensively ploughed by many able scholars, and more detailed and persuasive works will certainly appear in the near future, which will help fill the gaps.



My main aim is to show how the same cultural tradition can generate wildly different results, if applied to different socio-political and economic circumstances. Or, as Pasteur taught, that the receiving environment is even more important than the virus that infects it.

1. Even more than nuclear power and, of course, long before it, banking has been in the U. S. subject to extensive regulation. Like elsewhere regulation has been imposed on American banking by political forces. And, more often than not, regulation has been skillfully manipulated by some sectors of the financial community so that it may work to their own advantage, and to the detriment of their competitors. In order to do this, industrialists, farmers and other large blocks of the American political body have been used to serve the purposes of this or that section of the financial community. This, however, has been true of regulation in most countries. The interesting thing to discover is what interplay of political and economic forces led the American financial system to develop in a mode different from that according to which the financial system of other industrial countries developed. Equally interesting is to trace the impact of the peculiar mode of American financial development on the world financial and economic system.

Americans, and foreigners, still tend to think of the United States as a new country, with young institutions. But as far as banking is concerned, the United States has had an experience synchronous with that of every other developed country. Modern Banking developed on these shores exactly when it was developing in England; it therefore even preceded banking development in the rest of Europe. The same can be said of banking



and monetary theory, as the U. S. and Britain were a homogeneous intellectual community.

As to Central Banking, it is fair to say that in the U. S. it developed, in its most modern and accomplished form, before everywhere else. The First and the Second Bank of the United States resembled modern Central Banks more than the Bank of England of the early nineteenth century did.<sup>1</sup>

The Second Bank of the United States was partly owned by the Federal State, managed only secondarily for profit, and it acted as the Fiscal Agent of the Federal Government. After only a decade of existence, it had become one of the largest banks in the world. And it is generally recognized that the 1820s, the period in which the Bank of the United States was extending its operations, were, perhaps, before the 1940s and 1950s, the quietest period in American banking history. The Bank of the United States successfully managed to control the State banks by checking their overissue of bank notes. It thus stabilized economic activity.

The United States Government, however, having scored a first in world financial history until the 1820s, proceeded, in the next decade, to destroy its own achievement, by denying the Bank of the United States a renewal of its Federal charter.

As of 1836, as a result, one of the lynchpins of Hamiltonian state-building and one of the most innovative ones, was destroyed. The

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<sup>1</sup>On the first and second banks of the U.S., the locus classicus is Bray Hammond, Banks and Politics in America, Princeton, 1957.



United States had to wait until 1913 to have a central bank, and this time it was an institution different from all other central banks, the Federal Reserve System.

2. The coalition that brought about the demise of the Bank of the United States is worthy of careful study, as it was composed of the elements whose influence would set, and keep, the United States on its path of financial instability for much of the following period.

The masse de manœuvre of the coalition were the farmers. Unlike its European counterpart, American agriculture was, since the early decades of the nineteenth century, a highly innovative and highly indebted sector of the economy. When we read the financial history of the main European countries, in particular British financial history, we are always treated to an account of savings flowing from agriculture to other sectors, industry in particular. A part of the rent which is extracted from agriculture is transferred, via financial intermediaries, to the industrial entrepreneurs and to the government. In the U.S., on the contrary, agriculture absorbs credit, to buy land and to make it yield its fruits. Throughout the nineteenth century, agriculture remains an innovative sector of the American economy and a highly capital intensive one. It is also the sector that absorbs the largest share of manpower and the largest exporter. American farmers, like all farmers, would like to be paid in sound, stable money for their crops. But they would also like easy, freely flowing credit available on tap and at stable rates. It is this peculiar contradiction that makes the U.S. farmers the ready raw material for manipulation, on the part of politicians and of adventurous financiers.<sup>2</sup>

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<sup>2</sup>What I have just written could be read as going against the well



reasoned argument Bray Hammond develops, in his classic book, to prove that it was not the farmers, but other social forces, which fussed for free banking and cheap money in Colonial America and in the early decades of the Republic. My argument, however, is that the size and peculiar character of American farming made it easy prey to political manipulation because it had, by its nature, to take a contradictory position vis-à-vis banks credit and currency. As a result of their needing long-term loans and at the same time payment for their crops in sound money, American farmers' allegiances could be made to swing between "cheap money" "no banks" and "sound currency." That they were the most powerful force in the political arena is undeniable, and the mutual inconsistency of their needs was used by other forces to obtain political actions, with regard to banking and currency, which, if they did not benefit farmers, still were achieved with their essential support.

