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NEGOTIATING THE LENDER OF LAST RESORT:  
THE 1913 FEDERAL RESERVE ACT AS A  
DEBATE OVER CREDIT DISTRIBUTION

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*“Lending of last resort” is one of the key powers of central banks. As a lender of last resort, the Federal Reserve (the “Fed”) famously supports commercial banks facing distressed liquidity conditions, thereby mitigating destabilizing bank runs. Less famously, lender-of-last-resort powers also influence the distribution of credit among different groups in society and therefore have high stakes for economic inequality. The Fed’s role as a lender of last resort witnessed an unprecedented expansion during the 2007–2009 Crisis when the Fed invoked emergency powers to lend to a new set of borrowers known as “shadow banks”. The decision proved controversial and spurred legislative reform narrowing the Fed’s authority as well as an ongoing scholarly debate. Participants in this debate, the Article argues, limited their focus to financial stability considerations, thereby neglecting those powers’ considerable distributive implications.*

*This Article contributes to the current literature by demonstrating the distributive stakes of lender-of-last-resort powers through a concrete historical*

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*example: the legislative debate around the 1913 Federal Reserve Act that established the Fed. During that time, three different groups debated the legal definition of “eligible collateral” that the Fed could accept from borrowers to secure emergency loans. The first group was corporate financiers, who were interested in supporting capital markets. The second group was the Democratic framers of the Act, who tried to divert credit away from corporate securities and into small businesses. The third group was farmers that needed credit for developing the agrarian periphery. I argue that each of these groups tried to shape the definition of eligible collateral in ways that would promote that group’s unique credit needs and reduce its borrowing costs. For us today, this history is an invitation to reconsider the distributive implications of the current lender-of-last-resort powers and revise them accordingly.*

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#### INTRODUCTION

The power to act as a “lender of last resort” is one of the key roles of central banks: in the United States, the Federal

Reserve System (the “Fed”).<sup>1</sup> As a lender of last resort, the Fed comes to the rescue of banks facing distressed liquidity conditions. These liquidity stresses arise occasionally due to “maturity mismatch,” which is an essential feature of banking. While banks’ hold their assets in the form of long-term loans, their sources of funding consist primarily of demand liabilities, like deposits.<sup>2</sup> When a large number of depositors demand payment simultaneously, a bank cannot liquidate its long-term assets with sufficient speed and so must fail.<sup>3</sup> This is where the Fed’s lender-of-last-resort powers become relevant. The Fed lends to distressed banks by taking their long-term assets as collateral, and providing them with immediately available funds to make necessary payments to depositors.<sup>4</sup>

The financial crisis of 2007–2009 witnessed a dramatic expansion in the Fed’s role as a lender of last resort.<sup>5</sup> Historically, this role was limited to supporting the traditional commercial banking system. In the crisis, the Fed decided to extend its support to the “shadow banking” system that developed over the past decades.<sup>6</sup> Shadow banking, in brief, refers to institutions—like broker–dealers, hedge funds and others—that borrow on short maturities (often overnight) and invest in long-term securities.<sup>7</sup> Thus, shadow banking is a varia-

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1. Ben Bernanke, *Fed Emergency Lending*, BROOKINGS (Dec. 3, 2015), <https://www.brookings.edu/blog/ben-bernanke/2015/12/03/fed-emergency-lending/>.

2. *Id.* (“The most important tool that central banks (like the Fed) have for fighting financial panics is their ability to serve as a *lender of last resort*.”).

3. See, e.g., Anna Gelpern, *Common Capital: A Thought Experiment in Cross-Border Resolution*, 49 TEX. INT’L L.J. 355, 360 (2014).

4. Bernanke, *supra* note 1.

5. See, e.g., Michael J. Fleming, *Federal Reserve Liquidity Provision During the Financial Crisis of 2007–2009*, 4 ANN. REV. FIN. ECON. 161, 167, 175 (2012).

6. See, e.g., Eric A. Posner, *What Legal Authority Does the Fed Need During a Financial Crisis?*, 101 MINN. L. REV. 1529, 1546 (2017).

7. See PERRY MEHRLING ET AL., *BAGEHOT WAS A SHADOW BANKER: SHADOW BANKING, CENTRAL BANKING, AND THE FUTURE OF GLOBAL FINANCE* 2, CTR. EUR. U. (2013), <https://www.ceu.edu/sites/default/files/attachment/event/6574/nov05-perry-mehrling.pdf> (defining shadow banking as “money market funding of capital market lending”). For a different but related definition of shadow banking, see MORGAN RICKS, *THE MONEY PROBLEM: RE-THINKING FINANCIAL REGULATION* 96 (2016). For a discussion of shadow banking, see also Nadav Orian Peer, *Your Grandfather’s Shadow Banking: Clearing and Governance in Gilded Age New York*, in *INSIDE MONEY: RE-THEORIZING LIQUIDITY* (Christine Desan ed., forthcoming 2019).

tion on the essential feature of banking (maturity mismatch) and is vulnerable to similar liquidity strains.<sup>8</sup> The shadow banking system was at the heart of the market for subprime mortgage securitization that had grown rapidly since the early 2000s.<sup>9</sup> As pressures grew in that market, the Fed invoked emergency powers in the Federal Reserve Act (the “Act”) that authorized it to lend to counterparties other than commercial banks.<sup>10</sup>

The Fed’s lender-of-last-resort support to the shadow banking system proved highly controversial. Some welcomed the Fed’s actions as a necessary adaption of the century-old authority to modern financial conditions.<sup>11</sup> Others were concerned with lack of accountability, moral hazard, and potential ramifications for future financial instability.<sup>12</sup> Ultimately, the 2010 Dodd–Frank Act reflected a middle ground between these positions. It posed considerable constraints on the Fed’s emergency powers while not eliminating them altogether.<sup>13</sup>

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8. RICKS, *supra* note 7, at x.

9. Zoltan Poszar et al., *Shadow Banking*, 19 ECON. POL’Y REV. 1, 2 (2013).

10. Federal Reserve Act of 1913, Pub. L. No. 63-43, § 13(3), 38 Stat. 251, 263 (1913) (codified as amended at 12 U.S.C. § 343 (2012)). For use of this authority in a crisis, see Posner, *supra* note 6, at 1546–47. The more common (“peacetime”) authority the Fed uses allows lending on to its own member banks. Federal Reserve Act of 1913 § 10B. This authority was left unchanged by the Dodd–Frank Act. *See infra* note 13.

11. *See, e.g.*, PERRY MEHLING, *THE NEW LOMBARD STREET: HOW THE FED BECAME THE DEALER OF LAST RESORT* (2010); MEHLING ET AL., *supra* note 7; Posner, *supra* note 6.

12. This position was taken in what journalists described as an “unlikely pairing” between Senators Elizabeth Warren (D, Massachusetts) and David Vitter (R, Louisiana). Natalie Johnson, *Warren, Vitter Team up to Take on Wall Street’s ‘Too Big to Fail’ Megabanks*, DAILY SIGNAL (Sept. 17, 2015), <http://daily.signal.com/2015/09/17/warren-vitter-team-up-to-take-on-wall-streets-too-big-to-fail-megabanks>. *See also* JAMES CROTTY & GERALD EPSTEIN, DEP’T OF ECON. AND POL. ECON. RESEARCH INST., *THE COSTS AND CONTRADICTIONS OF THE LENDER-OF-LAST RESORT FUNCTION IN CONTEMPORARY CAPITALISM: THE SUB-PRIME CRISIS OF 2007–2008* (2008).

13. As amended by the Dodd–Frank Act, section 13(3) of the Federal Reserve Act, 12 U.S.C. § 343 (2012), now requires a number of conditions and procedures including prior approval by the Secretary of the Treasury, “broad based eligibility” criteria for borrowers, assignment of “lendable value” to collateral and extensive reporting to Congress. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys., *Federal Reserve Board Approves Final Rule Specifying Its Procedures for Emergency Lending Under Section 13(3) of the Federal Reserve Act* (Nov. 30, 2015), <https://www.federalre>

Today, the question of whether lender-of-last-resort support should be extended to shadow banks remains a central concern among policy makers and financial lawyers.<sup>14</sup> My own concern in this Article is with the terms on which this question is being debated. This Article, in other words, does not take a position either in favor or against extension of the authority, but instead chooses to focus on certain blind spots that both proponents and opponents in this debate actually share in common.

This Article argues that the post-crisis discussion on lender-of-last-resort authority is premised on a powerful—but highly incomplete—narrative of the creation of that authority by the Act.<sup>15</sup> According to that narrative, the defining precipitant of the Act is the long period of financial instability that plagued the U.S. financial system in the absence of a central bank, following President Jackson's 1832 veto of the rechartering of the Second Bank of the United States.<sup>16</sup> Commentators understand the Act as a belated response to a string of banking panics that erupted during that period, including the panics of 1873, 1884, 1890, 1893, and the infamous Panic of 1907.<sup>17</sup> As a point of divergence, in Europe—where central banks were well institutionalized by that time—banking panics were alleviated by authorizing central banks to act as lenders of last resort. On the other hand, it took the Panic of 1907

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serve.gov/newsevents/pressreleases/bcreg20151130a.htm (describing how the new rule implements these requirements). For critiques of the new rules, see, for example, Posner, *supra* note 6, at 1532, 1574; Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75, 130–31 (2011).

14. See MEHRLING ET AL., *supra* note 7; Posner, *supra* note 6; Ricks, *supra* note 13. For related Post-Crisis legal scholarship on lenders of last resort, see, for example, Dan Awrey, *Brother, Can You Spare a Dollar? Designing an Effective Framework for Foreign Currency Liquidity Assistance*, 3 COLUM BUS. L. REV. 934 (2017); Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM L. REV. 843 (2016); Hal S. Scott, *Interconnectedness and Contagion—Financial Panics and the Crisis of 2008* (June 26, 2014), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2178475&download=yes](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2178475&download=yes).

15. See Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 221–522 (2006)).

16. See Andrew Jackson, *Veto Message*, in A COMPILATION OF THE MESSAGES AND PAPERS OF THE PRESIDENTS 1139–54 (James D. Richardson ed., 1897).

17. For a discussion of these panics, see O.M.W. SPRAGUE, *HISTORY OF CRISES UNDER THE NATIONAL BANKING SYSTEM* (Forgotten Books ed. 2009) (1910).

with its violent economic contraction before Congress created a parallel institution in the United States.

Thus, the conventional narrative nearly exclusively focuses on financial stability considerations.<sup>18</sup> While financial stability concerns were certainly important in the creation of the Fed's lender-of-last-resort authority, the conventional narrative leaves out other, crucial considerations. Most importantly, it ignores that the Act was also designed to shape the distribution of credit in society. More than simply reacting to years of financial panics, the Act was equally the culmination of a contentious political debate in the United States concerning the distribution of credit among different groups and competing interests in the economy.<sup>19</sup>

Examining the *Congressional Record*, accounts by key reformers, and detailed analysis of the turn-of-the-century financial system, this Article reconstructs the history of the Act as the outcome of the debate over credit distribution. This Article focuses on the competing agendas of three groups that participated in this debate, each with its own distinct vision for economic life in the United States: the Corporate Agenda, the Urban-Competitive Agenda, and the Regional Development Agenda.<sup>20</sup>

The Corporate Agenda was primarily advanced by New York corporate financiers and the large industrial corporations

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18. In their use of the conventional narrative, financial lawyers are building on an important branch of financial history. See *infra* Section I.A for discussion and critique. Examples of lawyers' adoption of this history include: Scott, *supra* note 14, at 3, 19, 72, 93; Katharina Pistor, *A Legal Theory of Finance*, 41 J. COMP. ECON. 315, 322 (2013); Ricks, *supra* note 7, at 161.

19. The duality of financial stability and credit distribution concerns is reflected nicely in the Committee Report of the Senate Committee of Banking and Currency: "The chief purposes of the banking and currency bill is to . . . prevent panics or financial stringencies; make available effective commercial credit for individuals engaged in manufacturing, in commerce, in finance, and in business to the extent of their just deserts . . ." S. REP. NO. 63-133, at 6003 (1913). My theoretical focus on credit distribution builds on Christine Desan's work, *The Constitutional Approach to Money*. See *infra* note 69 and Section I.C.

20. I chose the word "agenda" to encompass both the political ideals as well as the material interests of members of each group. Interests and ideals intersect in complex ways that I do not attempt to disentangle. Also, the three agendas are intentionally heuristic: a useful schema rather than an attempt to capture the distributive debate in its entire complexity.

they served.<sup>21</sup> Already well-established by the turn-of-the-century, they promoted an economy organized around large corporations with market power in their respective industries. According to these corporate financiers, market power was necessary to cure the ills of “ruinous competition” that plagued rapid industrialization following the late nineteenth-century.<sup>22</sup>

The Urban-Competitive Agenda was a reaction to the rise of corporate power. This agenda was primarily advanced by the mainstream of the Democratic Party, winners of the 1912 presidential election by a landslide.<sup>23</sup> Influenced by the ideas of Louis Brandeis, mainstream Democrats called for a return to competition through a package of reforms of which the Act was a key component. However, the scope of their agenda was limited to already established industries in urban centers.

The Regional Development Agenda was primarily advanced by country bankers, farmers, and small producers on the periphery left out of the Urban-Competitive Agenda.<sup>24</sup> They called for developing the agrarian economy that, at the time, employed around one third of the U.S. workforce.<sup>25</sup>

The development of lender-of-last-resort power was profoundly impacted by the ways in which the credit needs of each of these three groups were—or weren’t—met by the financial system that existed prior to the Act and the ways each group approached the Act to rewire the financial system for its benefit. This Article reconstructs this history by tracking three different types of credit instruments corresponding to the activities each of the groups found most desirable: “call loans” that supported corporate securities, “commercial paper” that funded Main Street urban borrowing, and “accommodation paper” that funded the agrarian economy.

Call loans were made by banks to brokers on the New York Stock Exchange (“NYSE”). These loans were extremely

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21. For the Corporate Agenda and the assertions of this paragraph, see *infra* Part IV.

22. For the notion of “ruinous competition,” see *infra* Section I.B.

23. For the Urban-Competitive Agenda and the assertions of this paragraph, see *infra* Part II.

24. For the Regional Development Agenda and the assertions of this paragraph, see *infra* Part III.

25. See BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES 1789–1945: A SUPPLEMENT TO THE STATISTICAL ABSTRACT OF THE UNITED STATES 63 (1949).

short-term (i.e., overnight), but the NYSE brokers used them to fund long-term corporate securities. From the banks' point of view, call loans were a highly liquid asset that allowed them to meet their obligation to redeem deposits on demand. The nexus between the banking system and the call loan market supported the enormous expansion in corporate capital in the decades preceding the Act.<sup>26</sup>

Corporate financiers had been campaigning for the creation of a central bank since around 1900,<sup>27</sup> but that campaign took a decisive turn after Woodrow Wilson's election in 1912. The Wilson Administration reframed the creation of a central bank as an opportunity to disrupt the nexus between the banking system and the stock exchange and to divert the flow of credit away from corporate securities and into Main Street borrowing.<sup>28</sup>

The cornerstone of the Democrats' agenda was to replace call loans with Main Street friendly commercial paper as the asset banks use to manage their liquidity. As enshrined in the original language of the Act, commercial paper was defined as short-term borrowing "arising out of actual commercial transactions" to support "agricultural, industrial or commercial purposes."<sup>29</sup> Section 13 authorized the Fed, to act as a lender of last resort against commercial paper but specifically excluded call loans from this definition.<sup>30</sup> Thus, at its origins, lender-of-last-resort authority was integral to the plan of shifting credit from call loans to commercial paper.

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26. For a discussion of call loans, see *infra* Parts II & IV.

27. See JAMES LIVINGSTON, *Forgoing a Consensus on Central Banking, 1906–8*, in ORIGINS OF THE FEDERAL RESERVE SYSTEM: MONEY, CLASS, AND CORPORATE CAPITALISM, 1890–1913 (1989). "These men [referring to prominent bankers] had since 1901 been leading the discussion in New York of centralized banking." *Id.* at 159.

28. Some legal scholars, including Peter Conti-Brown and Sabeel Rahman, have recognized the emergence of the Democrat critique of corporate concentration as a transformative moment in the lead-up to the Federal Reserve Act. The focus of their work, however, is with the Fed's organization and governance rather than its effects on credit distribution which is our central concern here. See generally PETER CONTI-BROWN, *THE POWER OF INDEPENDENCE OF THE FEDERAL RESERVE* 17–23 (2017); SABEEL RAHMAN, *GOVERNING THE ECONOMY: MARKETS, EXPERTS, AND CITIZENS* 112–16 (2013).

29. See Federal Reserve Act of 1913, Pub. L. No. 63-43, § 13(3), 38 Stat. 251, 263 (1913) (codified as amended at 12 U.S.C. § 343 (2012)).

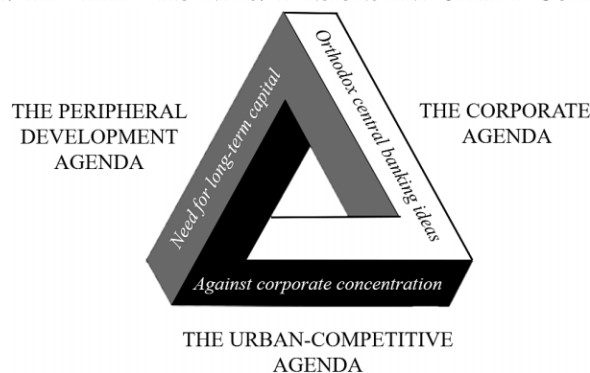
30. For a more complete discussion of this provision, see *infra* Section II.C.



Mainstream Democrats' harnessing of commercial paper against corporate finance mobilized support behind the Act, but it also created tensions with agrarian interests. Commercial paper was, by design, a rather short-term credit instrument.<sup>31</sup> Its short duration would have excluded vast portions of the peripheral economy that revolved around more flexible and informal credit known as "accommodation paper."

The drama that ensued between the three agendas underscores the importance of conceptual frameworks, political negotiations and delicate coalitions in the making of lender-of-last-resort power. As Figure 1 illustrates, these three agendas simultaneously had deep tensions and shared commitments. The Corporate and Urban-Competitive Agendas were at odds on the issue of corporate concentration, but agreed on important aspects of orthodox central banking theory. In turn, the Urban-Competitive and Regional Development Agendas were united in their aversion to corporate concentration, but the former's emphasis on short-term credit was incongruent with the latter's need for longer-term borrowing. Finally, the Corporate and Regional Development Agendas both demanded access to long-term capital, but they were deeply divided in all other respects.

FIGURE 1: THE THREE AGENDAS: TENSIONS AND SHARED COMMITMENTS



31. See *infra* Section II.C. The short duration of the paper was related to the "real bills" doctrine to be discussed throughout the Article. An exception in the section granted the Federal Reserve Board authority to extend the maturity for six months borrowing for agricultural purposes. See *infra* Section III.C. Curiously, the language of the original section 13 has largely survived in the modern Federal Reserve Act, 12 U.S.C. § 343, but it is now a relic, eclipsed by the far broader authorities later added in sections 10B and 13(3).

This Article's title—*Negotiating the Lender of Last Resort*—alludes to the complex political compromise that produced the Fed's original lender-of-last-resort authority. On the one hand, mainstream Democrats secured agrarians' support by partially accommodating their demands for longer maturities. On the other hand, despite the avowed anti-corporate purpose of the bill, Democrats were surprisingly successful in winning the support of corporate financiers. This article will shed light on this apparent paradox, explaining why corporate financiers still stood to benefit from the reform.

Some historians interpreted corporate financiers' support of the Act as a confirmation of the thesis that financial reform ultimately works to the benefit of corporate interests.<sup>32</sup> That conclusion reads a causal relationship into the Act that is unwarranted once the contemporaneous debate over credit distribution is brought to the fore. Such deterministic reading fails to appreciate the moment of enactment as the result of a public debate with high stakes and a range of possibilities for the design of the Fed's lender-of-last-resort authority.

This range of possibilities, each having different distributive implications, demonstrates that the Fed's powers were never designed to be a neutral tool. These powers are embedded with distributive agendas, grand public policies that they implement, although we rarely speak of them in those terms. Since their enactment over a century ago, lender-of-last-resort powers have undergone numerous revisions. Yet, these powers today continue to be grand public policy conveyed at a whisper, no more "neutral" than they were a century ago.

One of the most exciting developments in legal scholarship since the 2008 crisis has been the growing recognition of the monetary system as a product of legal design, and hence, subject to legal revision.<sup>33</sup> Building on these efforts, the history offered in this Article is a step towards a renewed appreciation

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32. See *infra* Section I.B for a discussion of Corporate Liberal historiography.