I would therefore heavily qualify some of Hammond's stronger statements on the issue. The farmers' support could be won in campaigns against banks and in favor of a gold currency, essentially because farmers were convinced that credit, as administered by American banks was not of the revolving type they needed—and not because they were against credit per se. American banks would solicit loans to farmers, in times of high prices, and foreclose on them in times of low prices. Still, the need for loans was there. Credit was essential to American agriculture but could not be given on terms farmers could find equitable. At the same time, the vagaries of crop prices were often attributed to unsound currency, hence the farmers' attention to sound currency campaigns.

These contradictions are not exclusively experienced by American society. Albert O. Hirschman has written, in his The Passions and the Interests, some very illuminating passages on the problem of the "mobilization" of land control in 18th century France. And the very high capital intensity and reliance on credit of American farming was noticed from the very early decades of the 19th century. As will be noted by looking at the appended Tables, while in Britain agriculture had already fallen to employing a very low share of total labor by 1841, in America it kept swelling in absolute terms as an employer, and maintained its share of total employment, between 1820 and 1870. (See Tables enclosed). American farmers had to rely on credit exactly because so many people still became farmers, and had to buy land and then the capital to work it. In his splendid book on American agriculture (Change in Agriculture, Harvard, 1968), Clarence Danhof tells us very clearly with many references to contemporary sources, how generalized farmers' indebtedness was as early as 1830. He conveys very well the feeling of need and at the same time, of hatred the farmer had for the banker, from the very start of the 19th century, and the contradiction between easy money and hard currency, two things the farmers wanted at the same time. That is why I have used the expression "masse de manœuvre" in the text.

To contrast European agriculture with its pressure of people on the land, with its high rents, hence with its inevitable financial surpluses, with American agriculture, perhaps the most dynamic sector throughout American economic history, with its low rents, high rate of owner-workers, and the resulting net absorption of financial resources, is the basis to understand the environment in which U.S. banking developed. This inspite



The Bank of the United States, because of the financial underdevelopment of the agricultural states, soon gained a foothold there. It helped to move the crops, in particular cotton, and put itself between the Southern farmers, the Eastern merchants and bankers, and the English financial institutions which financed the exports of cotton to its users in Lancashire. In its conservative management of the American paper currency, the Bank of the United States was, at one and the same time, exercising a restraining influence on the farmers, on its Eastern banking competitors and on the Bank of England, whose coffers it tended to deprive of gold. But these were potential enemies, and before they were mobilized, Congress renewed its charter. The Congressional decision, however, was vetoed by President Andrew Jackson, who had been elected on a platform which included a return to a sound metal-based currency, and a drastic decrease of the regulatory influence of Government, and took advice from enterprising financiers like Kendall and Van Buren. One year after the scrapping of the Federal Bank, the world experienced the first full scale financial crisis of predominantly American domestic origins. In order to deliver on his electoral promises, President Jackson had not only vetoed the renewal of the Federal charter for the Bank of the United States. He had also ruled that all sales of Federal land be paid for in gold, that the surplus of the

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of Bray Hammond's exhortation not to project back on the earlier age the accusation of "cheap money advocates" farmers received in the last part of the 19th century and in the early decades of the 20th. This position is simply not sensible. Other authoritative sources, like Danhof and his references, prove the early indebtedness, and thus the contradictory feelings of farmers concerning banking and currency problems.



Federal budget be redistributed to the States, and that the fiscal revenue of the Federal Government be deposited with a large number of banks, the so-called "pet banks," many of which were owned by government supporters. From the point of view of monetary management, a series of financial measures nearer to pure folly would be difficult to imagine. The scattering of financial armaments, which had been so wisely centralized before, resulted in an immediate run on the banks and a suspension of specie payments on their part when the Bank of England cut the American banks' discount facilities in London.

The clique of financiers which had skillfully manipulated the actions of General Jackson thus managed to destroy their main competitor and to move the financial center of the country to Wall Street from Philadelphia. But it did so at the cost of engendering a world crisis, whose worst effects were experienced in the cotton producing South of the U.S. and in the cotton using North of England. They also re-established freedom of banking operations but at the cost of precipitating the country into a financial anarchy which, if it was useful to promoters, speculators and robber barons, and thus to the fast growth of the U.S. economy, definitely wove the pattern of 150 years of world financial instability.