33. See, e.g., TAMARA LOTHIAN, *LAW AND THE WEALTH OF NATIONS: FINANCE, PROSPERITY, AND DEMOCRACY* (2017); RICKS, *supra* note 7; CHRISTINE DESAN, *MAKING MONEY: COIN, CURRENCY, AND THE COMING OF CAPITALISM* (2014); Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 CORNELL L. REV. 1143 (2017); Anna Gelpern & Erik F. Gerding, *Inside Safe Assets*, 33 YALE J. ON REG. 363 (2016); Roy Kreitner, *Legal History of Money*, 8 ANN. REV. L. & SOC. SCI. 415 (2012); Roy Kreitner, *Money in the 1890s: The*

of the distributive stakes of lender-of-last-resort powers. Current debates over reforms to lender-of-last-resort powers, therefore, are about more than securing greater financial stability. They are a chance to uncover the distributive schemes embedded in the current provisions of the Act and hold a public debate on their revision.

The remainder of the Article is divided into four parts. Part I discusses major themes in the historical literature on the origins of the Fed. These themes will help explain the emergence of the conventional narrative, as well as the critiques informing this Article. Parts II to IV discuss the Corporate, Urban-Competitive, and Regional Development Agendas and each respective group's disposition towards the Act. The Conclusion briefly explains how the Article might help frame debates and programmatic proposals over lenders of last resort today.

## I.

### RECEIVED ACCOUNTS OF THE ORIGINS OF THE FED

The conventional narrative of the Act is informed by a dominant account in financial history. That account views lender-of-last-resort powers in terms that are functional and rationalistic. I will refer to this tradition as “Bagehotian,” reflecting the importance of Walter Bagehot's 1873 work *Lombard Street* in formulating its central ideas. A second important historical account of the Act is articulated by scholars of “Corporate Liberalism,” who contemplate the creation of lender-of-last-resort powers through the lens of class conflict. According to this account, the Act represents one of the leading examples for corporations' use of the American state to entrench the corporate economy.<sup>34</sup>

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*Circulation of Politics, Economics, and Law*, 1 U.C. IRVINE L. REV. 975 (2011) [hereinafter Kreitner, *Money in the 1890s*].

34. The literature on the origins of the Fed is vast and there are many important accounts that do not fall clearly within either the Bagehotian or Corporate Liberal frameworks. Some of the works that informed this Article in particular include: ELIZABETH SANDERS, *ROOTS OF REFORM: FARMERS, WORKERS, AND THE AMERICAN STATE, 1877–1917*, at 217–66 (1999); Perry Mehrling, *Retrospectives: Economists and the Fed: Beginnings*, J. ECON. PERSP., Fall 2002, at 207; Jon R. Moen & Ellis W. Tallman, *Why Didn't the United States Establish a Central Bank Until After the Panic of 1907?* (Fed. Res. Bank of Atlanta Working Paper 99-16, 1999); Gerald T. Dunne, *A Christmas Present for*

While both traditions—Bagehotian and Corporate Liberal—offer important insights, both also fail to consider the contemporaneous debate over credit distribution. Their neglect of this debate is part of a broader inattention to the range of alternatives available in the design of monetary institutions. To bridge this gap, the Article builds on Christine Desan’s *Constitutional Approach to Money* with its analysis of money as a product of legal design and its strong distributive focus.<sup>35</sup>

A. *The Bagehotian Tradition: Rationalizing Lender of Last Resort*

In 1873, Walter Bagehot, an early editor-in-chief of *The Economist*, wrote his famous advice to the directors of the Bank of England (“BoE”).<sup>36</sup> Bagehot’s advice—lend freely, against good collateral and at a high rate—is a nearly universal idiom in policy circles.<sup>37</sup> It is of little surprise then that many of the most influential financial historians view the Act as the belated American creation of a Bagehot-style central bank.<sup>38</sup>

The context for the Bagehot rule is banks’ nature as agents that expand the money supply through maturity transformation. On the one hand, banks’ liabilities—bank deposits—are payable in cash on demand, which is a central feature of their use as means of payment between depositors. On the other hand, banks make their profits by holding the majority

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*the President: A Short History of the Creation of the Federal Reserve System*, BUS. HORIZONS, Winter 1963, at 43. Mary O’Sullivan’s work in 2016 on the call market and its significance for the Act was published while this Article was already at late stages. MARY A. O’SULLIVAN, DIVIDENDS OF DEVELOPMENT: SECURITIES MARKETS IN THE HISTORY OF U.S. CAPITALISM, 1866–1922 (2016).

35. See DESAN, *supra* note 33.

36. WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (Batoche Books 2001) (1873).

37. For an influential attempt to adapt the Bagehot rule to the conditions of the modern financial system, see MEHLING, *supra* note 11; MEHLING ET AL., *supra* note 7.

38. See, e.g., Ben S. Bernanke, E. Gerald Corrigan & Alan Greenspan, *Panel Discussion: November 6, 2010*, in THE ORIGINS, HISTORY, AND FUTURE OF THE FEDERAL RESERVE: A RETURN TO JEKYLL ISLAND 399, 408 (Michael D. Bordo & William Roberds eds., 2013); CHARLES GOODHART, THE EVOLUTION OF CENTRAL BANKS 6 (2d ed. 1988); ALLAN H. MELTZER, I A HISTORY OF THE FEDERAL RESERVE, 1913–1951, at 65–66 (2003); MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960, at 192 (1963). But see FRIEDMAN & SCHWARTZ, *supra*, for a sentiment of disapproval of speculation as important for section 13 of the Federal Reserve Act.

of their assets not in cash, but in the form of longer-term loans and securities. This is a profitable business model because interest earned on long-term loans is greater than interest paid on demand deposits—which is low, and often zero.

The Bagehotian framework posits banks' maturity mismatched structure functions tolerably well in ordinary times, but it is susceptible to occasional panics or "bank runs." If any considerable portion of a bank's depositors demand cash simultaneously, the bank could fail to meet its obligations as its assets are tied to illiquid loans. The failure of a single bank can breed unease among depositors, leading to widespread bank runs.

A central concern of such bank runs is their susceptibility to "self-fulfilling prophecies." Even when a depositor believes her particular bank to be solvent, she has a strong incentive to withdraw her funds if she suspects other depositors will do the same. This is because, once a bank exhausts its reserve of cash, it must suspend payments. Suspension of payments is undesirable because it turns immediately available deposits into long-term claims against the bank. It is therefore wise for the individual depositor to withdraw whatever cash it can from the bank rather than risk being too late.<sup>39</sup>

Bagehot's advice to the BoE was that faced with crisis, the BoE should act assertively as a lender of last resort. In other words, the BoE should open its "discount window" and lend freely against all collateral considered good in ordinary times.<sup>40</sup> When the BoE acted this way, it allowed banks to convert otherwise illiquid assets (i.e., collateral used for borrowing) into cash to meet depositors' withdrawals. Depositors would then be reassured that their banks were able to meet demand for cash, quelling the panic.<sup>41</sup>

From this Bagehotian perspective, U.S. financial history in the decades preceding the Act is a sequence of debilitating banking panics. The fatal flaw of the U.S. monetary system was its lack of an "elastic currency" that could expand and contract

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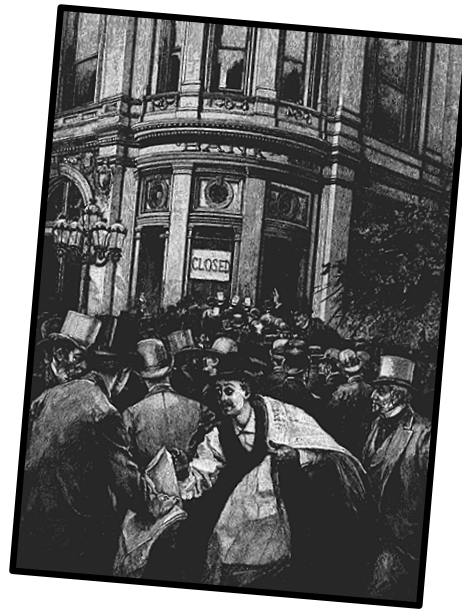
39. For a discussion of bank runs, self-fulfilling prophecies and multiple equilibria, see RICKS, *supra* note 7, at 53, 55, 62–73.

40. See BAGEHOT, *supra* note 36, at 21. As hinted above, the Bagehot dictum has an additional component, which is that the central bank should only make such lending available at a higher rate. *Id.* at 58.

41. *Id.* at 60.

according to the needs of the economy.<sup>42</sup> That inelastic currency produced occasional scarcities of cash that precipitated bank runs. Most importantly, during the harvest season, farmers at the periphery would need to increase their cash holdings to pay “farm hands” to move the crops. The farmers would draw cash from their local country banks. The local country banks would draw cash from their large correspondent banks in New York City. Before long, those large correspondents would quickly run out of cash; naturally, a general panic followed.<sup>43</sup>

FIGURE 2: A RUN ON THE BANK (HARPER'S MAGAZINE, FEBRUARY 1890)



Picture taken from HARPERS, <https://harpers.org/blog/2014/03/sins-of-the-fat-cat/> (last visited Feb. 25, 2018).

42. Under the National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as amended in various sections of 12 U.S.C.), national banks were authorized to issue national bank notes (Section 21), but only against government bonds deposited in the U.S. Treasury. Contemporaries often complained the issuance of those notes was cumbersome and unprofitable, hence they were notoriously “inelastic.” For a general discussion of national bank notes, see FRIEDMAN & SCHWARTZ, *supra* note 38, at 16–23.

43. The 1907 panic included an additional dimension of complexity due

The problem was that the United States lacked an entity—like the BoE—that could lend to banks against their assets.<sup>44</sup> In the absence of such lender of last resort, the rational course of action for individual actors was to run on their banks and hoard as much cash before others beat them to it.

Bagehotian historians understand Americans' failure to establish a central bank despite the enormous costs of panics as part of the controversial legacy of the Second Bank of the United States (1816–1836). The Second Bank became marred with corruption and capture by financial elites.<sup>45</sup> Many Americans feared that history would repeat itself. In the Bagehotian tradition, the Act, thus, represents overcoming this fear.<sup>46</sup>

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to the role of trust companies. See Jon Moen & Ellis W. Tallman, *The Bank Panic of 1907: The Role of Trust Companies*, 52 J. ECON. HIST. 611, 612, 617, 621 (1992) [hereinafter Moen & Tallman, *The Bank Panic of 1907*]. The initial trigger for that panic was the failed attempt by a speculator closely associated with the banking business (Augustus Heinze) to corner the stock of the United Copper Company. See Ellis W. Tallman & Jon R. Moen, *Lessons from the Panic of 1907*, ECON. REV., May/June 1990, at 4.

44. The U.S. Treasury and the New York Clearing House Association (“NYCHA”) provided some forms of lending of last resort, but those were too limited to provide a complete solution. See, e.g., 1 MARGARET G. MYERS, *THE NEW YORK MONEY MARKET: ORIGINS AND DEVELOPMENT* 426–28 (1931); DAVID KINLEY, *THE INDEPENDENT TREASURY OF THE U.S AND ITS RELATIONSHIP WITH THE BANKS OF THE COUNTRY* 268–72 (1910). For NYCHA clearinghouse loan certificates, see J.G. CANNON, *CLEARING-HOUSE METHODS AND PRACTICES* 75, 117 (1910).

45. For a nuanced discussion of the controversy surrounding the Second Bank of the United States, see Bray Hammond, *Jackson, Biddle, and the Bank of the United States*, 7 J. ECON. HIST. 1 (1947).

46. Friedman and Schwartz famously indicted the Fed with failure to fulfill its mission as a lender of last resort during the Great Depression. See FRIEDMAN & SCHWARTZ, *supra* note 38, at 299–419. Nevertheless, most financial historians see the creation of the Fed as a major step towards calming the previously chaotic U.S. financial system, and one that contributed to the long “quiet period” between the New Deal and the Global Financial Crisis. The other pillar of financial stability during this era is the Federal Deposit Insurance Corporation. See Banking Act of 1933 (Glass–Steagall Act), Pub. L. No. 73-66, § 8, 48 Stat. 162, 168 (1933); Banking Act of 1935, Pub. L. No. 74-305, § 1, 49 Stat. 684 (1935).

B. *The Corporate Liberal Tradition: Lender of Last Resort as Class Conflict*

Historians associated with the Corporate Liberal school offer a very different account of the determinants of the Act. This school, a branch of the broad field of history of American capitalism, focuses on the relationship between state power and the rise of the modern corporate system during the Progressive Era and the New Deal. It grew out of disagreement with the “consensus history” of the post-war period.<sup>47</sup>

To consensus historians like Richard Hofstadter, Arthur Schlesinger, and Louis Harz, the rise of the regulatory state reflected a tension between liberalism and corporate power. Liberal reformers, in other words, created regulatory agencies as part of their commitment to restrain the excesses of corporate power. Dissatisfied with this thesis, Corporate Liberal historians, including Gabriel Kolko and James Weinstein, reinterpreted the relationship between regulatory reforms and corporations.<sup>48</sup> Instead of curbing corporate power, they posited that Progressive Era and New Deal reforms promoted its rise and entrenchment.<sup>49</sup>

James Livingston’s *Origins of the Federal Reserve System: Money Class, and Corporate Capitalism 1890–1913* is a particularly influential Corporate Liberal reading of the Act.<sup>50</sup> Livingston’s thesis is that the Act was the result of a campaign led by corporate financiers who hoped to harness the central bank to stabilize securities markets. This article builds on Livingston’s insight to relate the origins of the Fed to the rise of corporate power, while also departing from his thesis in significant ways. The following paragraphs discuss three themes of Livingston’s work that are particularly noteworthy for present purposes: (1) the political controversy surrounding the modern corporation; (2) the 1890s debates on the monetary standard; and (3) the relationship between the monetary system and the capital

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47. My discussion of corporate liberal historiography draws on Eli Cook, *When Liberalism Went Corporate: The Evolution of the Corporate Liberal Historiography* (2009) (unpublished manuscript) (on file with author).

48. See GABRIEL KOLKO, *THE TRIUMPH OF CONSERVATISM: A REINTERPRETATION OF AMERICAN HISTORY, 1900–1916* (1967); JAMES WEINSTEIN, *THE CORPORATE IDEAL IN THE LIBERAL STATE* (Praeger 1981).

49. See, e.g., KOLKO, *supra* note 48, at 3.

50. LIVINGSTON, *supra* note 27.



market.<sup>51</sup> The first theme concerns one of the great political controversies of the Postbellum period. To many Americans the rise of the modern business corporation represented a threat to the tradition of small “r” republicanism.<sup>52</sup> This tradition was one of small proprietorship, self-employment, and competition between small producers, and it was central to the identity of many Americans throughout the nineteenth century. As Livingston explains, these small producers were “more interested in maintaining their standing as freeholders than in enlarging their claims on income and property. This is of course what Marx called . . . simple market society: it involves a market in products but not in labor.”<sup>53</sup>

By the late nineteenth-century, that tradition was severely threatened. An increasing share of economic activity was dominated by large corporations. These corporations increasingly came to exercise greater market power over their respective sectors (e.g., railroads, steel, oil, farm equipment, rubber, sugar, and tobacco). The entrenchment of corporate market power raised the issue of concentration that underlies so much of the development of modern corporate law.<sup>54</sup>

From the perspective of corporate leaders, the turn to concentration resulted from the inadequacy of the competitive price mechanism under the new industrial age. The notion of “self-regulating” competition relies on producers’ ability to flexibly adjust supply to meet demand. That is, for the price mechanism to work, producers must be able to adjust the quantities they produce based on prevailing prices.

Rapid industrialization, however, required firms to make large outlays of fixed capital—like plants and equipment—far in advance of sales. Faced with declining prices, firms could not recoup their fixed investment costs by lowering supply (factories and rail lines were already built). Instead, these firms ironically had to cut prices even further to increase their market share. The result was “overproduction” and “ruinous competition” between firms that led to mass bankruptcies and coincided with the Long Depression that lasted between 1873

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51. Livingston’s book is exceptionally rich and meticulously researched. The discussion that follows cannot do justice to this important work.

52. LIVINGSTON, *supra* note 27, at 33–70.

53. *Id.* at 92–93.

54. See MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870–1960: THE CRISIS OF LEGAL ORTHODOXY* 65–108 (1992).

and 1896. Corporate concentration emerged as the antidote to these problems.<sup>55</sup> A key insight Livingston offers in this context is to situate the Act within the broader controversy over corporate power. Contemporaries' views on the creation of a central bank were influenced by their broader stance on corporate power and the ways they believed the creation of a central bank would affect corporate power.

FIGURE 3: THE STATUE OF LIBERTY COVERED IN TRUST POSTERS (1889)



Picture taken from NEW INDEPENDENT WHIG, <https://newindependentwhig.blogspot.com/2012/07/on-liberty-enlightening-world.html> (last visited Feb. 25, 2018).

55. LIVINGSTON, *supra* note 27, at 51–53. See also Hyman Minsky, *Schumpeter and Finance*, in *MARKET AND INSTITUTIONS IN ECONOMIC DEVELOPMENT: ESSAYS IN HONOUR OF PAULO SYLOS LABINI* 109 (Salvatore Biasco et al. eds., 1992).

A second relevant theme in Livingston's analysis is the intense debate about the monetary standard in the 1890s.<sup>56</sup> Prior to the Civil War, the United States had a bimetallic standard, meaning that both gold and silver could be freely minted by the U.S. mint into legal tender according to ratios established (and occasionally recalibrated) by law.<sup>57</sup> During that period, bank deposits, bank notes, and government debt were ultimately convertible into gold and silver coin. The Civil War brought a suspension of this standard, replacing it with inconvertible paper money known as "greenbacks."<sup>58</sup> When Congress resumed the metallic standard in the late 1870s, only gold—not silver—could be freely minted into legal tender.<sup>59</sup> The United States thus effectively joined the international "gold standard."<sup>60</sup>

The gold standard coincided with a long period of monetary deflation (i.e., a decrease in the price level). The decline in the price of agricultural commodities and the burden of fixed mortgage payments meant that farmers were particularly hit hard by deflation.<sup>61</sup> In the 1890s, agrarian frustration resulted in the Populist Party campaign to expand the money supply through the reminting of silver. Such increase, agrarians believed, could bring prices back up to their traditional level. This "free silver" campaign divided the Democratic Party between the "Silverite" Populist wing, and the mainstream "Gold Democrat" camp, committed to the gold standard. The Populist wing triumphed when William Jennings Bryan won

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56. LIVINGSTON, *supra* note 27, at 71–128.

57. See, e.g., Coinage Act of 1792, 1 Stat. 246 (1792); Coinage Act of 1834, 4 Stat. 699 (1834); Coinage Act of 1853, 10 Stat. 160 (1853). For actual amounts of gold and silver coin minted, see DICKSON H. LEAVENS, *SILVER MONEY* 21 (1939).

58. See Legal Tender Act of 1862, 12 Stat. 345 (1862); see also *Knox v. Lee*, 79 U.S. 457 (1871).

59. For restrictions on minting of silver, see Coinage Act of 1873, ch. 131, § 21, 17 Stat. 424. Resumption took place later in 1879, with the Treasury standing ready to redeem greenbacks for coin on demand. See Specie Payment Resumption Act of 1875, ch. 15, 18 Stat. 296 (1875).

60. For discussion of the gold standard and related legal aspects, see Roy Kreitner, *The Jurisprudence of Global Money*, 11 *THEORETICAL INQUIRIES LAW* 177 (2010).

61. As Kreitner recounts, from 1866 to 1894 the price of wheat declined from \$3.00 to \$0.56 a bushel. Kreitner, *Money in the 1890s*, *supra* note 33, at 978.

the presidential nomination at the Democratic National Convention, although he ultimately lost in the 1896 general election.<sup>62</sup>

Like the Gold Democrats, corporate financiers strongly opposed the Populists' free silver agenda. According to Livingston, corporate financiers' opposition was rooted in two concerns. First, while Populists focused on money's role in facilitating present production and consumption, corporate financiers' priorities lay with money's role in enabling the accumulation of capital across time. Capital market securities—stocks and bonds—moved purchasing power away from investors with surplus funds and into the hands of corporations that made real investments.<sup>63</sup> Corporate financiers insisted that changes in the monetary standard would undermine investors' confidence and threaten the functioning of the capital market.<sup>64</sup> Corporate financiers also believed that monetary expansion would put more money in the hands of small producers, thus exacerbating the problems of overproduction and ruinous competition.<sup>65</sup> Livingston's key insight here is in considering the Act as a follow-up chapter in the history of the political debate over the monetary standard.

A third and final relevant theme from Livingston's work is the relationship between the capital market and the monetary system on the eve of the Act. According to Livingston, the impetus for the Act was corporate financiers' efforts to protect the capital market from monetary instability.<sup>66</sup> At the time, one of the key threats to the capital market came from harvest strains when agrarian needs overwhelmed New York banks with demands for cash to move crops. By the early 1900s, country banks transformed the way they held their balances in New York, destabilizing the capital market even further.

In addition to holding balance with large New York correspondent banks, country banks began holding part of their

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62. Nearly two decades later, tensions between the former Gold Democrat and Populist camps continued to reverberate in the debates over the Federal Reserve Act. *See infra* Part III.

63. LIVINGSTON, *supra* note 27, at 93–94.

64. *Id.*

65. *See id.* at 100–01.

66. *See id.* at 137–44, 155–58, 161–62, 178, 187.

balances as call loans.<sup>67</sup> Call loans are overnight loans made to brokers on the NYSE. NYSE brokers used these loans to finance securities purchased for their speculative customers. Come harvest, when the country banks' demand for cash increased, they would abruptly call back loans from brokers. The sudden shortage of funds would make interest rates on call loans rapidly increase. To repay the loans, brokers would liquidate their customers' positions *en masse*. The fire sales led to steep declines in securities' prices and general chaos in the capital market. Once harvest season was over, the flow of funds reversed. Brokers were glutted with loans from country banks and interest rates on call loans dropped to very low levels again.

According to Livingston's analysis, corporate financiers campaigned for the creation of a lender of last resort to alleviate strains from the call loan market. A lender of last resort would be able to increase the supply of cash during harvest, and contract it when that cash was no longer necessary. Then, the call loan market would be insulated from the boom–bust dynamic of the harvest that was increasingly threatening the health of the capital market. In this way, Livingston's work adds an important dimension to the conventional narrative. According to him, the creation of a lender of last resort was not merely an attempt to increase financial stability for the benefit of all. Instead, it was part of a broader agenda to use state power—the central bank—to stabilize and promote the corporate system against the embattled republican order.

C. *The Constitutional Approach: Lender of Last Resort and the Unit of Account*

The Bagehotian and Corporate Liberal accounts each provide important insights into the genesis of the Fed. However, the narratives they offer, even when taken together, remain incomplete. Bagehotian historians correctly acknowledge the centrality of financial panics in the development of lender-of-last-resort powers, but they omit any meaningful political or distributive stakes. In turn, Corporate Liberal histori-

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67. *Id.* at 144, 155–56, 178. A related, but distinct development was the rise of trust companies as major lenders to brokers. See Moen & Tallman, *The Bank Panic of 1907*, *supra* note 43. See also LIVINGSTON, *supra* note 27, at 139–40.

ans usefully locate lender-of-last-resort power within the broader controversy over corporate capitalism. The Fed, however, is so closely identified with corporate interests in the narrative that there is no consideration of the meaningful public debate over the design of lender-of-last-resort powers.<sup>68</sup>

A full account must address the distributive choices inherently involved in enacting foundational monetary reforms like lender-of-last-resort authority. Christine Desan's *The Constitutional Approach to Money* ("Constitutional Approach") provides a useful framework for analyzing such distributive choices.<sup>69</sup> Her *Constitutional Approach* conceives of the monetary system—like the financial activity it enables—as an object of governance. Desan critiques the widespread view that money arises spontaneously from private barter. Instead, she argues, collective or group decisions are essential to creating and maintaining money.<sup>70</sup> At the most basic level, Desan shows that collectives,

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68. Thus, Livingston argues that partisan lines made little difference in the way legislators approached the creation of a central bank in the years leading up to 1913 as all parties' positions were ultimately "the invention" of the corporate vision to "remake American banking in the image of the new corporate economy." LIVINGSTON, *supra* note 27, at 215. For critiques of this thesis, see SANDERS, *supra* note 34, at 238; Gerald Berk, *Corporate Liberalism Reconsidered: A Review Essay*, 3 J. POL'Y HIST. 70 (1991). It is interesting to note that side by side with Livingston's overarching narrative on corporate dominance, his work powerfully reveals instances where competing distributive agendas did in fact translate into legislative battles. Consider, for example, his discussion of the 1908 Aldrich Vreeland Act and debates over the definition of acceptable collateral for the issuance of emergency currency. LIVINGSTON, *supra* note 27, at 183–87.

69. DESAN, *supra* note 33; Christine A. Desan, *The Constitutional Approach to Money: Monetary Design and the Production of the Modern World*, in MONEY TALKS: EXPLAINING HOW MONEY REALLY WORKS 109 (Nina Bandelj et al. eds., 2017) [hereinafter Desan, *The Constitutional Approach to Money*]; Christine A. Desan, *The Monetary Structure of Economic Activity*, in INSIDE MONEY: RE-THEORIZING LIQUIDITY (Christine A. Desan ed., forthcoming 2019) [hereinafter Desan, *The Monetary Structure*]. As Desan explains, the "constitutional" in the "constitutional approach" refers to the foundational way in which monetary arrangements define public authority, its relationship to individuals, and the way individuals relate to one another. Desan, *The Constitutional Approach to Money*, *supra*, at 111, 115. Sometimes, these arrangements are made through the Constitution, but often they are made in other branches of law, including private law, regulatory practice, and international law.

70. See Desan *The Constitutional Approach to Money*, *supra* note 69, at 112–121.

rather than individuals, decide how to define the monetary unit of account (e.g., the U.S. dollar).

A dollar is, at its root, legally defined. The idea that banks must stand ready to redeem deposits in cash only finds logic where there is some legal definition of cash. This is often referred to as “legal tender”—the power to redeem debt denominated in the unit of account.<sup>71</sup> Collective decisions create a supply of cash by endowing certain assets as legal tender. And collective decisions generate demand for cash by levying public obligations—taxes—and by enforcing private obligations in legal tender.<sup>72</sup>

As Desan’s legal history of money demonstrates, collectives have great flexibility in defining what assets are legal tender, or would be easily convertible into legal tender. The decision to impart this quality on particular assets at the exclusion of others has distributive consequences. After all, the law grants these assets with a legal power that other assets lack: they can redeem debt. Demand for these assets, thus, becomes greater, raising their value and encouraging the economic activities to which they relate.<sup>73</sup> As Desan shows in her work—and as we will explore below—different people will be positioned differently to benefit from these activities. In this way,

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71. The term “legal tender” deserves clarification as different authors employ it in different ways. I use the term to denote the fact that the law recognizes that a certain instrument has the power to redeem debt in a given transaction. Defined this way, “legal tender” need not be universal: an instrument may work as legal tender to redeem some forms of debt but not others. The famous greenbacks are a case in point. Under section 1 of the 1862 Legal Tender Act, these notes were legal tender to all debts, public or private, *except* payments of customs to the government, and interest on the public debt from the government. Legal Tender Act of 1862, 12 Stat. 345 (1862). Similarly, transfers of commercial bank deposits today enjoy broad powers of redeeming debt between bank depositors, but not between banks, or from banks to depositors. For discussion of these themes, see Nadav Orian Peer, *A Constitutional Approach to Shadow Banking: The Early Shadow System* 21–26 (2016) (unpublished S.J.D. dissertation, Harvard Law School) (on file with author).

72. DESAN, *supra* note 33, at 24, 78–83 (discussing public and private payments, respectively).

73. See Desan, *The Constitutional Approach to Money*, *supra* note 69, at 113–117 (discussing the “cash premium”).

defining the unit of account presents society with first order questions on the character their economy is going to take.<sup>74</sup>

The insights of Desan's *Constitutional Approach* are directly relevant to lender-of-last-resort powers. When the central bank agrees to lend against particular types of collateral, it essentially converts that collateral into legal tender that can be used in payment. The Act authorized the Fed to issue "Federal Reserve notes" based on its loans (or "discounts") to member banks.<sup>75</sup> When lending to banks, the Fed therefore allowed them to transform their illiquid collateral into newly issued Federal Reserve notes. According to section 16 of the Act, these Federal Reserve notes were "obligations of the United States . . . receivable by all national and member banks and Federal reserve banks and for all taxes, customs, and other public dues."<sup>76</sup> Banks could also use these notes to satisfy their regulatory reserve requirements.<sup>77</sup> Thus, the Act made Federal Reserve notes legal tender for the most important payments in the economy.<sup>78</sup>

The notes themselves, it is important to mention, were still convertible into gold coin, and a provision in the Act explicitly reaffirmed the gold definition of the dollar.<sup>79</sup> However, the legal tender status of Federal Reserve notes for public taxes, national bank debt, and bank reserves made it all but certain that domestic users would gladly accept them in payment of debt, and had little incentive to redeem them for coin.<sup>80</sup> Furthermore, while the Act required the Fed to main-

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74. DESAN, *supra* note 33, at 24. See also Desan, *The Monetary Structure*, *supra* note 69.

75. Federal Reserve Act of 1913, Pub. L. No. 63-43, § 16, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 221-522 (2006)).

76. *Id.*

77. *Id.* § 19. However, part of the required reserve had to be kept in balances held with the Fed directly. Either way, a bank could always deposit Federal Reserve notes with the Fed to acquire the necessary balances.

78. For my use of the term "legal tender," see the discussion in Orian Peer, *supra* note 71. Under the current provisions of the U.S. Code, Federal Reserve notes today constitute legal tender for all debts, public and private. See 31 U.S.C. § 5103 (2012). The Fed does not need to redeem the notes in any other form of money.

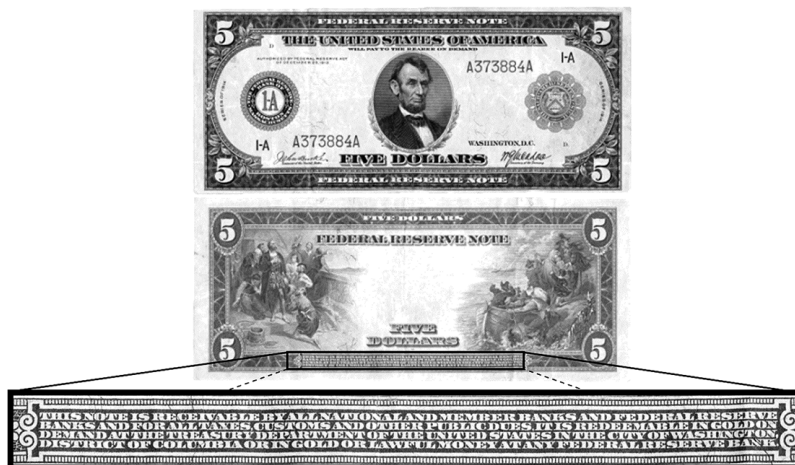
79. Federal Reserve Act of 1913 § 26.

80. I am referring here to domestic users, as opposed to international investors and foreign exchange arbitrageurs. The incentives of these actors are important, of course, but they should not detract from the large domes-



tain a gold reserve against its notes, that reserve was partial (40%) and subject to considerable flexibility.<sup>81</sup> After all, as its preamble declares, the Act was explicitly designed to “furnish an elastic currency.” This elasticity was achieved precisely by having the power to issue paper money only partially backed by a gold reserve.

FIGURE 4: FEDERAL RESERVE NOTES (1914) CONSTITUTED  
LEGAL TENDER IN PAYMENT TO THE TREASURY,  
NATIONAL BANKS, AND THE  
FEDERAL RESERVE



Picture taken from WIKIPEDIA, [https://en.wikipedia.org/wiki/Federal\\_Reserve\\_Note#/media/File:US-\\$5-FRN-1914-Fr-832a.jpg](https://en.wikipedia.org/wiki/Federal_Reserve_Note#/media/File:US-$5-FRN-1914-Fr-832a.jpg) (last visited Feb. 28, 2018).

This Article, in sum, builds on Desan’s *Constitutional Approach* by identifying lender-of-last-resort reform as an instance where the monetary unit of account itself is redefined. This moment entails a choice between different ways of redefining the unit of account, namely, deciding on the different collaterals that will be eligible for lender-of-last-resort support. In the

tic demand that is created for instruments with legal tender status. *See also* DESAN, *supra* note 33, at 406.

81. For the 40% gold reserve requirement, see Federal Reserve Act of 1913 § 16. Section 11(c) authorizes the Federal Reserve Board to suspend reserve requirements. The scope of the discretion is broad, though its use subjects the Fed to a tax on reserve deficiencies. *Id.* § 11(c).

remainder of the Article, we move to examine how each one of the three contemporary groups—mainstream Democrats, agrarians, and corporate financiers—tried to shape the definition of eligibility to promote its access to credit.

## II.

### THE URBAN-COMPETITIVE AGENDA

By 1912, the Populist wing of the Democratic Party, though still influential, had lost its leadership position.<sup>82</sup> With Woodrow Wilson's nomination at the Democratic National Convention, the old Gold Democrat wing that opposed the "free silver" campaigns of the previous decades resumed control of the party.<sup>83</sup> Despite their conservative support of the gold standard, these mainstream Democrats adopted a firm anti-corporate stance. Therefore, the Urban-Competitive Agenda of mainstream Democrats managed to simultaneously deride the political project of Populism, while nevertheless appealing to the shared values of small-scale entrepreneurship, economic independence, and producerism, all in the context of the embattled republican tradition.

The "Urban-Competitive Agenda" thus refers to the sum of views and commitments held by mainstream (as opposed to Populist) Democrats: men like President Wilson, Louis Brandeis (Wilson's political advisor and later Supreme Court nominee), Representative Carter Glass (Chair of the House Committee on Banking and Currency and co-sponsor of the Act), Henry Parker Willis (Committee Expert and one of its main drafters), and Samuel Untermyer (counsel of the influential Pujo Committee).<sup>84</sup> Pet peeves and turf battles demonstrate

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82. Bryan won the nomination (but lost the elections) in 1900 and 1908. ROBERT W. CHERNY, *A RIGHTEOUS CAUSE: THE LIFE OF WILLIAM JENNINGS BRYAN* 87, 111 (1985). In 1904, the nominee was Alton Parker, who supported the gold standard. *Id.* at 99.

83. See RICHARD J. JENSEN, *THE WINNING OF THE MIDWEST: SOCIAL AND POLITICAL CONFLICT, 1888-1896*, at 307 n.63 (1971).

84. I am intentionally leaving out of this list Democrats from the Populist or Bryanite wings. Their agenda differed from the Wilson camp and was sometimes (though not always) closer to the regional development vision. See *infra* Part III. For a rich history of the negotiations between the Bryan and Wilson wings over the Act, see Dunne, *supra* note 34. Samuel Untermyer was politically closer to the Bryanite wing but his views on credit distribution, I believe, sat comfortably with the Wilsonians.

that even within the mainstream Democratic camp, these men clearly did not possess a unified worldview.<sup>85</sup> And yet, the Urban-Competitive Agenda was broader than their sensitivities as individuals. The agenda was the party's platform and the party's face to the public and it powerfully animated the terms on which the Act was designed and debated.

This Part begins by describing mainstream Democrats' anti-corporate politics (Section A) and the ways these politics manifested in their assault of the call loan market (Section B). It then moves on to the role of the assault on the call loan market in the design of the Act (Section C).

#### A. Democrats' Anti-Corporate Politics

The 1912 election campaign brought the debate over the modern corporation to the fore, with each of the main contenders—the Democratic, Progressive, and Republican parties—articulating a different role for the corporation in the U.S. economy.<sup>86</sup> Influenced by the ideas of Louis Brandeis, the Democratic Party platform derided private monopolies as “indefensible and intolerable” and demanded new legislation for their complete elimination.<sup>87</sup> Opposing the Democrats, Theodore Roosevelt's new Progressive Party accepted that “[t]he concentration of modern business, in some degree, is both inevitable and necessary for national and international business efficiency.”<sup>88</sup> Instead of breaking the trusts, Progressives called for their regulation through new administrative commissions. Incumbent, President Taft, and the Republicans called for more vigorous prosecution of corporate abuses through the Sherman Antitrust Act but also accepted their permanent

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85. For an example of the tensions between Glass and Undermyer, see Edward J. Stevens, *The Founders' Intentions: Sources of the Payment Services Franchise of the Federal Reserve Banks* (Fed. Res. Fin. Serv., Working Paper No. 03-96, 1996). See also Henry Parker Willis, *The Federal Reserve Act*, 4 AM. ECON. REV. 1, 17 (1914); SAMUEL UNDERMYER, WHO IS ENTITLED TO THE CREDIT FOR THE FEDERAL RESERVE ACT?: AN ANSWER TO SENATOR CARTER GLASS (1927).

86. See William Kolasky, *The Election of 1912: A Pivotal Moment in Antitrust History*, 25 ANTITRUST 82 (2011).

87. *1912 Democratic Party Platform*, AM. PRESIDENCY PROJECT (June 25, 1912), <http://www.presidency.ucsb.edu/ws/index.php?pid=29590>.

88. *Progressive Party Platform of 1912*, AM. PRESIDENCY PROJECT (Nov. 5, 1912), <http://www.presidency.ucsb.edu/ws/index.php?pid=29617>.

role.<sup>89</sup> With the Republican vote split between Taft and Roosevelt's new Progressive Party, the Democrats' firm anti-corporate stance won by a landslide.

The Act, signed into law on December 1913, was part of the broader package of policies advanced by the Democrats to pursue decentralization and the return to competition. Dubbed as the "New Freedom," this package included a number of big-ticket items. The earlier Revenue Act of 1913 reinstated the income tax and substantially reduced the tariff that protected corporations from international competition.<sup>90</sup> The later Clayton Antitrust Act of 1914 was an attempt to prevent anticompetitive practices at their incipency.<sup>91</sup> Earlier in 1913, Wilson himself alluded to the close relationship between monetary reform and competition while addressing a joint session of Congress to compel legislative action on the Act. He argued that "[i]t is absolutely imperative that we should give the business men of this country a banking and currency system by means of which they can make use of the freedom of enterprise and of individual initiative which we are about to bestow upon them."<sup>92</sup>

The ideological glue joining together the New Freedom legislation also found its way into one of Clifford Berryman's caricatures (see Figure 5). The popular contemporary cartoonist depicted Wilson trying to prime the "business prosperity pump," pouring-in buckets of "Currency Legislation," "Antitrust Legislation," and "Tariff Legislation."<sup>93</sup>

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89. *Republican Party Platform of 1912*, AM. PRESIDENCY PROJECT (June 18, 1912), <http://www.presidency.ucsb.edu/ws/index.php?pid=29633>.

90. Revenue Act of 1913, 38 Stat. 114 (1913).

91. Clayton Antitrust Act of 1914, Pub. L. 63-212, 38 Stat. 730 (1914) (codified at 15 U.S.C. §§ 12-27 (2012)).

92. Woodrow Wilson, Address to a Joint Session of Congress on the Banking System, AM. PRESIDENCY PROJECT (June 23, 1913), <http://www.presidency.ucsb.edu/ws/index.php?pid=65369>.

93. CLIFFORD KENNEDY BERRYMAN, *Priming*, in BERRYMAN POLITICAL CARTOON COLLECTION, 1896-1949, NAT'L ARCHIVES & RECORDS ADMIN. (June 26, 1914), <https://catalog.archives.gov/id/306143>.

FIGURE 5: MONETARY REFORM AS PART OF WILSON'S  
"NEW FREEDOM" AGENDA



When applied in the context of money and banking, Democrats' anti-corporate stance translated into a critique of the "money trust." The money trust was a group of large New York financial institutions that brought together large investment banks like J.P. Morgan & Co. and Khun, Loeb & Co. with the largest NYCHA banks like National City and First National. Democrats argued this group held effective control over the distribution of industrial credit. They accused this group of using its control to channel credit to affiliated corporations like U.S. Steel and General Electric while denying it from any possible competitors. While still Governor of New Jersey, Wilson channeled this critique back in 1911:

The great monopoly in this country is the money monopoly. So long as that exists, our old variety and freedom and individual energy of development are out of the question. A great industrial nation is controlled by its system of credit. Our system of credit is concentrated. The growth of the nation, therefore, and all our activities are in the hands of a few men,

who, even if their actions be honest and intended for the public interest, are necessarily concentrated upon the great undertakings in which their own money is involved and who, necessarily, by every reason of their own limitations, chill and check and destroy genuine economic freedom. This is the greatest question of all; and to this, statesmen must address themselves with an earnest determination to serve the long future and the true liberties of men.<sup>94</sup>

By the 1912 election year, the Democrats, who won the House in 1911, formed a congressional subcommittee to investigate the money trust known as the "Pujo Committee."<sup>95</sup> Testimonies from leading financiers and cross-examinations by the committee's counsel, Samuel Untermyer made the Pujo Committee a widely covered spectacle.<sup>96</sup> In giant diagrams, Committee staff meticulously documented the web of ownership interests and interlocking directorates that linked New York's financial institutions to each other and to the nation's largest corporations (see Figure 6). The Committee submitted its final report in February 1913, just in time for the opening of the all-Democratic sixty-third Congress. The report was an important influence on the public debate and legislative hearings over the Act that would be signed into law by the end of the year.<sup>97</sup>

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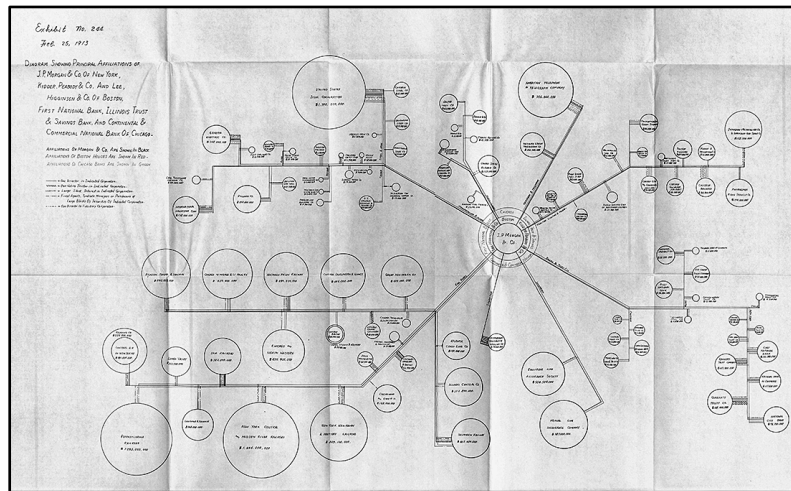
94. LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 1 (1914). See also CARTER GLASS, *AN ADVENTURE IN CONSTRUCTIVE FINANCE* 78-79 (1927).