It is worth asking why the Bank of the United States had so few friends. Part of the answer must surely be found in its peculiar charter. It was owned in part by the Government and in part by private investors, some of them foreigners. It could not, as a result, be described as a public agency, to be defended as part of the Constitution. But its main weakness was that it could not represent, like the Bank of England, a great



coalition of landed aristocracy, who provided a part of the capital, of gentry and middle class savers, who provided another part, and merchant bankers of the city of London, who managed the bank, staffing the Court of Directors, and electing from it the Governor.<sup>3</sup> With a coalition like that behind it, the Bank of England could stand the repeated attacks that Northern industrialists, country bankers and farmers waged against it in the same years when Nicholas Biddle and his Bank of the United States succumbed to Andrew Jackson and his chequered but unbeatable army of banking adventurers, who could mobilize the ill feelings of the indebted farmers. Deprived of its Federal Charter, the Bank of the U.S. could have re-emerged in a purely private incarnation, and run the U.S. banking system by the force of its sheer size. This was the course adopted, after all, by the Bank of England in the next thirty to forty years in order to keep its primacy. But Biddle could not rely on a coalition of savers. He thus tried to beat his adversaries at their own game. He attempted to corner the cotton market and to bring about a general suspension of cash payments. He failed in both enterprises, thus showing, as would be often shown in the future, that Central Bankers are not very successful when they try their hand at being real financial adventurers.

John Law's adventures in France can be read in much the same vein. But, apart from this personal failure, the structural reason for the failure of the B.U.S. is that it was created without a natural

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<sup>3</sup>On the Bank of England's shareholders, see J. Capham, The Bank of England, Vol. 1, Cambridge, 1945.



constituency, just when the country was at a watershed of its history, and was embarking upon the dazzling development of the huge American continent. How could an institution imitating that great coalition of savers and lenders, the Bank of England, succeed in a country where, for many future decades, borrowers prevailed?

In fact, perhaps the most useful interpretative key to the financial instability which the U.S. has shown through a great part of its history is the dynamism of the American development process. Financial stability depends on the existence of a consolidated coalition of creditors. How could such a coalition form and thrive in a country where land was not scarce, especially because of a moving frontier, and where development continuously changed the game, the place where it was played, the people it suddenly made rich?

After the dismantling of the first experiment at financial centralism, in the 1830's, the oscillations of political coalitions formed to deal with banks and banking resulted in a complete fragmentation of the American banking system. The fragmentation was increased by the establishment of the Independent Treasury which centralized Government revenue and had no officially devised way of re-cycling it back to the banking system. This was because it had been designed to fulfill the voters' dream of ridding the bankers of Federal Money, over which they may spin a web of unfair control.

The Independent Treasury managed to make the Federal Gold Reserve virtually unusable, and a net hindrance on the working of the national and international monetary system, as funds were locked away and could not be



recycled to the economy. The system thus needed a much higher quantity of gold to keep moving than it would have needed without the Independent Treasury.

The fragmentation of the American financial system which followed the 1830s and the lack of a lender of last resort joined with the rise of the powerful American export agriculture, to create another structural problem: the so-called seasonal fluctuations in the demand for cash. This lasted until the first world war and even beyond it.

Every summer, crops were moved from the farming States to the East or to foreign countries. Cash would move the other way to pay the farmers, thus depriving New York of its funds and sending the interest rate to very high levels. As there was no central bank, the financial strategy was communicated to the rest of the world. The Bank of England, which, in order to behave as a normal, profit making institution, subsisted on the smallest possible gold reserve, would put up its Bank Rate, and hope that money would come from Europe, so that it may be sent to New York to relieve the dearth of funds that was experienced there.<sup>4</sup>

Whenever bad luck ordained that another negative factor intervene, in the U.S., or elsewhere, at the time of the Autumn Drain, a major financial crisis would break out.

This annual pattern of financial stringency, which shook the world financial system with weather-like periodicity, could not be altered as

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<sup>4</sup>On the seasonal fluctuations and their consequences, the reader can be referred to my Money and Empire, Oxford, 1974, where he will find further references.



long as the American financial system remained without a center which may function as lender of last resort.