95. Some Republicans also played an important role in the creation of the subcommittee, most notably, Rep. Charles August Lindbergh (Minnesota), father of the famous aviator. In 1913, Lindbergh bitterly opposed the Federal Reserve Act. See C.A. Lindbergh, *Minority Views on the Glass Bill*, in HOUSE BANKING AND CURRENCY COMMITTEE REPORT, H.R. 7837, 63d Cong. (1913).

96. See *Money Trust Investigation: Investigation of Financial and Monetary Conditions in the United States Under House Resolutions Nos. 429 and 504 Before a Subcommittee of the Committee on Banking and Currency, House of Representatives*, 62d Cong. 1865-1974 (1912). The climax of the hearings was J. Pierpont Morgan's testimony in December 1912. *Id.* at 1003.

97. ARSÈNE PAULIN PUJO, REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, H.R. REP. NO. 62-1593 (1913). See S. REP. NO. 63-133, pt. 1, at 6003 (1913) ("The [Pujo Committee] hearings were published in twenty-nine parts, consisting of thousands of pages, and with a most illuminating report showing the existence, substantially, of a vast

FIGURE 6: “BANKING INFLUENCE IN LARGE CORPORATIONS”:  
ORGANIZATIONAL CHART FROM  
THE PUJO COMMITTEE



ARSÈNE PAULIN PUJO, REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, REP. NO. 1593, 62D CONG., 3D SESS. (1913), Ex. No. 244, <https://info.publicintelligence.net/PujoCommitteeReport.pdf>.

### B. Democrats' Assault on the Call Loan Market

The Democrats' critique of the money trust is complex and multilayered. One aspect of this critique is especially relevant for the legislative efforts on the Act: the fierce assault on the call loan market. Again, call loans were short-term loans made to brokers on the NYSE. Brokers used these short-term loans to purchase corporate securities for their speculative customers. The securities themselves were pledged as collateral to secure those loans, such that customers could post a very small “margin” of their own capital—say 20% of a security’s price—and borrow the remaining through the broker.<sup>98</sup>

As discussed in Part I, the call loan market was notoriously unstable. Modern and contemporary observers alike have thus

concentration of power in the hands of a few men over the credit system of the United States.”). See also SANDERS, *supra* note 34, at 244.

98. See Orian Peer, *supra* note 7, for a description and analysis of the call loan market.

attributed the creation of the Federal Reserve to the need to remedy that instability.<sup>99</sup> While certainly correct, the focus on instability ignores the ways in which those stability considerations were intertwined with distributive concerns. To Democrats, the problem posed by the call loan market was not merely a matter of financial stability; it was the way in which that market channeled credit away from small communities and into the Money Trust.

By 1912, the call loan market was large. The Pujo Committee Report provides a conservative estimate of some \$766 million.<sup>100</sup> This figure represents almost 10% of the entire amount of individual demand deposits outstanding throughout the country at the time (\$8323 million).<sup>101</sup> Moreover, the average rate charged on call loans was considerably lower than the rate charged on banks' direct lending to the economy. Taking 1912 as an example, the average call rate was 3.42%, while the rate on even the most highly regarded short-term commercial paper was 4.58%, a sizeable spread of over 116 basis points.<sup>102</sup> Figure 7 uses data included in the Senate hear-

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99. See *supra* Section II.B; *supra* note 67 and accompanying text. See also Jon R. Moen & Ellis W. Tallman, *Outside Lending in the NYC Call Loan Market* 13 (Fed. Res. Bank of Cleveland, Working Paper No. 14-08, 2014).

100. H.R. REP. NO. 62-1593, at 45 (1913). The Pujo Committee figures do not distinguish between loans to brokers that were due on demand-call loans—and “time loans.” The distinction is not of great significance for our current purposes, as even time loans to brokers were of rather short maturities.

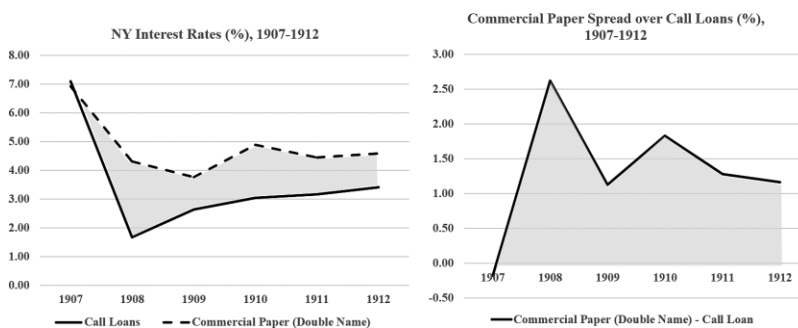
101. See U.S. DEP'T OF TREASURY, ANN. REP. OF THE COMPTROLLER OF THE CURRENCY TO THE THIRD SESSION OF THE SIXTY-SECOND CONGRESS OF THE UNITED STATES, DOC. NO. 2662, at 35–36 (3d Sess. 1912) [hereinafter COMPTROLLER]. This figure includes all demand deposits, from national banks as well as states banks, trusts and private banks.

102. Calculations are based on the numbers in *Banking and Currency: Hearings on H.R. 7837 (S. 2639) Before the S. Comm. on Banking & Currency*, 63d Cong. 1374–77 (1913) [hereinafter *Banking and Currency Hearing*]. The spread was calculated using the rate on “double name commercial paper (choice, 60–90 days).” Contemporaries considered double name paper to be highly safe and conservative, such that it reflects virtually no credit risk. The average spread is even greater (133 basis points) when less conservative “single name” commercial paper is taken for comparison (= 4.74% average rate on single name commercial paper—3.42% average call loan rate). Given the near risk-free nature of the double name paper, the spread owes almost entirely to the “liquidity premium” of call loans. See *infra* Section II.C. All calculations of average annual rates are time weighted according to the dates provided in the Senate data.



ings on the Act to plot the same spread during the half decade prior to the Act. This data reveals an even larger average spread of 160 basis points between the average call loan rate (2.78%) and the average commercial paper rate (4.39%) over the period.<sup>103</sup> As contemporaries readily observed, the call loan market was a source of abundant low-cost credit for investment in the securities of the giant corporations.<sup>104</sup>

FIGURE 7: ANNUAL AVERAGE NY INTEREST RATES (LEFT PANEL) AND SPREADS (RIGHT PANEL)



Authors' calculations are based on *Banking and Currency: Hearings on H.R. 7837 (S.2639) Before the S. Committee on Banking and Currency*, 63d Cong. 1374-77. See notes 102-103 for methodological discussion.

The Pujo Committee Report found that the group of institutions that formed the money trust held the power to “determine what constitutes satisfactory collateral” in the call loan market.<sup>105</sup> This naturally allowed those institutions to channel

103. Calculations are based on the data from *Banking and Currency*, *supra* note 102, at 1374-77. This average excludes the panic year of 1907. During that year, the average call loan rate spiked above the commercial paper rate. Even with 1907 is re-introduced into the average, the spread is still a considerable 130 basis points (= 4.81% average commercial paper rate—3.50% average call loan rate). Here again, the average spread is even higher (176 basis points) when single name commercial paper is taken for comparison (= 4.55% average rate on single name commercial paper—2.79% average call loan rate). All calculations of average annual rates are time-weighted according to the Senate data.

104. See *infra* Section III.C of this article for a discussion of the way in which the low call loan rate created financial incentives for speculators to increase their investments in corporate securities.

105. H.R. REP. NO. 62-1593, at 139 (1913). However, the Committee was careful to qualify its argument. See *id.* For a modern critique of the Pujo

credit to affiliated corporations and restrict access to potential competitors. Writing for *Harper's Weekly* just one month before the Act's passage, Louis Brandeis brought this way of thinking to a popular audience. The article series, soon published as the highly influential *Other People's Money and How the Bankers Use It*, merits quotation at some length:

When bonds and stocks are issued to finance permanently these corporations, the bank deposits can in large part be loaned by the investment bankers in control to themselves and their associates; so that securities may be carried [i.e., funded] by them until sold to investors. Or these bank deposits may be loaned to allied bankers, or jobbers [i.e., brokers] in securities, or to speculators, to enable them to carry [i.e., fund through call loans] the bonds or stocks . . . . The control by the leading investment bankers over the banks and trust companies is so great, that they can often determine for a time the market for money by lending or refusing to lend on the Stock Exchange. In this way, among others, they have power to affect the general trend of prices in bonds and stocks. Their power over a particular security is even greater. Its sale on the market may depend upon whether the security is favored or discriminated against when offered to the banks and trust companies, as collateral for loans.<sup>106</sup>

Democrats' assault on the call market went hand-in-hand with a commitment to channel those funds employed in the call loan market back to the communities "to which they belong."<sup>107</sup> The notion of call loan credit being wrongly appropriated from those communities was a recurring theme. It was evoked by Democrats ranging from the deeply anti-corporate Untermyer (Pujo Committee counsel), to the more conservative Representatives Carter Glass and Henry Parker Willis at

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Committee's thesis on money trust control of the call market, see O'SULLIVAN, *supra* note 34, at 217-66.

106. Louis D. Brandeis, *Breaking the Money Trust, Part 1 — Our Financial Oligarchy*, HARPER'S WEEKLY, Nov. 22, 1913, at 10, 12-13. See also BRANDEIS, *supra* note 94.

107. Carter Glass, *The Opposition to the Federal Reserve Bank Bill*, in 4 PROCEEDINGS OF THE ACADEMY OF POLITICAL SCIENCE IN THE CITY OF NEW YORK 18 (1913).

the House Banking and Currency Committee.<sup>108</sup> But how, one might well ask, did funds from peripheral communities find their way into the financial metropole in the first place? To answer this question, we must look into the mechanics of bank reserves during the national bank era, from 1863 to 1913. Those same mechanics are responsible for the abnormally low rates that call loans enjoyed as compared to banks' direct commercial lending (Figure 7).<sup>109</sup>

The National Bank Act, passed during the Civil War, codified a structure known as the "pyramiding of reserves."<sup>110</sup> The thousands of small national banks throughout the country were required to maintain a 15% reserve against their deposits. A small portion of these reserves (6%) had to be kept in vault.<sup>111</sup> The larger portion (9%), however, could be kept as deposits with correspondent banks in larger "reserve cities" like Boston, San Francisco, and Detroit.<sup>112</sup> In turn, banks in the sixty or so reserve cities were required to maintain a 25% reserve ratio: one half (12.5%) in vault, and the remaining as deposits further up the pyramid, in one of three "Central Reserve Cities." New York functioned as the chief central reserve city, with Chicago and St. Louis lagging far behind.<sup>113</sup> Thus,

108. *See id.* *See also* Henry Parker Willis, *The Federal Reserve Act*, 4 AM. ECON. REV. 1, 20 (1914); *Banking and Currency Hearings*, *supra* note 102, at 919, 1292 (1918) (statement of Samuel Untermyer, counsel of the Pujo Committee). *See also* H.R. REP. NO. 62-1593, at 158-59.

109. The Pujo Committee Report suggested the call rate was effectively controlled by the money trust. H.R. REP. NO. 62-1593, at 139. However, as discussed below, there are additional institutional explanations to account for the low average level of the call rate, most notably the high liquidity of call loans.

110. *See* National Bank Act of 1864, Ch. 106, §§ 31-32, 13 Stat. 99 (codified as amended in various sections of 12 U.S.C.). *See also* MYERS, *supra* note 44, at 226-30.

111. Reserves had to be maintained in "lawful money"—primarily coin and legal tender notes (greenbacks). National bank notes did not qualify as lawful money. *See* FRIEDMAN & SCHWARTZ, *supra* note 38, at 21.

112. National Bank Act of 1864 § 31. The original National Bank Act designated only twenty or so reserve cities. Other cities were designated following later amendments to the act. *See* National Bank Act, S. 216, 66th Cong. (1920).

113. National Bank Act of 1864 § 32 (Originally, New York was the sole central reserve city. Chicago and St. Louis were designated following later amendments to the act. *See* COMPTROLLER, *supra* note 101, at 70-71); MYERS, *supra* note 44, at 241. It is important to note that under the National Bank Act, country bank funds held directly with a New York correspondent

New York national banks came to hold hundreds of millions in deposits owed to other banks throughout the country. These deposits were known as “bankers’ balances” and Democrats were determined to abolish them.<sup>114</sup>

New York’s position at the pinnacle of the reserve pyramid reflected—and sustained—its position at the pinnacle of the national payments system. Experience showed that out-of-town banks typically kept bankers’ balances in New York well above their reserve requirements.<sup>115</sup> Their key motivation in doing so was that out-of-town banks could use bankers’ balances to make their inter-regional payments.<sup>116</sup> New York, in effect, was acting as the nation’s clearinghouse, and that unique role made bank bankers’ balances held in New York particularly attractive.<sup>117</sup>

As part of their day-to-day activities, banks need to make very large payments to each other. Clearinghouses are institutions that banks use to facilitate the collection of those very large payments.<sup>118</sup> On the eve of the Act, the U.S. financial system had some 242 clearinghouses.<sup>119</sup> The activities of most

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(rather than a mid-tier Reserve City bank) also qualified for reserve status. *Id.* at 241–42. See also *infra* Section III.C.

114. Classical works on bankers’ balances and their enormous significance include MYERS, *supra* note 44, and LEONARD L. WATKINS, *BANKERS’ BALANCES: A STUDY OF THE EFFECTS OF THE FEDERAL RESERVE SYSTEM ON BANKING RELATIONSHIPS* (1929).

115. See MYERS, *supra* note 44, at 331–35.

116. According to some contemporaries, a 2% interest rate on bankers’ balances was another factor in attracting those balances. In her classical work, Myers was skeptical of the claim. *Id.* at 249–50. Her skepticism is supported by the fact that rates on loans at out-of-town banks’ communities of origin were typically much greater than 2%. See *id.* at 332. See also *Banking and Currency Hearings*, *supra* note 102, at 1949 (statement of Frank A. Vanderlip). Finally, another consideration for out-of-town banks maintaining additional bankers’ balances in excess of reserve requirements was securing credit lines with New York correspondents. See *Epilogue infra* Part IV.

117. In the language of Section I.C, we may therefore speak of New York bankers’ balances as a kind of de facto “legal tender” for inter-regional bank payments. For New York’s rise as an inter-regional clearinghouse, see John A. James & David F. Weiman, *From Drafts to Checks: The Evolution of Correspondent Banking Networks and the Formation of the Modern U.S. Payments System, 1850–1914*, 42 J. MONEY, CREDIT & BANKING 237 (2010).

118. For a discussion of clearinghouses, see Orian Peer, *supra* note 71, at 17–26. For an early twentieth-century classic, see CANNON, *supra* note 44.

119. ARSÈNE PAULIN PUJO, REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRA-

of these clearinghouses, however, were of a rather local nature. They cleared the payments of banks in their towns and cities, or at most, within their regions. To clear payments across regions, banks had to turn to New York. Take, for example, a bank in Boston wishing to make a payment to a Chicago bank. The easiest way to make the payment would be for both of these banks to keep a correspondent account in New York. The Boston bank could then instruct its correspondent to transfer bankers' balances to the account of the Chicago bank's New York Correspondent.

The New York correspondents that kept these bankers' balances were typically members of the NYCHA. By 1910, \$445 million out of around \$650 million in bankers' balances were further concentrated within the "Big Six" NYCHA banks.<sup>120</sup> According to the National Bank Act, the NYCHA banks had to maintain only 25% of those balances in reserve.<sup>121</sup> The remaining could be lent to their customers; and lend they did. Most of this lending the NYCHA made to the NYSE brokers, some \$526 million.<sup>122</sup>

From the perspective of the NYCHA banks, call loans had unique advantages. The bankers' balances of out-of-town banks were particularly volatile. Out-of-town banks routinely used these balances to make payments and to supply themselves with cash as necessary. Having the ability to call back loans from brokers (call loans were due on demand) afforded the NYCHA banks greater liquidity to manage those demands. The arrangement worked tolerably well in ordinary times, because NYCHA bank could simply shift call loans among themselves.<sup>123</sup> But when country banks attempted to redeem bankers' balances *en masse*, the NYCHA banks as a group came

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TION OF CONTROL OF MONEY AND CREDIT, H.R. REP. NO. 62-1593, at 18 (1913).

120. MYERS, *supra* note 44, at 248. Four of the "Big Six" banks were related to the money trust: National City, First National, National Bank of Commerce, and Chase National. The other two banks were National Park and Hanover. See Moen & Tallman, *supra* note 99, at 278.

121. National Bank Act of 1864 § 31, 13 Stat. 99 (1864).

122. H.R. REP. NO. 62-1593, at 45 (explaining that NYCHA banks carried approximately \$766 million in call loans, minus \$240 million which they lent for the account of out-of-town banks. Note that NYCHA banks also had a local deposit base, and could have used part of those deposits to fund call loans as well).

123. For discussion and analysis, see Orian Peer, *supra* note 7.

under pressure, and suspended their redemptions.<sup>124</sup> This was how a panic unfolded.

The key point to appreciate here is that the Democratic assault on call loans reflected more than a concern with the financial risks posed by that market. By redesigning the structure of bank reserves and payments, the architects of the Act hoped to shift that large amount of bankers' balances away from the call loan market and back to their communities of origin. So much so, that in the midst of the public debate around the bill, Democrats framed the opposition to the bill precisely in these terms. The fight by the opponents, wrote Carter Glass in a particularly polemic piece,

[I]s to drive us from our firm resolution to break down the artificial connection between the banking business of this country and the stock speculative operations at the money centers . . . the banking and currency committee of the House has gone to the very root of this gigantic evil, and in this bill proposes to cut the cancer out . . . . The avowed purpose of this bill is to cure this evil, to withdraw the reserve funds of the country from the congested money centers and to make them readily available for business uses in the various sections of the country to which they belong.<sup>125</sup>

While NYCHA banks were the important lenders in the call market, they were not the only lenders.<sup>126</sup> As discussed in Part I (Section B), since the 1900s, out-of-town banks emerged as direct lenders in the call market.<sup>127</sup> They too were drawn into this market by the great liquidity of call loans (that could

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124. See, e.g., H.R. REP. NO. 63-69, at 4 (1913). In the 1907 Panic, the failure of trust companies was an important aspect of this interplay between stress on the call loan market and runs by out-of-town banks on their New York correspondents. See Moen & Tallman, *supra* note 99.

125. Glass, *supra* note 107, at 18. The language omitted from the quote highlights the mechanism of payments suspension. It demonstrates the interweaving of financial stability concerns and credit distribution concerns. For the Democratic narrative on the sources of political opposition to the Act, see UNTERMAYER, *supra* note 85, at 5, 7. Untermeyer argued that the opposition to the bill came not from country banks, but from the New York banks keeping their bankers' balances. *Id.* at 3, 4.