We can safely say that the lender of last resort function is one of the most unambiguously defined public functions, as it is certain that it cannot be efficiently performed by a profit maximizing institution. In times of crisis the lender of last resort has to provide funds, at punitive rates, to borrowers in need, against collateral of acceptable quality so that the banking system may not contract too adversely or even collapse. The essential features of the function are, first, that the institution which performs it must be generally known to have unlimited funds at its disposal. And second, that the operation must be performed quickly, with only scant probability of inspecting the quality of the property accepted as collateral. After the crisis period is passed, therefore, this paper may take a long time in being liquidated.<sup>5</sup>

Hence the impossibility for a profit maximizing bank to perform this function without endangering its profitability. Hence the very marked difficulty the Bank of England encountered in performing it every year. What happened in practice was that, aware of the peculiar structure of the U.S. banking system, and of the inevitable recurrence of the so-called autumn drains, the Bank of England would protect its gold reserve by devices which amounted to partial inconvertibility, or to a fluctuating gold-sterling rate. In the twenty-five years before 1914, the Bank of England could also rely on the reserves the Indian Empire earned in world markets and was compelled to hold as deposits in London.

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<sup>5</sup>If we make use of one of Albert O. Hirschman's most useful contributions to economic thought, the lender of last resort function can be considered as a contradiction of the rules of "exit" and "arms' length relations"



In the 1860s the American banking system was reformed, with the passage of the National Banking act. It was a further step in the process of differentiation of the American financial system from those of the main European countries. Like many monetary reforms, it was the product of war finance and outmoded monetary theory.<sup>6</sup> It tried to bring all banks under National, i.e., Federal, charter, by imposing a punitive tax on State bank notes. All National bank notes were to be secured by Federal obligations. But no Central Bank was provided, to give elasticity to the money supply. And no rules were given to regulate the creation of deposits, the more modern banking device. And individual States were still allowed to charter banks. As a result, the dual banking system was founded, which exists even today.

Thus in the decades before the end of the century, while the U.S. economy advanced by leaps and bounds to become the largest and richest in the world, the American banking system grew as fast as the economy, but according to a model different from that according to which the major European financial systems were developing.

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predicated by the market system. To be exercised wisely, the lender of last resort function, in fact, requires that, first of all, "exit" that is to say bankruptcy, be suspended, and funds be advanced against collateral of an illiquid nature, i.e. against the normal rules of banking conduct. The intervention of this Central Bank, that is to say, is meant to save the money market as an essential institution, against its short-run illiquidity. By negating the "exit" rules in the case of a crisis, the Central Bank ensures that they remain in existence in normal times, when their operation may prove useful for the economic system's general efficiency. It was, in fact Albert Hirschman, who in his Strategy of Economic Development, called the central banker a sort of honorary member of the market forces, (p. 64, footnote).

<sup>6</sup>On the Act, see Eugene N. White's excellent The Regulation and Reform of the American Banking System, Princeton, 1981.



The National Banking Act forbade branching, with the result that small banks mushroomed everywhere, while some New York and Chicago banks reached gigantic size. The small banks, following what the Act prescribed, deposited funds with the large ones, and these funds, which were considered as reserves by the small banks, were either invested by the large banks in stock exchange speculation or lent on short-term, to the stock exchange speculators. Thus what the small banks considered as their reserves were funds which were lent for the most risky and unstable use. When a cloud appeared over the financial horizon, this system would contract credit as fast as it had expanded it. Small banks would call in their loans to large banks, and large banks would recall their loans from the stock exchange brokers. As a multiplier was in operation, there was not enough money to satisfy every bank that claimed its funds back. Interest rates soared, the Stock Exchange plunged, and in the absence of a lender of the last resort, money was supposed to come from abroad to re-establish equilibrium.

The proneness to crisis of this inverted financial pyramid increased as the financial sophistication of the country increased. We have to remember that financial sophistication is not necessarily by itself conducive to the balanced growth of the economy. Quite to the contrary, it is an attempt, on the part of financial operators, to maximize the volume of transactions with respect to basic financial resources. And this, while it induces fast growth, also causes deep cyclical oscillations. In the last quarter of the nineteenth century and in the years before the Great War, fast technological advances united the United States to a degree it had not been before; the improvement in communications and transportation



was tremendous. But this, for the financial system, only meant that small banks could proliferate even more than before, and that the whole system could be united by a web of inter-bank deposits which, being the system still headless, increased the rate of credit expansion but also that of credit contraction.

The co-existence of very small banks and very large banks contributed to instability by giving depositors little trust in small banks, to which they were lured by high deposit rates. Competition drove the cost of inter-bank deposits high and encouraged large banks to lend funds to lucrative but risky stock exchange adventures. Large banks were not in favor of a branch banking reform that may squeeze the small banks out because by their existence the fixed costs implied by branch banking were avoided. Large banks would solicit inter-bank deposits when they needed them and get rid of them when they did not.

In this period, banking was being extended to larger and larger sections of the population, thus involving people who could be easily exploited but who also more easily got frightened and wanted their money back, if the shadow of a panic appeared.

And panics were frequent. Between the establishment of the National Banking System and the First World War there was a panic every ten years, with an increase in frequency towards the end of the period. They ushered in widespread bank failures and industrial depression, and would spread quickly to the rest of the world, as transatlantic communications had become much better and new possibilities for international speculation opened up.



3. If we compare financial development in the U.S. in the two decades preceding the Great War with financial development in Europe, we find that a common feature to all national experiences was the rise of large banks. But, while in Europe banks became large by establishing huge national branch networks, in the U.S. banks became large by increasing the size of their wholesale operations, on the asset side, and by getting more and more interbank deposits from small banks, on the liability side.

There was, therefore, in the U.S., a growth of financial instability associated with the rise of large banks, as they engaged in fierce oligopoly battles for customers and for funds and did not have any Central Bank to restrain them or to get them out of the trouble in which they placed themselves frequently.

In addition, those were the decades when trust companies grew in the U.S. to challenge the operations of large banks unfettered by even the scant controls the National Banking System exercised on federally chartered banks. Financial innovation, in the form of the enormous development of stock exchange transactions, favored the peculiar type of financial development the U.S. experienced in this period.

Rapid financial innovation, together with the diffusion of growth and with improvement in communications, coupled with the interest of the large financial institutions in maintaining the institutional status quo would, however, not be enough to explain a course of financial development which was peculiar to the U.S. As I said earlier, in all major European countries branch banking had spread to the remotest corners, and Central Banks had been established to rule over an oligopolistic banking structure.



The degree of autonomy of the banking system from the political world varied according to the countries. But the banking structure prevailing everywhere was the same.

One has, therefore, to look again at the peculiar political coalition prevailing in the U.S., and to the even more peculiar regulation it imposed and maintained on banking if one wants to explain the different course financial development took in the U.S. in the four decades preceding the First World War. As I said, branch banking was, in fact, almost universally prohibited, at State and Federal levels. And the prohibition suited very well the local interests politicians were inclined to bow to, as it would allow enterprising individuals to try their hands at banking. Deposit insurance was the answer to the riskiness of this course of financial development, and it was duly adopted in several states, after the panic of 1907.

The main feature of the dual banking system, created by the National Banking Act and still in function today, was and is that it allows banks to arbitrage between Federal and State regulations in the search for an optimal result which will not necessarily agree with public welfare or macroeconomic stability.<sup>7</sup> I do not want to convey to you that the European mode of financial development had no problems. In its British incarnation, for instance, which is the one morphologically nearest to the American, it witnessed, in the 25 years before the First War, the great and increasing difficulties of the Bank of England to organize a working relationship with

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<sup>7</sup>See White, *op. cit.*



the giant clearing banks which had resulted from the merger movement. These banks were a new force in the traditional City landscape. They were outside the sancta sanctorum of British finance and threatened to organize themselves in a way that would do away with the services of the Bank of England. As lender of last resort this function was performed by the Bank of England with increasing difficulty because the Bank had to maximize profits and to keep a large gold reserve, which reduced profitability. The bank also threatened to invade the field of operations of the Merchant Banks, from whom the directors of the Bank of England and its governors were chosen. The crisis of July, 1914, showed how advanced was the degradation of the British financial system's control network. On the news of Sarajevo, and before war had broken out, the clearing banks organized a run on the City, by withdrawing money from the Stock Exchange and even by trying to get gold from the Bank of England.

But, again, the coalition, which stood behind the inner sanctum of the City, intervened powerfully and swiftly to rap the uncouth clearing banks' fingers and to rescue the Bank of England and the Merchant Banks with all the weight of the British Government. From the minutes of the "crisis conferences" Lloyd-George held to stem the financial panic, the picture emerges clearly of the financially powerful but politically unprotected Clearing Bankers being pushed back into their place.<sup>8</sup>

Not very differently had they been treated a quarter of a century before, at the time of the Baring Crisis. It is worth noting, moreover,

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<sup>8</sup>See de Cecco, *op. cit.*



that on the same occasion, July 1914, there was wild financial panic on Wall Street. The stock market collapsed, the foreign exchange market was closed. Bond prices sawk. The finance of foreign trade virtually ceased. And the U.S. was not involved in the war.