126. MYERS, *supra* note 44, at 265.

127. See *supra* note 67 and accompanying text.

be called back on demand) as well as by the rate of interest offered on them.<sup>128</sup> The Pujo Committee Report found these out-of-town balances represented a considerable proportion of call market lending, some \$240 million.<sup>129</sup>

According to Livingston's analysis, this out-of-town lending represented a particular threat to stock exchange stability. Out-of-town banks could withdraw their loans from brokers more quickly and erratically than the NYCHA banks that felt a sense of responsibility for shielding that market.<sup>130</sup> Thus, the need to protect the stock exchange was one of the key motivations in corporate financiers' campaigns campaign for a central bank. As Livingston demonstrates, those campaigns started years before the Democrats took up monetary reform after the 1912 election. From the perspective of corporate financiers, a central bank could act as a lender of last resort when the call market was in distress. Similarly, in periods where out-of-town banks glutted the market with funds, the central bank could raise its interest rate to prevent destabilizing speculation.<sup>131</sup>

While entirely correct, Livingston's analysis of the origins of the Fed nevertheless ignores important differences between the agendas of corporate financiers and mainstream Democrats. Where corporate financiers viewed the central bank as

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128. Recall that the New York banks paid country banks 2% on their bankers' balances. When the call loan rate went above 2%, country banks thus had an incentive to shift any excess balances (not required for their reserves) to higher interest call loans. For further discussion, see MYERS, *supra* note 44, at 268.

129. ARSÈNE PAULIN PUJO, REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, H.R. REP. NO. 62-1593, at 45 (1913). The estimate relies on partial data and appears to be conservative. Interestingly, the Pujo Committee Report revealed skepticism that monetary reform alone would reverse the trend of out-of-town banks lending on call. For this reason, it recommended an explicit limitation on the proportion of bank assets invested in call loans. *Id.* at 158–59. This recommendation was not included in the Act, but is close in its spirit to later regulations of loans to brokers under the Securities Exchange Act of 1934. See Securities Exchange Act of 1934, 15 U.S.C. § 78a (2012). For a discussion of the modern regulatory framework (and the flexibility it allows to brokers), see Nadav Orian Peer, *Broker-Dealers in Monetary Transmission: Mark-to-Market Mismatch and Margin Netting* (work in progress, 2018).

130. See MYERS, *supra* note 44, at 268–69. See also Moen & Tallman, *supra* note 99, at 1.

131. See, e.g., LIVINGSTON, *supra* note 27, at 157–58.

means to sustain and stabilize the corporate system, Democratic reformers were using central bank reform as means of decentralizing credit away from corporations. In the last section of this Part, we move to examine how they intended their design of the Act to achieve this goal.

C. *Democrats' Design for the Federal Reserve Act*

Democrats' plan to shift bankers' balances away from the call loan market and into direct lending in banks' community of origin had several components. First, dismantling the pyramiding of reserves and transferring reserves to the Fed. Second, having the Fed acquire commercial paper with those new reserves.<sup>132</sup> Third, and most importantly, increasing the willingness of banks to hold commercial paper, knowing they could rely on this paper to borrow from the Fed as a lender of last resort. With greater demand for commercial paper, Democrats hoped rates would drop, increasing the supply and reducing the cost of credit to small commercial borrowers. The following paragraphs take these different design components in turn.

First, the Act repealed the reserve status of balances kept with correspondents under the National Bank Act.<sup>133</sup> Section 2 of the Act established twelve regional Federal Reserve Banks, each presiding over its respective district. National banks within those regions were required to become "members" of the Federal Reserve Banks if they wished to maintain their national bank charter.<sup>134</sup> Section 19 of the Act then provided that all member banks—including country banks, Reserve City, or Central Reserve City banks—could only meet their reserve requirements by keeping cash in vault and by maintaining balances with their Federal Reserve Bank. The Senate

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132. To clarify, under the Act, commercial paper was not to be the only asset the nascent Federal Reserve was allowed to hold, but it was to play a highly substantial role.

133. 12 U.S.C. § 19. The repeal of reserve status for bankers' balances was one of the key distinguishing features between the Democratic Federal Reserve Act and the Republican 1911 Aldrich Plan for a central bank. *See* NELSON W. ALDRICH, SUGGESTED PLAN FOR MONETARY LEGISLATION, S. DOC. NO. 784 (3d Sess. 1911). *See also* SANDERS *supra* note 34, at 246; Willis, *supra* note 108, at 19.

134. In other words, national banks wishing to remain out of the Federal Reserve System had to switch to a state charter.



Committee Report on the bill estimated the amount of reserves thus transferred to the Federal Reserve Banks at over \$600 million.<sup>135</sup> For reference, this is roughly the size of the call loan market.<sup>136</sup>

Like the bankers' balances kept with NYCHA banks, member banks could use their new balances kept with the Federal Reserve Banks to settle inter-regional payments.<sup>137</sup> Thus, the Federal Reserve Banks came to replace New York as the nation's inter-regional clearinghouse. And whereas the New York Banks channeled funds into the call loan market, the provisions of the Act required the Fed to deploy its resources into very different avenues. This leads to section 13, the centerpiece of the Act and the Fed's power as a lender of last resort.<sup>138</sup> Section 13, authorizes the Fed to "discount"—essentially, to lend against<sup>139</sup>—the commercial paper of its member banks:

Upon the indorsement [sic] of any of its member banks . . . any Federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes . . . .<sup>140</sup>

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135. S. REP. NO. 63-133, pt. 1, at 10 (1913). With an additional paid-in capital of \$50 million, and government deposits of some \$150 million, the Federal Reserve Banks would have a minimum balance sheet of \$800 million. For reference, this was almost half the assets of all New York national banks (\$1,762 million). See COMPTROLLER, *supra* note 101, at 196.

136. See ARSÈNE PAULIN PUJO, REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, H.R. REP. NO. 62-1593 (1913).

137. As Edward Stevens explains, the Act has also established the Federal Reserve Banks as local clearinghouses within their respective regions. See Stevens, *supra* note 85, at 19.

138. In addition to section 13 discounts, the other main authority for Fed investments was asset purchases through open market operations (Section 14). The framers of the Act, however, considered discounts as far more significant than open market operations.

139. From a technical point of view, discounting involves the endorsement of a negotiable instrument and is legally distinct from secured lending. The economic essence, however, is virtually identical.

140. Federal Reserve Act of 1913, Pub. L. No. 63-43, § 13, 38 Stat. 263 (1913).

As discussed in the Introduction, section 13 commercial paper was of very short term, “not more than ninety days” (an important exception will be discussed in Part III below). The limitation of commercial paper to short maturities was part of a conservative banking doctrine known as “real bills.” Real bills doctrine was advanced by not only the Democratic framers of the Act, but also by many contemporary bankers and even corporate financiers.<sup>141</sup> This doctrine played a key role in the complex coalitions and tensions that emerged between the Urban-Competitive Agenda (represented by the Democratic framers), the Regional Development Agenda, and the Corporate Agenda.

The central tenet of the real bills doctrine was to limit monetary expansion by the banking system, and, most of all, the central bank. According to that doctrine, monetary expansion should be limited to the humble purpose of providing short-term working capital as opposed to facilitating fixed capital investment.<sup>142</sup> Thus, the money supply may expand to allow a retailer to purchase a stock of goods from a wholesaler in January, so that the retailer can sell the merchandise by April, and quickly repay the loan. On the other hand, the money supply should not expand to allow investment in a steel factory that may take years to repay.<sup>143</sup> Such expansion, real bills advocates feared, would be purely speculative and could breed inflation and financial instability.

While there was nothing particularly radical about real bills ideas (in fact, it was a hallmark of banking conservatism), the Democrats’ Urban-Competitive Agenda imbued this doctrine with subversive content. Thus, Democrats made real bills doctrine a lynchpin of their assault on the call loan market.

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141. Modern authors, including Mehrling, *supra* note 34, and LIVINGSTON, *supra* note 27, distinguished corporate financiers’ position from the real bills doctrine. While their work reveals that corporate financiers’ position was indeed distinct in important ways, I believe corporate financiers shared many of the key principles of the doctrine. Most importantly, they shared the aversion to allowing discounting of longer-term loans—“accommodation paper”—held by country banks. This will be discussed in Part III below.

142. See, e.g., BANKING REFORM 75 (James L. Laughlin ed., 1912).

143. For a modern discussion of the real bills doctrine, see Mehrling, *supra* note 34, at 209. For a contemporary description, see Eugene E. Agger, *The Commercial Paper Debate*, 22 J. POL. ECON. 661, 668 (1914). For a powerful contemporary critique of real bills ideas, see H.G. Moulton, *Commercial Banking and Capital Formation II*, 26 J. POL. ECON. 638, 638–63 (1918).

The type of credit required by large corporations was primarily for fixed investments (like industrial plants) and for mergers and acquisitions. For this reason, Democrats' attempt to reconstruct the monetary system around real bills was at the same time also an attempt to divorce the monetary system from corporate finance.<sup>144</sup> Henry Parker Willis, one of the main drafters of the bill, referred to this split as he explained the philosophy behind the Act. The new Act, he wrote,

[D]eclines to consider the banker as one whose duty it is to promote enterprises, float issues of securities, or aid in stock speculation [e.g., by lending through call loans]. That all these phases of financial effort have their place—a desirable place when properly defined and recognized—the act fully concedes, but it holds in principle that that place is not found in connection with the work of commercial banks.<sup>145</sup>

Translated into the language of section 13, corporate investment in fixed capital did not arise from “actual commercial transactions” and hence, failed to meet the eligibility test for section 13 discounting by the Fed. To remove any doubt, the definition of eligible paper explicitly excluded call loans used to fund corporate securities, and “such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities<sup>146</sup> . . . [i.e., call loans].”<sup>147</sup>

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144. The 1933 Glass–Steagall Act, with its famous separation of commercial and investment banking, was the culmination of this agenda. Banking Act of 1933, 12 U.S.C. § 227 (2012).

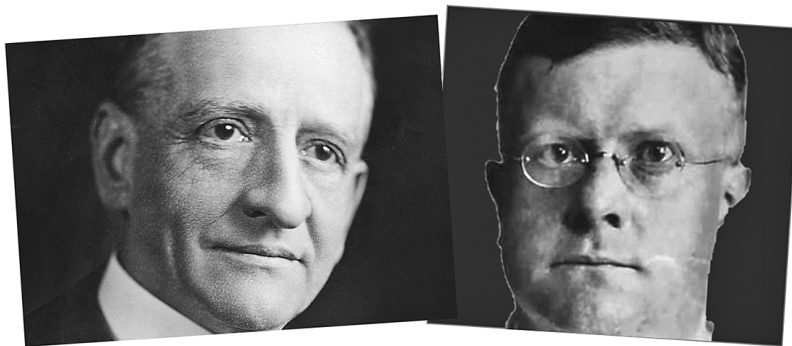
145. Willis, *supra* note 108, at 19.

146. The exception here was notes, drafts, and bills carrying United States government securities.

147. It is interesting to note that the Republican Aldrich Plan also generally denied the discounting based on investment securities. NELSON W. ALDRICH, SUGGESTED PLAN FOR MONETARY LEGISLATION, S. DOC. NO. 784, at 15 (3d Sess. 1911); but see *id.* § 40 for emergency authority. However, while the restrictions appear similar, the significance of the Democratic version for credit distribution was arguably much greater. The reason is that, as discussed *supra* note 133, the Aldrich Plan did not require the transferring of out-of-town banks' reserves away from the New York banks to the newly created central bank. Thus, the size of discounts by that central bank would have likely been much smaller.

In fact, the language of the Act later gave rise to the argument that section 13 prohibited banks from discounting even otherwise eligible commercial paper, if they intended to use the proceeds of the discounts to increase their call loans to brokers.<sup>148</sup>

FIGURE 8: SEN. CARTER GLASS (CHAIR, LEFT PANEL) AND HENRY PARKER WILLIS (EXPERT, RIGHT PANEL) OF THE HOUSE BANKING AND CURRENCY COMMITTEE



This brings us to the third and final component of Democrats' plan: the broader implications of a lender of last resort for the commercial paper market. With the Fed standing ready to lend against commercial paper, Democrats anticipated that commercial paper would become far more desirable to banks. Banks would reduce their demand for call loans and increase their demand for commercial paper. The increased demand, in turn, would lead to reduced costs for borrowers on commercial paper (i.e., lower commercial paper rates).<sup>149</sup> In this way, Democrats' design for a lender of last resort was part of their broader agenda of competition and decentralization. As Henry Parker Willis explained, "local banks will be able, by rediscounting the paper of local enterprises, to provide the funds needed by such enterprises in their operations" and

148. Controversy around this point arose during the Fed's attempts to curb the bull market of the late 1920s before the Stock Market Crash of 1929. See A.C. Miller, *Responsibility for Federal Reserve Policies: 1927-1929*, 25 AM. ECON. REV. 442, 454 (1935).

149. See, e.g., Willis, *supra* note 108, at 19. See also *Banking and Currency Hearings*, *supra* note 102, at 825-26 (statement of Samuel Untermyer).

“credit . . . will be cheaper and more evenly diffused, as well as more steady and more certainly to be counted upon by those who do business by acceptable methods.”<sup>150</sup>

Democrats’ analysis of the links between credit availability and lender-of-last-resort power is consistent with the Constitutional Approach to money, as discussed in Part I. When the law authorizes a central bank to act as a lender of last resort against certain assets, it is essentially providing a guarantee that these assets will be easily convertible into legal tender. That guarantee is a highly valuable advantage that those assets would enjoy over assets that are not eligible for Fed support.

In modern terms, this advantage is called a “liquidity premium.” Because holders of eligible assets value their special liquidity (their convertibility into legal tender), they would be willing to hold those assets for even substantially lower interest rate returns.<sup>151</sup> All things equal, standard economic analysis predicts an increase in the access to credit of borrowers who can issue eligible assets (i.e., commercial paper borrowers). In this way, one sees the Constitutional Approaches’ claim that the definition of the unit of account raises choice between alternatives—namely, which assets will be eligible. These choices have important distributive stakes: what class of borrowers will enjoy preferred access to credit?

Thus, to summarize this Part, the Democratic design for the Act was part of an agenda of replacing corporate concentration with competition and decentralization. The Fed’s

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150. Willis, *supra* note 108, at 20. One other initiative Democrats hoped to achieve with the Act is the creation of an active secondary market for “acceptances.” Acceptances are a particular type of commercial paper that bears the endorsement (essentially, the credit guarantee) of a bank or other large financial institution. The most important promoter of the acceptance principle in the U.S. was corporate financier Paul Warburg. See PAUL M. WARBURG, NAT’L MONETARY COMM’N, *THE DISCOUNT SYSTEM IN EUROPE*, S. DOC. NO. 61-402 (1910). I chose to leave out the discussion of acceptances given the somewhat limited scope in which Democrats incorporated that project into the Act. National banks were only authorized to accept paper arising from import and export transactions. This restriction meant that the acceptance project was largely irrelevant for domestic transactions. See Federal Reserve Act of 1913, Pub. L. No. 63-43, § 13, 38 Stat. 263 (1913).

151. See DESAN, *supra* note 33 (analysis of the “cash premium”). See also Ricks, *supra* note 13, at 93–95 for a discussion of empirical work quantifying the size of the liquidity premium in short-term Treasury bills (this work was later published as Robin Greenwood et al., *A Comparative-Advantage Approach to Government Debt Maturity*, 70 J. FIN. 1683 (Aug. 2015)).

lender-of-last-resort powers need to be understood within this broader context. They were not only attempts at preventing panics but a program to redistribute credit away from the corporate capital market and into smaller scale commercial activity. The next part will explore how the Democrats' agenda interacted with the agrarian economy of the periphery.

### III.

#### THE REGIONAL DEVELOPMENT AGENDA

The Regional Development Agenda refers to the heritage of the developing and largely agricultural economy of the United States throughout the nineteenth century. On the eve of the Civil War, 53% of the U.S. workforce was employed in agriculture, towering over 14% in manufacturing and 12% in trade.<sup>152</sup> By 1910, despite rapid urbanization in the intervening half century, agriculture still accounted for 31% of the workforce, only slightly less than manufacturing (22%) and trade (14%) combined.<sup>153</sup>

The position of the agricultural periphery<sup>154</sup> towards the Act reveals a combination of support and even excitement with a thread of continuous frustration. On the one hand, agrarian representatives shared the bill's goal of driving credit from Wall Street into Main Street<sup>155</sup> and overwhelmingly voted for it in Congress. It is telling, in this respect, that this support encompassed not only the Democratic party—with its disproportionately large agrarian base—but also agrarian members of the Republican and Progressive parties.<sup>156</sup>

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152. See Stanley Lebergott, *Labor Force and Employment, 1800–1960*, in *OUTPUT, EMPLOYMENT, AND PRODUCTIVITY IN THE UNITED STATES AFTER 1800*, at 118 (Dorothy S. Brady ed., 1966).

153. *Id.* For reference, the current share of the U.S. workforce employed in agriculture is 1.5% while the world average is around 29%, roughly the same as the U.S. economy during the passage of the Act. See *Employment in Agriculture (% of Total Employment) (Modeled ILO Estimate)*, WORLD BANK, <https://data.worldbank.org/indicator/SL.AGR.EMPL.ZS?end=2017&start=1973> (last visited Feb. 10, 2018).

154. I use the term “periphery” in the way suggested by SANDERS, *supra* note 34, at 16.

155. See e.g., *id.* at 249, 470 n.99; *Banking and Currency Reform: Hearings Before the Subcomm. of the H. Comm. on Banking & Currency*, 62d Cong. 516 (1913) [hereinafter *Reform Hearings*] (statement of T.J. Brooks).

156. See SANDERS, *supra* note 34, at 76, 252. Sanders' data from congressional votes on the Federal Reserve Act shows support was considerably

While agrarian support was crucial, however, for many members of the periphery, mainstream Democrats' limitation of lender-of-last-resort powers to short-term commercial paper proved to be a lasting source of frustration.<sup>157</sup> The Regional Development Agenda sought to harness the monetary system to provide flexible and long-term credit. This agenda proved to be at odds with mainstream Democrats' commitment to the real bills doctrine and its ideal of short-term mercantile activity.

This Part begins by exploring the clash between mainstream Democrats' real bills ideals and the Regional Development Agenda (Section A). It then documents the repeated agrarian complaints of discrimination against country bank "accommodation paper" in the Act's provision for lender-of-last-resort support (Section B). Finally, this Part demonstrates the complex negotiation between mainstream Democrats and agrarians over the final language of the Act (Section C). This negotiation provides another example of how concerns with credit distribution determined the scope and nature of lender-of-last-resort power.

#### A. *The Clash Between the European Ideal and Local Needs*

By the 1912 elections, the "silver debates" of the 1890s had all but faded. The Gold Standard Act of 1900 codified the dollar unit of account as 25 8/10 grains of gold (nine-tenths fine). All other forms of money—greenbacks, national bank notes, and the largest portion of the money supply, bank deposits—were ultimately convertible into gold coin in one way or another.<sup>158</sup> That the United States would remain on the international gold standard was a political reality that virtually no participant in the debates over the Act (including Bryan

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higher for "periphery" as opposed to "core" and "diverse" regions (in the House, 86% support by periphery as opposed to 67% support in core, and in the Senate 76% to 47% percent respectively). *Id.* For Republican and Progressive agrarian support, see *id.* at 251.

157. To be sure, the circumstances of agricultural communities across the country varied widely. In some communities, the Act's provision for ninety-day paper raised no problems. My goal here is to articulate a set of concerns that resonated with a substantial group within the countryside, rather than to suggest these concerns were shared by all agrarians.

158. See Gold Standard Act, ch. 41, §§ 1–2, 31 Stat. 45 (1900).

himself) sought to undermine.<sup>159</sup> But where the gold definition of the dollar now seemed indisputable, the broader ethos and institutions of the gold standard were still up for grabs.<sup>160</sup> This is particularly the case with the definition of section 13 eligible paper that the Fed could discount as lender of last resort.

For Democrats, the decision to design the Act around short-term commercial paper served two essential goals. On the one hand, as discussed in Part II, commercial paper grounded in "actual commercial transactions" suited Democrats' anti-corporate politics and their assault on the call loan market. At the same time, advancing the market for commercial paper to these Democrats was part of a program to establish the kind of institutions that prevailed in the core countries of the international gold standard: England, Germany, and France. Here, ironically, Democrats were very much in line with the aspirations of the corporate financiers whom they so severely criticized.

Under the international gold standard, countries undertook to maintain price parity between their domestic unit of account (e.g., the British pound) and a given quantity of gold. In the core gold standard countries, central banks relied on highly liquid markets in commercial paper to defend the gold parity of their unit of account. In brief, by raising their interest rates (tightening monetary policy) central banks could bring about an increase in the rate paid on commercial paper. Higher rates tended to draw international investors to purchase that commercial paper, thus propping up the domestic currency in the foreign exchange markets.<sup>161</sup> In the United States, absent a central bank and a liquid commercial paper

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159. An outlier case is Rep. Charles August Lindbergh. See C.A. Lindbergh, *Minority Views on the Glass Bill*, in HOUSE BANKING AND CURRENCY COMMITTEE REPORT, H.R. 7837, 63d Cong. 156 (1913). Ironically, less than one year after the passage of the Act the international gold standard was suspended due to eruption of World War I. The United States remained virtually the only major economy on gold.