4. In 1914, the Federal Reserve Act had been in force for one year, but in spite of its formal passage, the new control structure it had created would not start to operate until November 16, 1914. Consequently, it had not been able to avert the panic in July 1914 which, as in previous cases, preceded the crisis in London and contributed decisively to its outbreak and added to its gravity. It was in fact on learning that the markets had closed in New York that the British Clearing Bankers took fright, as London was New York's largest creditor and the interruption of transactions there meant that London Merchant Banks and other financial institutions would not be able to recover the short term funds they had lent to New York in the immediate future.

The Federal Reserve System was once more the product of a compromise between the main political and economic forces in the U.S.<sup>9</sup>

After the panic of 1907, a large coalition had formed in favor of financial reform. Prominent in the coalition however, were the proponents of the real bills doctrine, a banking theory fallacious but capable of attracting the fervor of industrialists, small bankers and farmers.

The real bills doctrine's main contention is that banking will be conducted without problems, if bank loans are supported by real bills, that

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<sup>9</sup>For all the references to the literature on the origins of the .ED, see White, op. cit.



is to say, if money is lent on the collateral of paper proving a real mercantile transaction, which will be "self-liquidating". Of course, Henry Thornton, as early as 1807 had proved the fallacious nature of the doctrine, showing how the same sum of money could be used to finance a very large number of real bills, thus causing an uncontrollable expansion of credit. What was really at issue was, of course, the Central Bank's power to exercise quantitative control of Credit. Real bill proponents maintained that quantitative control was impossible and that quality control over the real transactions which credit financed was all that mattered.<sup>10</sup>

As everyone is against bad debts and everyone thinks his own debt is good and socially necessary while the next guy's debt is bad, the real bills doctrine has traditionally been a great social catalyst. A battle was fought over it in Britain in the first half of the nineteenth century, but the real bill supporters were effectively incapacitated as a political force by Peel's Act and never recovered since essentially because of the political weakness of industrialists country bankers and small farmers. In the U.S., however, the charm of the real bills doctrine still worked. The 1907 crisis had awakened the public to the extremes of financial speculation and people were therefore inclined to believe a doctrine that maintained that there was nothing wrong with any quantity of credit the banks generated provided it financed honest and productive transactions, and not the financial speculations of stock exchange promoters.

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<sup>10</sup>It is interesting to note that among American writers on banking and currency problems. A strong predominance exists, since the earliest times, and until quite late in the 20th century, of supporters of the real bills doctrine. This has been noticed, and exhaustively commented upon, by the two main students of American banking theory, Miller and Mints. They have



The Federal Reserve Act was, as a result, based on the principles of free banking, of qualitative credit controls, of the choice by bankers between State Banking and Federal Banking. In the spirit of pluralism, it also mandated that no less than 12 Federal Reserve Banks be set up. And to cap it all, the Federal Reserve Act incorporated the United States' adherence to a rigid version of the Gold Standard, such as it had never functioned anywhere in the world.

With such internally contradictory foundations, the new system began to operate, after the big parenthesis of War and War Finance, in a way that helped induce and certainly did not prevent the financial crises of 1920, 1929, 1930, 1932 and 1933.

5. If we compare the performance of the Federal Reserve System with that of its predecessor, we must draw a *prima facie* conclusion that the inter-war performance was even worse than the pre-war one. This may be

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both remarked on the Scarcity of Quantity Theory Supporters among American economists. This can be contrasted with the British literature, but is not very different from German experience in the same period, as analyzed for instance, by H. Ellis in his German Monetary Theory. There does not seem to have been however, an American version of the *Stratliche Theorie des Geldes*. Early American banking writers seem to often devote a lot of attention to the credit problems of farmers. And it is interesting to see how they manage to reconcile the farmers' credit needs and the real bills doctrine, with its insistence on "self-liquidation." Eligibility of agrarian paper for rediscount would overcome most real bill supporters' requirements, such was its political importance, and be specifically mentioned in the most important pieces of U.S. banking legislation. See, for the relevant literature, L. Mints, A History of Banking Theory in Great Britain and the United States, Chicago, 1945, and H. Miller, Banking Theory in the United States Before 1860, Harvard, 1927, to be contrasted with F.W. Fetter, The Development of British Monetary Orthodoxy, Harvard, 1965.



unfair, because the structural problems of the international economic system, and in particular of the American economy, were far greater in the inter-war period.