160. In this sense, the debate over the Federal Reserve Act provides an example for what Duncan Kennedy called "nesting": "the reproduction, within a doctrinal solution to a problem, of the policy conflict the solution was supposed to settle." Duncan Kennedy, *A Semiotics of Legal Argument*, 42 SYRACUSE L. REV. 75, 97 (1991).

161. See, e.g., *Reform Hearings*, *supra* note 155, at 76–77 (statement of Paul M. Warburg); WARBURG, *supra* note 150, at 17.



market, adjustments to defend gold parity were far less smooth and, oftentimes, chaotic.<sup>162</sup>

On the eve of reform, corporate financiers and mainstream Democrats—despite their deep political disagreements—were united in their desire to follow the European precedent and establish a liquid market in commercial paper in the United States.<sup>163</sup> The Fed's standing as a lender of last resort against short-term commercial paper was crucial in providing support and stability to that commercial paper market. As it turns out, however, the European inspired short-term commercial paper market went against the grain of a long-standing local tradition in the United States.

In a young and capital starved economy like the nineteenth century United States, commercial paper had simply never played the role it had under the more mature European economies. In her seminal work *The New York Money Market*, Margaret Myers reflected on the significance of this theme in the early days of U.S. banking:

[A]lthough the early banks of the United States were modeled upon those of Great Britain as to the charter provisions, it was impossible for them to adopt the rule laid down in England for the safe conduct of banks, which would confine the loans and discounts to self-liquidating paper based on exchange of goods [i.e., real bills]. The place of trade in the economy of Great Britain was far more important than in America; in this country there was a very large demand for long-term credit for the development of new lands and new industries, and a comparatively small demand for short-term credit with which to finance the exchange of products.<sup>164</sup>

As Myers' work demonstrates, the focus on long-term credit was in itself part of a broader understanding of the place of banking within the community. In the early nineteenth century, U.S. public opinion considered a banking charter as a "valuable monopolistic privilege" granted to the bank by the polity. In return for that privilege, communities expected their banks to lend within the community, and to

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162. See, e.g., WARBURG, *supra* note 150, at 21–22.

163. See, e.g., WILLIS, *supra* note 108, at 20.

164. MYERS, *supra* note 44, at 44.

lend on a long-term basis.<sup>165</sup> Later reformers loosened procedures to receive bank charters,<sup>166</sup> but the nexus between banking and the capital development of the community survived. The 1864 National Bank Act arguably reflected this ethos in its restriction of branch banking.<sup>167</sup> Restrictions on branch banking resulted in a radically decentralized banking system, with over seven thousand national banks, most of which were operating with small capital on a local scale.<sup>168</sup> Such banks were naturally subject to considerable pressures in meeting the credit needs of their communities.<sup>169</sup>

As the century drew to a close, demands for flexible and long-term credit also became part of the turbulent silver debates of the 1890s. Parallel to their campaign for the re-monetization of silver, Populists advocated plans to use their crops as collateral for low-cost borrowing from the government. Their proposal, known as the “Sub-Treasury Plan” could be understood as an early Populist vision for section 13 of the Act. Crucially, the Sub-Treasury Plan provided farmers a full year to sell their crops before loans had to be redeemed.<sup>170</sup> This is a

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165. *Id.* at 45–46.

166. *Id.* at 85. For a discussion of the significance of the history of bank charters for corporate law theory, see Robert C. Hockett & Saule T. Omarova, “*Special, Vestigial, or Visionary? What Bank Regulation Tells Us About the Corporation — and Vice Versa*,” 39 SEATTLE U. L. REV. 453 (2016).

167. See Federal Reserve Act of 1913, Pub. L. No. 63-43, §§ 6(2), 8, 38 Stat. 251 (1913). Another aspect of the National Bank Act—its restrictions on mortgage lending—was deeply problematic from the point of view of community development. See *id.* § 28. The restriction, however, was partially evaded. See, e.g., *Banking and Currency Hearings*, *supra* note 102, at 1539–65 (testimony of H.A. Moehlenpah). Section 24 of the Federal Reserve Act partially loosened these restrictions as part of the broader compromise with agrarians. See *infra* note 195.

168. See COMPTROLLER, *supra* note 101, at 12. Out of a total of paid in capital of about \$1,046 million for all national banks, some 60% of banks had paid in capital of less than \$1 million. Around 40% had capital less than \$250,000.

169. In distinction, the modern U.S. commercial banking sector is dominated by large holding companies operating on a national scope. Under the current system, banks’ obligations to their communities regulated by the 1977 Community Reinvestment Act (“CRA”). See Community Reinvestment Act § 802, 12 U.S.C. §§ 2901–2908 (2012).

170. See *Report of the Committee on the Working of the Monetary System*, in A POPULIST READER: SELECTIONS FROM THE WORKS OF AMERICAN POPULIST LEADERS (George Brown Tindall ed., 1889) (Charles Macune is believed to be the author of the document).

far longer period than the short-term commercial paper envisioned by mainstream Democrat. The stakes of the difference in duration are high. The shorter the duration, the faster farmers had to repay their loans after the harvest. Marketing their crops with haste often forced farmers to sell at depressed prices. In a second and even more ambitious plan—the “Land Loan System”—Populists proposed the Treasury would lend against fifty-year mortgages.<sup>171</sup>

Figure 9 presents a cartoon satirizing the Farmers’ Alliance demands for government credit. The cartoon presents a farmer approaching Uncle Sam’s pawn shop, mortgage deed in hand. The sign next to the pawn shop reads: “Your Uncle Sam will advance money on crops and make loans to farmers without interest . . . All the greenbacks you wish. Two percent mortgages on your farms.”

FIGURE 9: “THE NEW UNCLE SAM: HOW THE FARMERS’ ALLIANCE PROPOSE TO HAVE THE GOVERNMENT RUN WHEN THEY GET THE POWER” (1891)



Bernhard Gillam, *The New Uncle Sam: How the Farmers' Alliance Propose to Have the Government Run When They Get the Power*, JUDGE MAG. (Jan. 17, 1891), <https://www.loc.gov/item/97504631/>.

And so, the creation of a lender of last resort raised not only the question of corporate power that divided Democrats and corporate financiers. It also raised a question about the legitimacy and relative importance of peripheral credit as a

171. See *id.* at 175.

model of development. This tension between the Urban-Competitive and Regional Development Agendas became a central theme in the congressional hearings over the Act.

B. *The Debate over "Accommodation Paper"*

The congressional hearings about the Fed contained repeated agrarian complaints that section 13's definition of eligible paper was discriminatory against the periphery. In many regions, country bank loans were far more flexible in the duration of time they offered the borrower to repay. Farmers typically borrowed as early as spring and could not repay their loans until selling their crops towards the end of the year. As one witness before the Senate Committee on Banking and Currency explained, "the country banker's paper is seasonal paper. It would be utter folly to take from the ordinary farmer, or the merchant who is dependent upon the farmer in the country, a piece of paper maturing at any other time than in the fall of the year."<sup>172</sup>

Another witness, a manufacturer of farm equipment in the grain economy of Minneapolis complained that if eligible paper were limited to ninety days, "[y]ou might just as well say to us, 'Get off the earth.' We cannot give the bank in Minneapolis or any other place our paper, which they can in turn take to regional [Federal Reserve] bank and get it rediscounted, simply because we cannot borrow under six months at a time."<sup>173</sup> His testimony then accused the bill of geographical discrimination. The bill, he argued, suited the needs of regions with short production cycles, like metropolitan New York. The Act, however, was ill suited for the grain economy of the Northeast, where the production and distribution cycle was considerably longer.<sup>174</sup>

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172. *Banking and Currency Hearings*, *supra* note 102, at 946 (testimony of Edward B. Wells).

173. *Id.* at 968 (testimony of F.E. Kenaston). It is important to note that the provision for ninety-day paper referred to the maturity of the paper "at the time of discount," rather than the time of its making. The Senate committee amended the bill to make this point explicit. *See* H.R. 7837, 63d Cong. §§ 13-14 (1913). Some agrarians found this adjustment sufficient; many others did not.

174. *Banking and Currency Hearings*, *supra* note 102, at 968 (testimony of F.E. Kenaston).

In addition to their longer maturities, loans in the country—often dubbed “accommodation paper”—were made with the tacit understanding of repeated renewal. Country bankers did not insist on timely repayment of the loans, but realized they will have to extend the loans if the need arose for the borrower: a bad crop, low prices, sickness in the family, roads in disrepair.<sup>175</sup> One witness, a correspondent banker from St. Louis described the methods of his country bank customers and argued they will not be able to discount their loans with the Fed:

If the crop is not good, [the loan] runs until the next crop comes in . . . it is renewed and renewed again. The loans of a country bank are never cleaned up [i.e., repaid, as opposed to extended] like those of a city bank or like those of a reserve city bank . . . . Therefore, in dealing with that subject [i.e., Fed discounting for banks] you must perforce be dealing with the institutions that are in the larger centers relatively.<sup>176</sup>

Another witness from Minnesota—a wholesale grocer—insisted country banks were loath to demand clients to meet maturing bills at inconvenient times, as this risked losing their business.<sup>177</sup> A country banker from Hattiesburg, Mississippi described repeatedly extending a four-month loan to a firm for no less than fourteen years.<sup>178</sup> An outlier case perhaps, but it nevertheless demonstrates the ways in which country bankers were pushing the boundaries of short-term “working capital” and—through renewals—extending to their clients what was essentially longer-term fixed capital.

Such flexible renewals were anathema to adherents of the real bills doctrine, for whom safety in bank credit expansion required the discipline of prompt repayment by borrowers. Just so, Henry Parker Willis’ advice to bankers briefly after the passage of the Act was essentially to stop lending on accommo-

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175. For some of these factors, see *id.* at 973–74.

176. *Banking and Currency Hearings*, *supra* note 102, at 128–29 (testimony of Festus J. Wade). The witness, Festus J. Wade, was President of the Mercantile Trust Co. in St. Louis, Missouri—apparently, a city bank offering correspondent services to country banks. *Id.* at 125.

177. *Id.* at 1079.

178. *Id.* at 1525.

dation paper. The banker, said Willis, ought to “bring his methods of borrowing and his view of commercial paper into harmony with European practice, to accustom himself to adopt prompt payment of notes and bills without extended renewals, and to putting his business on short-term cash basis.”<sup>179</sup>

From the perspective of the agricultural periphery, statements like Willis’ surely carried overtones of condescension and aggression. They contributed to a sense that corporate financiers and urban merchants were joining forces against the periphery. As one witness before the House Committee complained, “[in] the United States finance and commerce have locked shields in a common cause and have prospered amazingly. Agriculture and urban labor each stand aloof and are fighting a losing battle.”<sup>180</sup> Finance and commerce secured their prosperity through a financial architecture that better served their credit needs. Thus, the witness continued, “[c]ommerce has a dynamic dollar and agriculture a static dollar. Commerce has a liquid credit and agriculture a vicious credit. Commerce can mobilize its capital credit and agriculture cannot. Agriculture needs a system that will vitalize its resources, mobilize its capital, liquefy its assets, and render dynamic its collateral.”<sup>181</sup>

In the next section, we move to see how the tension between these different agendas channeled into debates over the definition of section 13 eligible paper.

### C. *Negotiating Section 13 Eligible Paper*

The tension between mainstream Democrats and agrarian complaints resulted in repeated changes to the language of section 13. The overall result of these changes reflected a compromise: it stretched mainstream Democrats’ real bills ideals in some respects, but also left unsatisfied some agrarian claims.<sup>182</sup> In the context of this Article, these repeated

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179. Willis, *supra* note 108, at 23–24.

180. *Reform Hearings*, *supra* note 155, at 504 (statement of T.J. Brooks).

181. *Id.*

182. My argument in this section builds on excellent work by SANDERS, *supra* note 34, at 217–66, as well as original primary source research. Sanders critiques Livingston’s conclusion that attributes the Act primarily to the efforts of corporate financiers. Instead, she proposes that the Fed was a compromise between capitalists, state officials, and farmers. *Id.* at 257. My own

changes demonstrate a real-life debate over credit distribution at work. They show us that the lender-of-last-resort power is not merely an issue of financial stability, but a constitutional (small c) decision over the relative access of different groups to credit.

When Rep. Carter Glass initially introduced the bill, the definition of commercial paper was made for just 45 days, far too short to meet agricultural demands.<sup>183</sup> Discomfort with this provision was one of the main grievances in a Democratic agrarian rebellion that took place at the House Committee on Banking and Currency. In the midst of this rebellion, Rep. Robert Lee Henry of Texas introduced an amendment to extend the maturity for commercial paper to 120 days. Henry also proposed a “modern version of the old populist sub-treasury plan”: lending based on Warehouse receipts, state and local government bonds to the tune of \$700 million (for reference, recall this was, again, roughly the size of the call loan market).<sup>184</sup> As historian Elizabeth Sanders describes, the Henry rebellion “was ended only after a long and unruly Democratic caucus.”<sup>185</sup> The rebels managed to double the maturity of eligible paper, from 45 to 90 days.<sup>186</sup> They also negotiated other concessions on banking matters that concerned the periphery, including a pledge from President Wilson to support

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emphasis in this section is more specifically with the tension between farmers and mainstream Democrats on the question of what type of credit should be eligible for lender-of-last-resort support.

183. *See id.* at 250. The 1911 Republican Aldrich Plan allowed for discounting of paper with maturity of only 28 days. NELSON W. ALDRICH, SUGGESTED PLAN FOR MONETARY LEGISLATION, S. DOC. NO. 784, at 12 (3d Sess. 1911). Other provisions in the bill allowed for discounting of longer-dated paper (four months), but they required further procedures—the willingness of a local association of banks to guarantee the paper—and the payment of an additional commission for that guarantee. It is difficult to estimate how these conditions would have allowed for discounting of paper longer than 28 days.

184. *See SANDERS, supra* note 34, at 250.

185. *Id.*

186. The language of the House bill also included authority for discounting of 120-day paper, but subjected this authority to restrictions concerning the Fed’s reserve ratio and the proportion of 120-day paper discounted by the borrowing member bank. *See* H.R. 7837, 63d Cong. §§ 13–14 (1913).

a standalone measure for long-term agricultural credit.<sup>187</sup> The House Democratic caucus made the compromise binding.

As it happened, however, the controversy soon reemerged in a second revolt, this time at the Senate Banking and Currency Committee. Three Democratic members of the Committee—Senators James Reed, James O’Gorman, and Gilbert Hitchcock—joined Republicans to oppose the bill. Unlike the first revolt, which was purely agrarian, the second rebellion brought together a complex coalition of radical agrarians like Reed (D, Missouri) and Bristow (R, Kansas), with the conservative and Bryan opponent Hitchcock (D, Nebraska) leading the group.<sup>188</sup> The second rebellion involved numerous controversies surrounding the Fed’s design that need not concern us here. Its key significance for our purpose, however, is the way that revolt ultimately broadened the Fed’s lender-of-last-resort powers.

As Sanders explains, the competition between the two camps at the Senate “brought important benefits to the agrarian regions.”<sup>189</sup> An ultimate deadlock (6:6) meant that the Committee reported two amendments in disagreement: the Hitchcock amendment, which sought to replace various provisions of the Act, and the Owen amendment, endorsed by the administration.<sup>190</sup>

The Hitchcock amendment doubled the maturity of eligible paper from three to six months. In explaining the change, it alluded to all the witnesses who came before the committee

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187. That stand-alone measure became the Federal Farm Loan Act of 1916. See SANDERS, *supra* note 34, at 259–61. The rebels had several other valuable achievements. See *id.* at 250.

188. See *id.* at 252–53, 470 n.190; Dunne, *supra* note 34.

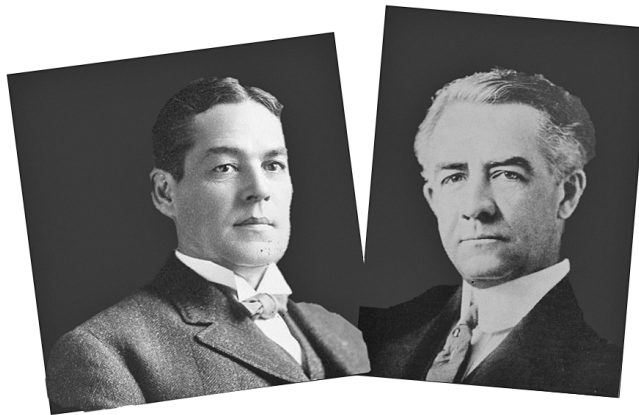
189. SANDERS, *supra* note 34, at 254. One of the other main achievements Sanders mentions here is relaxation of restrictions on national bank lending on farm land from one year (in the Glass bill) to five years. It is important to note, however, that this lending authority was restricted to only one third of the land’s value and 25% of the bank’s capital or one third of its time deposits (deposits with a maturity greater than thirty days). See Federal Reserve Act, *supra* note 15, §§ 19, 24; H.R. 7837, 63d Cong. §§ 20, 26 (1913).

190. See S. REP. NO. 63-133, pt. 1, at 2. Sen. Reed and O’Gorman were ultimately converted to the Owen camp. Dunne, *supra* note 34, at 23. In fact, some attribute the puzzling fact that Missouri received two regional Federal Reserve banks (St. Louis and Kansas City) to Reed’s last-moment conversion. See David C. Wheelock, *Economics and Politics in Selecting Federal Reserve Cities: Why Missouri Has Two Reserve Banks*, 97 FED. RES. BANK OF ST. LOUIS REV. 269, 275 (2015).



and voiced their complaints of geographic discrimination. “Thousands of banks in the West and in the South,” the amendment explained, “necessarily take six months’ paper because of the longer time required for agricultural processes than for the manufacturing and mercantile processes of the East.”<sup>191</sup> That said, side by side with this nod to agrarians, the fine print of the Hitchcock amendment also placed significant constraints on the amount of six-month paper eligible for discount.<sup>192</sup> These constraints likely reflected the unstable coalition between agrarians and conservatives within the Hitchcock camp itself.

FIGURE 10: SEN. OWEN (LEFT PANEL) AND SEN. HITCHCOCK (RIGHT PANEL)



*The Life of Robert L. Owen, Jr.: A Chronology*, OKLA. HISTORY CTR., <http://www.okhistory.org/historycenter/federalreserve/owentl.html> (last visited Feb. 27, 2018) (right panel); *THE WORLD'S WORK* 642 (Doubleday, Page & Company 1922) (left panel).

The Senate ultimately rejected the Hitchcock amendment, but its extension of the duration of commercial paper

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191. H.R. 7837, 63d Cong. § 2.

192. The Hitchcock amendment on this point reads: “Notes and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than one hundred and eighty days: Provided, however, That not more than fifty per cent of the paper discounted for any member bank shall have a maturity exceeding ninety days and in no case shall any member bank have more than \$200,000 of rediscounts bearing a maturity longer than ninety days.” *Id.* at 15.

was nevertheless influential. Floor amendments to the administration-sponsored Owen amendment incorporated the measure to extend the duration of eligible paper. The new language authorized the regional Federal Reserve Banks to discount six-month paper "drawn or issued for agricultural purposes or based on livestock."<sup>193</sup> If that language had stood alone, it would have represented a considerable achievement for the agrarian camp. Moderating that achievement somewhat was, again, further language limiting the amount of six-month paper to be discounted by the regional Federal Reserve Banks. This time, authority to determine the limitations was granted to the Federal Reserve Board in Washington.<sup>194</sup>

The tension between mainstream Democrats and agrarian interests was present throughout the conference report. One of the tasks of the conference committee included reconciling the three-month commercial paper of the House bill with the six-month provision of the Senate amendment. As conferee for the House, Carter Glass followed the instructions to accept the Senate amendment, but only begrudgingly. His grudges again reveal how different the mainstream Democrat position was from the agrarian agenda. "In the judgment of some of us," complained Glass, "the difference [between three and six month discounts] is more apparent than real, and certainly more political than economic."<sup>195</sup> In fact, Glass' remarks hint his belief that the Federal Reserve would effectively limit the regional Federal Reserve Banks' authority to discount the longer paper:

I wish to say that while the House conferees would have, in any event, implicitly followed the instruction of the House, we did so the more readily in this case from the conviction that sound banking instinct and universal banking experience will take care of the situation presented by this change in the house bill. In short, we are perfectly confident that those to whom shall be confided the power and responsibility of ad-

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193. H.R. 7837, 63d Cong. § 14.