Some of these problems are so well known and so well studied that it would be useless to go over them again. For my purposes here, however, it is useful to focus on one aspect of the inter-war scene which has received less attention. In the 1920's and early 1930's, the American banking system went through one of its most dynamic phases. The instability of Europe in this period, added to the huge demand for credit on the part of European and Latin American countries, found large American banks ready to take up the challenge. We must appreciate that in the 1920's the demand for bank loans on the part of American corporations declined very substantially, as they found it more profitable to finance themselves out of retained profits and to finance their sales by trade credit and cash discounts.<sup>11</sup>

At the same time, a whole new world had opened up for American banks in personal financial management. Because of the extremely large gains all sectors of the American economy had made by supplying first all European warring nations and then the Allies, a new dimension of prosperity had been reached, and millions of American citizens were now in a position where they had money saved and money to be invested.

The banks, especially the large banks, had acquired expertise in dealing with this new demand when they had been given the task of retailing

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<sup>11</sup>I have dealt at greater length with this subject in "The International Debt Problem in the Inter-War Period" in Miles Kahler, (ed.) *The International Debt Problem*, (forthcoming), 1984, where I have also given the relevant bibliography.



Liberty Bonds and then government war debts. After the war they found it very profitable to maintain and increase this activity by selling the same clientele foreign bonds and by entering en masse the field of trust and security operations. Large American banks, in the same years, also began to attract short-term deposits from, and to make short term loans to, foreign individuals and governments. In this period, as a result, we see the American banking system, and in particular, its most dynamic components, become at the same time international bankers and investment bankers. The Federal Reserve Act, much more than the National Banking Act, had been a product of large banks' pressure on their traditional allies. Having satisfied the other partners of the coalition with the offal of the real bills doctrine and the twelve Reserve Banks, the Act went a long way towards giving the large money market banks more than proportional representation in the twelve Federal Reserve Banks' open market committees and on the Board of Governors.

It is thus natural that, in the '20s and early '30s, the monetary policy of the United States was motivated by the needs of the banking community, as perceived by large money market bankers.

The level of interest rates thus became heavily influenced by the need to maintain the values of their security portfolios which was common to all banks and to keep a hold on the notoriously volatile and interest-elastic foreign short-term deposits, a need especially felt by large money market banks. Thus in the 1920's, the American large banks happily lent to foreign governments and other public and private foreign customers, in an attempt to replace declining home business demand and to



expand their trust and securities operations with American families. And, starting in 1928, they switched to domestic stocks and bonds placements, stoking the fires of the Wall Street boom and at the same time inducing, by the sudden withdrawal of loans, the default of their foreign customers.

European financial turmoil and major banking crisis followed in 1931. The sudden drop of foreign demand for American goods which the drying up of American foreign loans induced reverberated upon American industry and was an important cause of the Depression. But it is fair to say that, in an attempt to prevent the withdrawal of foreign balances which was one of the results of the cessation of American loans abroad, the Federal Reserve put up interest rates and thus busted the Wall Street boom. In the following years interest rates were kept high, in spite of the huge fall in economic activity, because to have lowered them would have meant to decrease the banks' profitability and to accelerate the flight from the dollar, which was taking place after the devaluation of Sterling. Foreign owners of sterling balances, scalded by the experience, expected the same fate for their dollar balances.

6. The New Deal Banking legislation is commonly credited with the "reining in" of banks. But it does not seem to have been capable of giving the American economy a stable financial system. Stability in this field was achieved in the 1940s and 1950s, but this came largely because the banks were inundated with War Bonds and transformed, for a long time, into rentiers. This, however, was not true of all banks, but mainly of provincial banks, while the large money market banks plunged more deeply



into foreign operations, to gain a competitive edge on the rest of the financial system.

With the return of the Western financial system to convertibility, in the late fifties, and with the start of the Great American inflation, a few years later, the large banks found themselves exposed to external as well as internal threats.<sup>12</sup> Convertibility had revived the possibility of arbitrage, i.e., of shifting funds between financial centers following interest differentials and of international speculation based on exchange rate changes. The large banks thus found themselves exposed to sudden withdrawals of foreign-owned balances if American interest rates went, for purely domestic reasons, out of alignment with foreign ones.

The Great American Inflation meant that the financial resources of the United States grew at very high speed.<sup>13</sup> The large banks found themselves at a disadvantage vis à vis non-bank financial intermediaries as they were saddled with reserve requirements. Against small local banks they had difficulty in competing, as they were deprived of branches to attract deposits and generally to look after the financial needs of provincial communities enriched by the migration of industry and populated by families who had been made financially sophisticated by the growing inflation.

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<sup>12</sup>See my "International Financial Markets and U.S. Domestic Policy Since 1946," in International Affairs, 1976. Also, C.A.E. Goodhart, "Structural Changes in the Banking System and the Determination of the Stock of Money," presented to the Conference on Western European Priorities," Brussels, Decembr 1982, mimeo.