194. *See id.* Sanders' account does not mention those limitations on the discount of longer-term paper, either in the Hitchcock amendment or the Conference Report. SANDERS, *supra* note 34, at 254, 256.

195. Hon. Carter Glass, Speech in the House of Representatives (Dec. 22, 1913).

ministering this new banking and currency system will have the wisdom and courage to maintain it in the most efficient state possible.<sup>196</sup>

And so, after the House bill, the Henry amendment, the House caucus compromise, the Hitchcock amendment, the Senate floor amendment and the Conference Report, the long standing clash between mainstream Democrats and the agrarian periphery finally came to a rest.<sup>197</sup> At every turn of this legislative saga, actors were not only debating lending of last resort merely from the perspective of financial stability. Instead, the definition of lender-of-last-resort powers became the ground for a broader debate about credit distribution and who was entitled to accommodation from the sovereign power to issue money.

#### IV.

##### THE CORPORATE AGENDA

The Corporate Agenda was the result of an accelerated transformation the U.S. economy had been undergoing in the decades preceding the Act. As late as the 1880s, U.S. industrial firms in the sectors of manufacturing, distribution, extraction, and processing were predominantly small and local affairs.<sup>198</sup> The very largest of these firms had a capitalization of \$5–10 million, a trifle when compared to \$100 million by the large railroads. What is more, unlike the railroads, which had been raising capital in the securities markets for decades,<sup>199</sup> industrial firms were “closely held.” They were owned and managed by a small number of partners, and used banks for their financing. Only two decades later, giant industrial trusts were coming of age. U.S. Steel held a market share of two thirds of

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196. *Id.*

197. A decade later, Congress further amended the Fed’s authority to include discounting of nine-month paper. 12 U.S.C. § 348 (2012) (as added March 4, 1923, ch. 252, title IV, § 404, 42 Stat. 1479).

198. This paragraph draws on Thomas R. Navin & Marion V. Sears, *The Rise of a Market for Industrial Securities, 1887–1902*, 29 BUS. HIST. REV. 105 (1955). For the four categories of business activities that Navin and Sears define as “industrial,” see *id.* at 108.

199. See MYERS, *supra* note 44, at 32–37.

steel in the United States and soon became the first corporation with a billion dollar capitalization.<sup>200</sup>

The corporate financiers who served these new corporations were also key protagonists in the campaign for a central bank. Men like Frank Vanderlip of City National Bank and Paul Warburg of Kuhn Loeb & Co. began campaigning for reform years before the 1912 elections that brought Wilson to power. They remained important interlocutors throughout the legislative process, testifying in Congress and corresponding with Democratic leaders.<sup>201</sup> In regard to the definition of eligible paper, the position of these corporate financiers presents an apparent paradox, and one that remains underappreciated and unresolved in the historical literature.

On the one hand, corporate financiers were, by their very nature, creatures of the securities market where corporations raise capital. The call loan market was a pillar of the securities market.<sup>202</sup> One would therefore expect corporate financiers to bitterly resist Democrats' assault on the call loan market through denial of lender-of-last-resort support to those loans and the revocation of reserve status to bankers' balances.<sup>203</sup> Not so. Against this expectation, corporate financiers took a position that was very much consistent with mainstream Democrats' design. They too exalted the virtues of short-term com-

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200. U.S. Steel's capitalization at that time was \$1.4 billion. See *United States Steel Corp.*, ENCYC. BRITANNICA (Jan. 30, 2018), <https://www.britannica.com/topic/United-States-Steel-Corporation>.

201. For details on Vanderlip and Warburg's efforts as part of the reform movement, see LIVINGSTON, *supra* note 27. See also Paul M. Warburg, American and European Banking Methods and Bank Legislation Compared, in *THE CURRENCY PROBLEM AND THE PRESENT FINANCIAL SITUATION: A SERIES OF ADDRESSES DELIVERED AT COLUMBIA UNIV., 1907-1908*, at 119-51 (Edwin R.A. Seligman ed., 1908); Frank A. Vanderlip, The Modern Bank, in *THE CURRENCY PROBLEM AND THE PRESENT FINANCIAL SITUATION: A SERIES OF ADDRESSES DELIVERED AT COLUMBIA UNIVERSITY, 1907-1908*, at 1-18 (Edwin R.A. Seligman ed., 1908); *Reform Hearings*, *supra* note 155, at 60-85 (statement of Paul M. Warburg); *Banking and Currency Hearings*, *supra* note 102, at 1933-2037, 2052-69, 2911-67 (statement of Frank A. Vanderlip). To be clear, Warburg and Vanderlip each had important disagreements with Democrats on other aspects of their plan but were highly supportive of the initiative to create a lender of last resort.

202. See *infra* Section IV.B. See also O'SULLIVAN, *supra* note 34, at 59-60; STEVEN H. JAFFE & JESSICA LAUTIN, *CAPITAL OF CAPITAL: MONEY, BANKING, AND POWER IN NEW YORK CITY 1785-2012*, at 96 (2014).

203. See *supra* Sections II.B-C.

mercial paper and insisted no other paper shall be included in section 13. They too opposed the pyramiding of reserves, and looked forward to replacing call loans with commercial paper as their main liquid asset.

This puzzling coalition between corporate financiers and mainstream Democrats has made it more difficult to appreciate the underlying debate around credit distribution that was so integral to the Act. To reconstruct this dimension of the debate, this Part begins by more fully describing corporate financiers' agenda for a post-competitive and cooperative society (Section A). It then demonstrates the centrality of the call loan market to the corporate agenda (Section B) and sheds some light on the puzzling coalition between corporate financiers and mainstream Democrats (Section C). Finally, an Epilogue to this Part offers a brief reflection on the failure of agrarians and corporate financiers' to collaborate and develop an alternative to mainstream Democrats' design.

#### A. *Life After Competition*

While mainstream Democrats like Brandeis lamented the decline of competition, to corporate financiers the rise of the giant industrial corporations was hardly a fall from grace. Concentration in industry—"cooperation," as they preferred to call it—reflected the needs of a maturing industrial economy and the technological leaps in energy, transportation and communications. Electric power, the transcontinental rail, the transatlantic steamship, the telegraph, the telephone: all of these technologies required enormous outlays of long-term capital. These outlays of fixed capital, argued the corporate financiers, were simply inconsistent with decentralized pricing. Waves of bankruptcies due to "ruinous competition" between smaller industrial firms lent force to their reasoning.<sup>204</sup>

To corporate financiers, the Brandeisian plea to return to competition, therefore, seemed nostalgic at best and irresponsibly dangerous at worst. The real challenges of the day, they believed, were about adjusting to the new corporate society. The adjustments necessary were political, legal, cultural, and even psychological. The smaller businessmen who were still advocating the old doctrines of free competition and laissez-faire were out-of-touch with the conditions of industrial society. In-

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204. See *supra* Section II.A; see also Minsky, *supra* note 55.

deed, they were so desperately out-of-touch that clinging to those doctrines would only breed social dislocation and foment. The imperative of adjusting to the new corporate society, argued the corporate financiers, meant finding a third way between the anachronism of competition and the specter of Socialist revolution.<sup>205</sup>

Consider, for example, the case of labor relations. As historian James Weinstein argued, corporate financiers' position towards trade unions was considerably more flexible than the hard "open shop" (anti-union) line led by small and medium sized business leaders. The National Civic Federation ("NCF") sponsored by corporate financiers was willing to embrace labor unions so long as unions acted conservatively. They hoped these unions could develop into intermediaries that would stabilize the relationship between labor and capital.<sup>206</sup>

Corporate financiers also acknowledged that the new conditions of dispersed corporate ownership, with passive shareholders and professional managers, meant a far greater role for government in corporate affairs. One notable exponent of these views was George Perkins, a partner at J.P. Morgan & Co. Perkins' views are notable for his later leadership role in Roosevelt's 1912 presidential campaign. A few years earlier, Perkins addressed a crowd at Columbia University as part of a lecture series on "The Currency Problem and Present Financial Situation" following the 1907 panic.<sup>207</sup> His lecture, *The Modern Corporation*, is an excellent example of the way corporate financiers were creating a new political theory. Some of the tenets of this theory might seem strangely illiberal; many others have become mainstays of economic regulation.

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205. See, e.g., WEINSTEIN, *supra* note 48, at 9, 11, and ch. 1 generally.

206. See *id.* at 13.

207. George W. Perkins, *The Modern Corporation*, in THE CURRENCY PROBLEM AND THE PRESENT FINANCIAL SITUATION: A SERIES OF ADDRESSES DELIVERED AT COLUMBIA UNIV. 1907-1908, at 154-70 (Edwin R.A. Seligman ed., 1908).

FIGURE 11: GEORGE PERKINS: PARTNER AT J.P. MORGAN & CO. AND LATER EXECUTIVE SECRETARY OF THE PROGRESSIVE PARTY



Picture taken from Prints & Photographs Online Catalog, LIBRARY OF CONGRESS, <http://www.loc.gov/pictures/resource/cph.3b10274/> (last visited Feb. 19, 2018).

Perkins acknowledged that with 100,000 shareholders, U.S. Steel and other giant corporations “became not only vast business enterprises, but great and growing institutions for savings.”<sup>208</sup> Anticipating securities regulation by twenty-five years, he called for a governmental authority to ensure the affairs of these corporations were “ably and honestly conducted.”<sup>209</sup> Perkins also called to harness experienced former businessmen to create a new form of “expert” and “rational” government supervision.<sup>210</sup> He analogized these new public servants to justices on the Supreme Court, arguing they would be able to “solve most of our difficult problems and be of the greatest possible benefit and protection to one and all.”<sup>211</sup> In raising such proposals, Perkins’ vision for social adjustment was

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208. *Id.* at 164. Perkins, it is worth noting, was one of the organizers of U.S. Steel. *See e.g.*, JOHN GARRATY, *RIGHT-HAND MAN: THE LIFE OF GEORGE W. PERKINS* 86, 93 (1960).

209. Perkins, *supra* note 207, at 165.

210. *Id.* at 166.

211. *Id.*

straightforward. If the enormous benefits of corporate society were to be maintained, the evils had to be contained through public authority. This compromise would become the key message of the 1912 Progressive campaign.

Greater public regulation of private activity was just one aspect of Perkins' vision for adjustment to life after competition. Equally important was the melding of the private and public spheres themselves and the anticipation of what we today would call corporate social responsibility. The giant corporations, said Perkins, had become "semi-public" and their managers "semi-public servants."<sup>212</sup> Corporate responsibilities thus extended "not only to their stockholders, but to the public as well."<sup>213</sup> In Perkins' view, the separation of ownership from control—which many feared was the fatal flaw of the corporation—was actually an important benefit. Unlike small business owners, said Perkins, the ownership share of corporate managers was "infinitesimal" compared to the size of the corporation.<sup>214</sup> Their small private stake made managers free to disregard their self-interest, adopting instead the position of "the impartial judge, the intelligent, well-posted and fair arbitrator."<sup>215</sup>

The new semi-public role of corporations was most easily evident in the rapid expansion of welfare programs that took place in the decade preceding the Act. As historian James Weinstein noted, corporations were taking on the responsibilities of providing for their workers a long list of services, many of which we would today regard as basic governmental functions (or Google-style benefits). The long list of welfare programs included "continued technical education for workers, kindergarten for their children, low-cost housing, recreational facilities and some aspects of public health programs, saving and lending money, insurance, pensions."<sup>216</sup>

Corporations, to summarize, were in the process of becoming little polities.<sup>217</sup> The rise of these corporations—and

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212. *Id.* at 162–63.

213. *Id.*

214. *Id.*

215. *Id.*

216. See WEINSTEIN, *supra* note 48, at 19–21.

217. Equally true, in the eyes of corporate financiers, government itself increasingly resembled a vast "trust." See, e.g., Robert H. Wiebe, *The House of Morgan and the Executive, 1905–1913*, 65 AM. HIST. REV. 49–50 (Oct. 1959).



their continued flourishing—depended on the institution of the stock exchange. As another speaker at the 1908 Columbia lecture series explained, the corporate system was only made possible “by enlisting the active interest of the multitude, and for this a wide and free market [in securities] is an indispensable piece of machinery.”<sup>218</sup> That indispensable piece of machinery was the NYSE, where both stocks and bonds were listed at the time.

By 1913, the NYSE listed securities with a par value of \$26 billion, around three times the size of all demand deposits in the U.S. commercial banking system.<sup>219</sup> With \$800 million or so, the call loan market—where bankers made overnight loans to the NYSE brokers—represented only a small fraction of outstanding securities. But the relatively small size of the market does not reflect its enormous significance. The call loan market was the beating heart of the stock exchange and integral to its day-to-day working. In the next section, we explore the role of the call loan market as an engine of corporate finance.

#### B. *The Call Loan Market as an Engine of Corporate Finance*

The call loan market was indispensable to corporate financiers for two interrelated reasons. The first reason was already discussed in the context of Democrats’ assault on the call loan market. It concerns the exceptionally low average rates that NYSE brokers and their speculative customers enjoyed when borrowing through call loans.<sup>220</sup>

To recap our discussion in Part I, banks were willing to lend on call for exceptionally low rates because of the special liquidity that call loans offered them. On average, the interest rates on these loans was some 160 basis points (1.60%) below even the most highly rated commercial paper. The next step is

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218. Thomas F. Woodlock, *The Stock Exchange and the Money Market*, in *THE CURRENCY PROBLEM AND THE PRESENT FINANCIAL SITUATION: A SERIES OF ADDRESSES DELIVERED AT COLUMBIA UNIVERSITY 1907–1908*, at 23–24 (Edwin R.A. Seligman ed., 1908).

219. R.C. Michie, *THE LONDON AND NEW YORK STOCK EXCHANGES 1850–1914*, at 168 (Routledge Revivals 2012); *see also supra* Part I.

220. Customers could not generally borrow directly in the call market, but borrowed through their brokers. *See* Orian Peer, *supra* note 7. The role of these early brokers was thus analogous to the role of modern broker-dealers in the repo market. Broker-dealers borrow in the tri-party repo market and lend to their hedge fund customers. *Id.*

to understand how these low interest rates on call loans created an incentive for speculators to leverage up their capital, and purchase a much larger amount of securities than they would have under regular interest rates. The speculators, in fact, were engaging in maturity transformation, analogously to commercial banks.<sup>221</sup>

Consider a highly stylized example where a speculator on the NYSE purchases \$100 of securities with an expected return of 4.25%. To fund the trade, the speculator will use a small amount of its own capital, say, \$20.<sup>222</sup> The remaining \$80 the speculator will borrow through a call loan at 3%. A speculator pursuing this strategy is pocketing the spread between low rates on overnight borrowing (3%) and higher rates on longer-term lending (4.25%). In our example, this strategy has a lucrative expected return of 9.25%.<sup>223</sup> Note that this is nearly double the return that speculator would have made without borrowing on call (i.e. if she had limited her securities purchases to her own capital of \$20 and simply lent at 4.25%).<sup>224</sup>

Crucially, in our example, this excess return of 5% (9.25% less 4.25%) is entirely attributable to the liquidity premium that makes borrowing on call loans cheap. An investor facing a “normal” commercial borrowing rate of 4.25% has no incentive of borrowing to increase her securities purchases beyond her capital (there is no point to borrowing at 4.25% to generate an expected return of 4.25%). Such an investor would purchase \$20 of securities rather than \$100. All things

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221. Today, similar strategies are taken by high leverage credit hedge funds. See Ricks, *supra* note 13, at 85–87. In distinction from commercial banks, call loans (or modern repo) represent borrowing on a secured basis, and the value of collateral is marked-to-market on a frequent basis. See Orian Peer, *supra* note 129.

222. This reflects a 20% required “margin” on the loan. For a discussion of margin requirements in the call loan market, see Orian Peer, *supra* note 7.

223. The computation is as follows: At the end of the year, the security generates a gross expected return of \$4.25 ( $= 4.25\% \times \$100$ ). Against this, the speculator pays interest of \$2.4 on the call loan ( $= 3\% \times \$80$ ). The net expected return is thus \$1.85 ( $= \$4.25 - \$2.4$ ). On a capital base of \$20, this is a 9.25% expected annual return ( $= \$1.85 / \$20$ ).

224. For expositional simplicity, this example abstracts from the liquidity risks the speculator faces due mark-to-market constraint. For a discussion of these risks, see Orian Peer, *supra* note 129.

equal, the low demand would make corporate securities more difficult to sell. The likely result would be a considerably higher cost of capital for corporations.

FIGURE 12: NEW YORK STOCK EXCHANGE FAÇADE CIRCA 1904



Picture taken from SHORPY, <http://www.shorpy.com/node/10999> (last visited Feb. 19, 2018).

Having seen how call loans incentivized speculators to increase their purchases, we now explore the role of those speculative purchases in the floatation of new corporate securities. The act of purchasing new securities from corporations and distributing them to investors is called “underwriting.” Speculators’ increased purchases facilitated the underwriting process by helping corporate underwriters meet their own pressing liquidity constraints.

The reason underwriters’ liquidity was constrained was the traditional separation between commercial and investment banking.<sup>225</sup> At the turn of the twentieth century, the leading corporate underwriters were private investment banks like J.P. Morgan & Co. and Khan Loeb & Co. These investment banks

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<sup>225</sup> The lines of division, however, were moving rapidly, which will be expounded on below. *See infra* Section IV.C.

did not hold a banking charter and were therefore restricted under New York state law in their ability to maintain deposit accounts for the general public.<sup>226</sup> National banks, on the other hand, were allowed to issue deposits, but the National Bank Act did not allow them to engage in corporate underwriting.<sup>227</sup> “The gods,” goes the proverb, “send nuts to those who have no teeth.”

This mismatch between nuts and teeth helps explain the significance of the \$766 million call loan market to the \$26 billion securities market.<sup>228</sup> While the call loan market was small in comparison to the total stock of securities, it was actually quite large when scaled relative to resources of those underwriters.

The relatively small size of underwriters meant these underwriters were subject to serious liquidity constraints. When an underwriter purchases securities from a corporation, it typically takes time to find “real money investors” who are willing to purchase them. Real money investors are actors, like pension funds, who can purchase securities out of accumulated savings. In other words, real money investors are actors who do not have to borrow in order to pay the purchase price to the underwriter.<sup>229</sup> Meanwhile, while waiting to sell its securities to real money investors, the underwriter itself could come under a serious cash squeeze. The reason is that one of the main functions of an underwriter is to advance cash to corpora-

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226. Private bankers could generally avoid regulation by the state of New York as long as they complied with certain requirements that prevented them from holding small deposit accounts. *See* U.S. SENATE COMMITTEE ON BANKING & CURRENCY, *THE PECORA INVESTIGATION: STOCK EXCHANGE PRACTICES AND THE CAUSES OF THE 1929 WALL STREET CRASH* 224–25 (Cosimo Reports 2010) (1934).

227. National banks are only allowed to engage in activities included or incidental to the “business of banking” as defined in Section 8 of the National Bank Act. *See* National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as amended in various sections of 12 U.S.C.). *But see infra* Section IV.C (discussing the use of affiliates by the largest New York banks to circumvent this provision).

228. *See* MICHIE, *supra* note 219; *see also* ARSÈNE PAULIN PUJO, *REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT*, H.R. REP. NO. 62-1593, at 45 (1913).

229. At the turn of the century, when pension and mutual funds were still in their infancy, life insurance companies and investment trusts were the most important real money investors.

tions.<sup>230</sup> When an underwriter purchases securities from a corporation, it pays that corporation immediately, which could be months before real money investors purchase the securities from the underwriter.<sup>231</sup> The call loan market emerged as a way for underwriters to meet that cash squeeze.

To meet the cash squeeze, underwriters could sell the new securities to speculators.<sup>232</sup> The speculators, of course, used only a small portion of their own capital to finance those purchases; the remainder they borrowed through the call loan market. The speculators would hold the securities for a few months, make a profit, and then sell them on to more conventional “real money investors.”<sup>233</sup> With the proceeds from real money investors, the speculators could repay their call loans to the banks. They would then borrow again when underwriters floated a fresh issue of securities.

It follows that the call loan market was not a static quantity, but a dynamic flow. Underwriters and speculators used this market as a kind of conveyor belt to move securities from their initial purchasers to their ultimate investors. It is likely that most securities listed on the NYSE—the big \$26 billion—began their lives as collateral in the much smaller call loan market.<sup>234</sup>

Contemporaries of the Act had a clear understanding of this conveyor-belt nature of the call loan market. Take, for example, a speech by Thomas Woodlock, former editor of the *Wall Street Journal*, at the 1908 Columbia lecture series on monetary reform. Woodlock explained to the audience that securities were very much like consumer goods in that securities are

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230. See JAMES EDWARD MEEKER, *THE WORK OF THE STOCK EXCHANGE* 439–41 (1922).