<sup>13</sup>See Henry Kaufman, Complexities of U.S. Stabilization Policies in an International Context, Salomon Brothers International, October 1983.



To fight this battle for a share of the fast-growing financial cake, large banks have resorted to the invention of means to increase their domestic competitiveness, like Certificates of Deposit, and to the exporting of more and more of their operations to the offshore money markets, where reserve requirements do not apply. At the same time they have tried to specialize in loans to genuine foreign borrowers.

In addition, they have been clamoring for the repeal of the New Deal Banking Legislation, and they have largely won the deregulation battle with the passage of the Depository Institution Deregulation and Monetary Control Act of 1980, which treats all depository institutions on the same footing for what concerns reserve and other requirements.

As in 1928, the freeing of the domestic market in 1980, has induced American banks to expand their operation at home relative to their foreign loans. This in addition to the Federal Reserve restrictive policy, has meant a drastic reduction of their foreign lending. The sudden dearth of funds thus induced has in turn placed the large banks' biggest foreign customers in near bankruptcy position. To relieve the situation, the Federal Reserve was compelled, in August 1982, to climb down from its restrictive stance, reducing interest rates. This brought about a stock market boom, and a revival of the domestic economy. But the attraction of a very high real interest rate remained, as prices slowed down, and as the main foreign countries tried to revive their economies by dropping interest rates in step with the United States. The resulting strength of the dollar has induced a huge balance of trade deficit.

The parallel with the end of the 1920's is inevitable. We are again at the end of an extremely dynamic phase for the American financial system,



which has again changed the name of the game, the place where it is played, and the people who are made rich by playing it. The large money market banks have reacted to a domestic and international challenge with a behavior which, if it has helped them to keep their market shares, has increased the instability of the U.S. financial system.

The Great American inflation, superimposed on the New Deal Banking legislation, has resulted in a complicated scramble for a very much expanded financial cake, with running battles between thrift institutions, large and small banks and non-bank financial intermediaries. The increase in anarchy was greatly facilitated by the great break-through in communication, achieved by the electronics revolution. And, as I said earlier, innovation is not necessarily by itself conducive to more order. To retain their hold on the financial system, the American monetary authorities have been compelled to dangerously stretch the interest rates instrument. Historically interest rate policy is viable only if, by small changes, large results are obtained. If the oscillations become wide, history teaches us that direct control weapons have to be used.

We are now clearly at a watershed. But whether direct control will be resorted to before or after a disastrous financial crisis we shall learn before the end of this year. Western financial history, however, teaches us that controls are usually introduced only to stem a crisis which is actually taking place.



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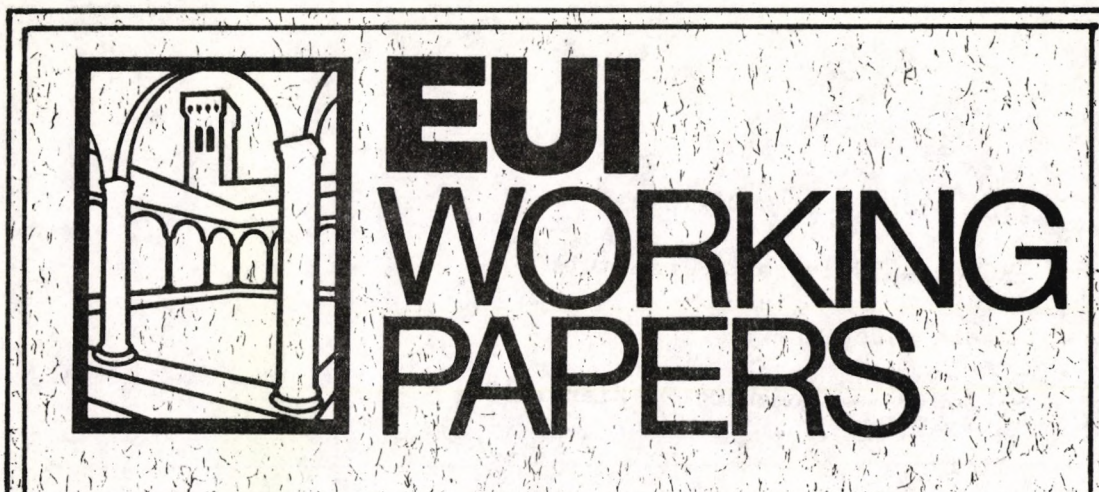
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