231. *Id.* See Woodlock, *supra* note 218, at 25–27. Woodlock and Meeker explain real money investors’ reluctance to purchase unseasoned securities by focusing on the lack of reliable information of unseasoned securities, and the low risk tolerance of real money investors. For an alternative explanation focusing on monetary theory, see Orian Peer, *supra* note 7, ch. 3.

232. 232. In jargon, underwriting is considered a “moving” rather than a “storage” business. For a modern discussion, see Report of Anton R. Valukas, Examiner, at 58–78, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (JMP) (Bankr. S.D.N.Y. 2010).

233. Meeker, *supra* note 230, at 457–59.

234. See, e.g., WILLIAM CLARKSON VAN ANTWERP, *THE STOCK EXCHANGE FROM WITHIN* 110–11 (1913).

produced “in advance of the actual demand for them.”<sup>235</sup> Until that actual demand appears, securities must be financed somehow, just like inventories of consumer goods at the store. The call loan market is that system which allows for the carrying of securities inventories:

We have seen whence comes the demand for loans on securities [i.e., call loans]. It comes from the people who, as promoters, syndicators, jobbers, brokers or speculators are carrying that floating mass of securities of all kind . . . which has not yet gone into the hands of permanent investors.<sup>236</sup>

Of course, if speculators had to borrow on call to relieve underwriters of their inventories, that borrowing had to be profitable. As demonstrated above, the opportunities created by the low call rate was an important factor in the profitability of the strategy. To summarize, low call rates increased speculative demand and this speculative demand facilitated the work of liquidity-constrained underwriters. In this way, the call loan market was the financial machinery that made the rise of corporate society possible. Given the enormous significance of the call loan market, it is therefore, more than a little strange to find corporate financiers supporting mainstream Democrats’ definition of commercial paper. In fact, corporate financiers supported the very same definition Democrats believed would handle a severe blow to the call loan market. In the next section, we move to explore this peculiar coalition.

C. *The Puzzling Coalition: Corporate Financiers and Mainstream Democrats*

One of the most surprising aspects of the politics of the Act is the coalition between mainstream Democrats and corporate financiers on the exclusion of call loans from lender-of-last-resort support. Given the central importance of call loans to corporate finance, one would expect corporate financiers had bitterly resisted this exclusion. Indeed, as discussed in Section II, mainstream Democrats like Glass and Untermeyer believed Wall Street opposed the Act precisely on these

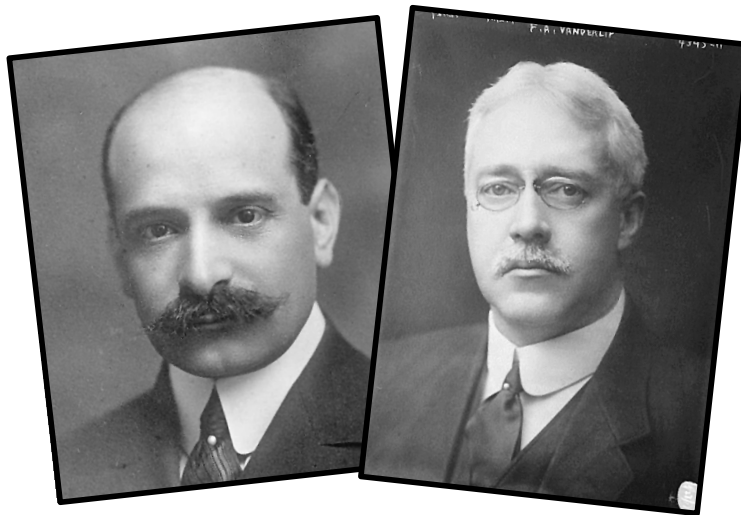
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<sup>235</sup> Woodlock, *supra* note 218, at 25.

<sup>236</sup> *Id.* at 33. See also Warburg, *supra* note 150, at 29 (“[T]he amount invested in stock exchange loans . . . represent[s] undigested securities and securities carried for speculative investors.”).

grounds.<sup>237</sup> Against this intuition, one discovers that the corporate financiers who took the most active role in monetary reform—men like Frank Vanderlip and Paul Warburg—were very much in line with mainstream Democrats’ vision.<sup>238</sup>

FIGURE 13: FRANK VANDERLIP OF NATIONAL CITY BANK (RIGHT) AND PAUL WARBURG OF KUHN LOEB & CO (LEFT).



Paul Warburg (left), picture taken from WIKIPEDIA, [http://en.wikipedia.org/wiki/Paul\\_Warburg](http://en.wikipedia.org/wiki/Paul_Warburg) (last visited Mar. 18, 2019); Frank Vanderlip (right), picture taken from PRINTS & PHOTOGRAPHS ONLINE CATALOG, LIBRARY OF CONGRESS, <http://www.loc.gov/pictures/resource/ggboun.25357/> (last visited Mar. 18, 2019).

Take for example, Paul Warburg, a partner at the investment bank Kuhn Loeb & Co. that the Pujo Committee Report described as belonging to the “inner circle” of the money trust. Having recently migrated to the United States from Germany, Warburg had been actively campaigning to create a Eu-

237. See *Banking and Currency Hearings*, *supra* note 102, at 18.

238. It is important to note that my focus in this part is with corporate financiers’ position on the Act’s lender-of-last-resort provision rather than the Act as a whole. As hinted at in footnote 201 above, Vanderlip and Warburg disagreed with Democrats on many details of the Act. Vanderlip even cooperated with the group of senators on the Senate committee that ultimately added the Hitchcock amendment against the position of the administration. See *supra* Section III.C. President Wilson and Carter Glass believed Vanderlip was trying to sabotage the reform. Dunne, *supra* note 34, at 23–24. As the discussion below demonstrates, that seems unlikely.

ropean style central bank in the United States since the Panic of 1907. Throughout his advocacy work, Warburg bitterly complained about bank investment in call loans as their liquid assets and sought to replace call loans with commercial paper. Very much in line with mainstream Democrats' later design, Warburg argued a commercial paper market could only be established with a lender of last resort against that paper.<sup>239</sup> Frank Vanderlip, president of National City Bank (another inner circle member of the money trust) shared similar views in his Senate committee testimony. When asked whether call loans presented an element of danger or safety, he responded "an element of danger and unsound banking."<sup>240</sup> Call loans had to be stopped, "and no one is more anxious than the great banks of New York to aid in this situation."<sup>241</sup>

Corporate financiers' agreement with mainstream Democrats, as was noted above, is deeply puzzling. This puzzle is not sufficiently appreciated, let alone resolved, in the historical literature. Livingston, to take a prominent example, is undoubtedly correct in highlighting corporate financiers' dissatisfaction with the growing instability of the call loan market.<sup>242</sup> The Fed's role as a lender of last resort was desirable to corporate financier's to the extent it would help stabilize the call loan market. Surely, however, corporate financiers did not intend to "throw the baby out with the bathwater" and to have the Act destroy the call market, instead of stabilizing it.

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239. See, e.g., Warburg, *supra* note 150, at 20, 28 (referring to call loans as "one of the gravest dangers of our time"); *Reform Hearings*, *supra* note 155, at 63 (statement of Paul Warburg).

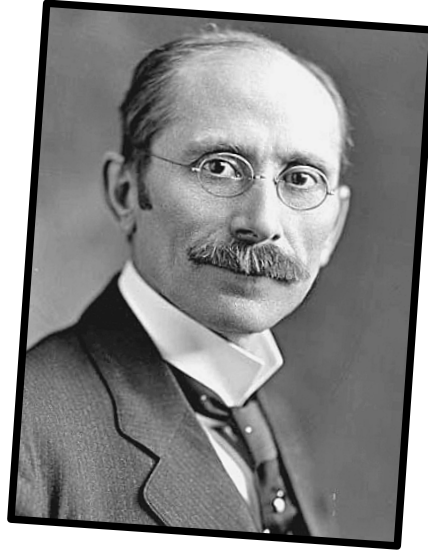
240. *Banking and Currency Hearings*, *supra* note 102, at 1926 (statement of Frank A. Vanderlip).

241. *Id.* at 1946.

242. See *supra* Section I.B.



FIGURE 14: SENATOR JOSEPH BRISTOW (R, KANSAS) OF THE  
SENATE BANKING AND CURRENCY COMMITTEE



Picture taken from SHORPY, <http://www.shorpy.com/node/10999> (last visited Feb. 19, 2018).

Corporate financiers' coalition with mainstream Democrats is all the more puzzling considering that there were lesser-known voices on Wall Street who believed call loans certainly ought to be entitled to lender-of-last-resort support. This was especially the case with commentators affiliated with the NYSE.<sup>243</sup> Van Antwerp, a broker himself and author of a popular work on the stock exchange, analogized the broker's role to that of a "dealer in merchandise."<sup>244</sup> Desperately trying to fit the broker within the mold of the real bills doctrine, he explained the broker "seeks advances of credit upon his wares just as the merchant does."<sup>245</sup> To exclude call loans from Fed

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243. On the eve of the Federal Reserve Act, securities brokerage and investment banking were largely distinct lines of business. The New York Stock Exchange was an association of 1100 brokers, governed by an elaborate constitution. See N.Y. STOCK EXCH., CONSTITUTION OF THE NEW YORK STOCK EXCHANGE, WITH SOME RESOLUTIONS ADOPTED BY THE GOVERNING COMMITTEE (1902).

244. VAN ANTWERP, *supra* note 234, at 104.

245. *Id.*

discounting, argued van Antwerp, would be not only unfair but highly disruptive to corporate investment. He stated:

Prevent the banks from lending money to facilitate stock-market operations [i.e., call loans] and business ceases; interfere with it or hamper it and confidence is impaired, and when these things happen the industrial system collapses in terror. Until a system is devised whereby large undertakings may enlist public support in other ways than by offering securities in our great Exchanges and by maintaining a market for them there, it is useless to talk of interfering with that necessary relationship which exists between the banks and the stock market.<sup>246</sup>

In imagining a system of Fed support for call loans, van Antwerp was certainly not alone.<sup>247</sup> Indeed, when Thomas Woodlock addressed the audience at Columbia in 1908, his proposed solution was to stabilize the call loan market through cooperation between the large New York banks, not through a massive exodus of funds away from the call market into commercial paper:

The main thing that seems to be needed is some stabilizing force in the call-money market, and, if I may be permitted the suggestion, it might be possible to find this force in some method of concerted action by lenders of money in which the bankers' clearing-house might play a part.<sup>248</sup>

Why then, one is pressed to ask, did men like Vanderlip and Warburg so readily ignore the possibility of including call loans in section 13, an omission that seems to be in such sharp contrast to their agenda on credit distribution?<sup>249</sup> While a fuller examination of this apparent paradox awaits further work, the remainder of this section offers several observations that shed light on the paradox. These observations all point to

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246. *Id.* at 107–08.

247. For a similar complaint on the exclusion of call loans from a NYSE economist, see MEEKER, *supra* note 230, at 196 (1922).

248. Woodlock, *supra* note 218, at 39–40. See also LIVINGSTON, *supra* note 27, at 178.

249. This is especially puzzling given historical work that distances corporate financiers from real bills doctrine. See, e.g., Mehrling, *supra* note 34, at 212; LIVINGSTON, *supra* note 27, at 24–25. See also *supra* note 141.

the possibility that corporate financiers may have reasonably believed the mainstream Democrats' design could still further the corporate distributive agenda despite its avowed purpose.

The first direction concerns corporate financiers' expectation that the Act would improve their ability to compete for deposits on a national scale. Recall that under the Democrats' design for the Act, the dismantling of the "pyramiding of reserves" meant New York clearinghouse banks would lose hundreds of millions in bankers' balances, the same bankers' balances these banks channeled to the call loan market. As Frank Vanderlip explained in his testimony at the Senate Committee, while the loss of bankers' balances was painful, the New York banks believed they could offset it by new opportunities opened by the Act:

Mr. Vanderlip: I believe we [National City Bank] will make up for those [country bank balances] in various ways, some ways, perhaps, that will not be altogether to the satisfaction of those who want to see the importance of New York reduced as a financial center. I do not believe this measure will so reduce New York.<sup>250</sup>

These new opportunities came from New York banks' increased ability to compete with banks outside New York that issued the vast majority of deposits in the country.<sup>251</sup> With over \$200 million in deposits, National City was the largest bank in the country.<sup>252</sup> Nevertheless, as Vanderlip explained to the senators, his bank faced serious obstacles in competing for depositors outside New York. The first obstacle was that under the system of pyramided reserves, country banks were highly valued customers for the NYCHA banks, because of the large bankers' balances they kept with them. National City itself held \$102 million of such balances. National City feared that

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250. *Banking and Currency Hearings*, *supra* note 102, at 1959 (statement of Frank A. Vanderlip).

251. New York national banks had deposits of about \$767 million, only 16% of total national bank deposits of \$4808 million. *See* COMPTROLLER, *supra* note 101, at 2. The proportions change somewhat when taking into account non-national banks, but the point is clear.

252. *See* ARSÈNE PAULIN PUJO, REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, H.R. REP. NO. 62-1593, at 72 (1913); *see also* *Banking and Currency Hearings*, *supra* note 102, at 1959 (statement of Frank A. Vanderlip).

trying to develop direct relations with depositors outside New York would “invade the field” of country bankers and result in retaliation and loss of bankers’ balances.<sup>253</sup>

An even more important obstacle was the byzantine system of inter-regional check collections that existed on the eve of the Act. As James Cannon documented in his classic work, the collection of checks between the country and New York was a frustratingly long, circuitous, and expensive endeavor.<sup>254</sup> The typical journey of a country check involved multiple correspondent banks and local clearing houses with fees charged at every step of the way.

The system’s inefficiency was notorious but it had an important side effect. The long and expensive process of check collection rendered it impractical for many businesses to keep deposits in New York for payments they intended to settle in the country. Depositors were thus encouraged to maintain their deposit accounts with country banks instead of moving them to New York. In this way, the “inefficient” system of inter-regional check collection was actually an essential component of the National Bank Act’s restriction on branch banking. After all, to the extent banks acquire means of serving customers without physical branch presence, branching restrictions became far less effective.<sup>255</sup>

Ironically, mainstream Democrats’ design for the Act was going to modernize that “inefficient” system that supported country banks. Democrats’ plan to establish the Fed as the new national clearinghouse would have considerably reduced the costs of inter-regional check collection.<sup>256</sup> Country bankers bitterly resisted these provisions of the Act while corporate finan-

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253. For size of balances see MYERS, *supra* note 44, at 246, 248 (1910 figure). It is important to mention in this respect that some country banks held their bankers’ balances directly in New York (though they were allowed to also hold them with dozens of Reserve City banks in various regional centers). For the “pyramiding of reserves,” see *supra* Section II.B.

254. CANNON, *supra* note 44, at 64–74 (especially the itinerary on p. 71).

255. Vanderlip, it is worth noting, considered the restrictions on branch banking to be prejudiced and unnecessary. See Vanderlip, *supra* note 201, at 1, 14–15, 17.

256. See Federal Reserve Act of 1913, Pub. L. No. 63-43, § 16, ¶ 14, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 221–522 (2006)); Willis, *supra* note 108, at 20; Edward J. Stevens, *The Founders’ Intentions: Sources of the Payment Services Franchise of the Federal Reserve Banks*, (Fed. Reserve Fin. Servs., Working Paper No. 0396, 1996).

ciers strongly supported them.<sup>257</sup> Vanderlip believed that this new system of collection would allow New York to draw deposits from afar, essentially overcoming the restrictions on branch banking. New York banks would be able to “offer to the country commercial borrower the same terms for collecting his checks as his local bank could offer. So I think we will become competitors for business in a much wider circle.”<sup>258</sup>

Vanderlip, of course, tried to win the Senators’ support by promising this transformation would serve the interest of Main Street commercial borrowers. The New York banks will use a portion of the new deposits to increase their holding of commercial paper, thus driving down rates for commercial borrowers. In reality, of course, nothing prevented Vanderlip from channeling a substantial portion of these funds to the stock exchange.<sup>259</sup>

This brings us to a second trend that sheds light on corporate financiers’ support of the mainstream Democrat design. It concerns the erosion of the dividing line between commercial and investment banking. As discussed above, that dividing line was important for understanding the significance of the call loan market in late nineteenth century.<sup>260</sup> In the years preceding the Federal Reserve Act, those lines were being rapidly redrawn. Vanderlip’s National City was itself a case in point. Despite holding a national banking charter, the bank was increasingly venturing into the securities underwriting business through newly formed affiliates.<sup>261</sup>

On the other side of the divide, investment banks were venturing into the core function of commercial banking busi-

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257. Country banks derived a large portion of their earnings from the charging of fees on exchange. For country bank resistance, *see, e.g., Banking and Currency Hearings*, *supra* note 102, at 1566–67 (statement of George W. Rogers); *id.* at 1526 (statement of Francis W. Foot).

258. *Id.* at 1959 (statement of Frank A. Vanderlip).

259. As Vanderlip argued, the relatively higher interest rates on commercial paper would have made it profitable for his bank to shift out of call loans into commercial paper. However, this narrow calculus completely ignores the side benefits that investment in call loans had in supporting the banks’ underwriting business. *See supra* Sections II.B, IV.B.

260. *See supra* Section IV.B.

261. *See* ARSÈNE PAULIN PUJO, REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, H.R. REP. NO. 62-1593, at 72 (1913); Brandeis, *supra* note 106.

ness. Though prohibited from maintaining deposit accounts for the general public, investment banks were becoming depositories to the large corporations they served.<sup>262</sup> In fact, as the Pujo Committee Report documented, J.P. Morgan & Co. and Kuhn Loeb & Co. were among the largest lenders in the call loan market.<sup>263</sup> What is more, investment and commercial banks were increasingly cooperating with each other, thereby further blurring the dividing lines between their activities. That, at the very least, was the central thesis of the Pujo Committee Report. The Report's list of the "most active agents" of "concentration in money and credit" included J.P. Morgan and Kuhn Loeb side by side with Vanderlip's National City and the First National Bank of New York.<sup>264</sup> As the Pujo Committee Report meticulously documents, these institutions frequently cooperated in underwriting syndicates.<sup>265</sup> Finally, a third development that was changing the relationship between commercial banking and securities markets was the rise of what contemporaries called "financial banking."<sup>266</sup> Financial banking referred to banks increasing the share of their assets held as corporate securities in distinction from traditional loans to non-corporate borrowers. According to Anna Youngman, an early observer of financial banking, the share of banks' corporate securities to their individual deposits nearly tripled between 1889 and 1905, from 8% to 22%.<sup>267</sup>

It is strikingly ironic, then, that while men like Vanderlip and Warburg were joining mainstream Democrats in exalting the virtues of commercial paper, the U.S. banking system was rapidly moving in the opposite direction.<sup>268</sup> These various trends all had a similar effect. They were structurally opening up possibilities for corporate financiers to harness the money supply to channel credit into corporate activity.

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262. See, e.g., H.R. REP. NO. 62-1593, at 57.

263. *Id.* at 34.

264. *Id.* at 56.

265. *Id.* at 92-100.

266. Anna Youngman, *The Growth of Financial Banking*, 14 J. POL. ECON. 435, 435-43 (1906). See also LIVINGSTON, *supra* note 27, at 138-39.

267. Youngman, *supra* note 266, at 436. This statistic includes national, state and private banks, and loan and trust companies. The increase for national banks alone was from 7% to 17%.

268. Indeed, Vanderlip himself alluded to this theme in his address at the 1908 Columbia lecture series. See Vanderlip, *supra* note 201, at 12.

The pyramiding of reserves was once necessary to channel deposits from the country into New York due to the fragmented conditions of the check collection system. With a more “efficient” system, the large New York banks could compete for those deposits directly, thus becoming immune to the loss of bankers’ balances. Sales of securities to speculators were once necessary to ease the cash squeeze experienced by underwriters that lacked a deep depository base. With the blending of commercial and investment banking, underwriters could now fund their securities inventories with deposits, thereby reducing the need for speculators to borrow on call. Finally, sales of securities to speculators were also necessary because banks themselves were rather timid in their purchases of corporate securities. With greater and greater willingness to purchase these securities outright (and fund them through deposits), speculators’ demand could again be expected to decline. The banks and the underwriters were essentially internalizing the function formerly played by speculators.

From the point of view of corporate financiers, the Federal Reserve’s powers as a lender of last resort could support this development. As a lender of last resort, the Fed could perhaps play a supportive role for New York banks’ expanded role in securities markets, even if call loans themselves were excluded from lender-of-last-resort support. These banks could hold a relatively small portion of their assets in the form of commercial paper, while continuing to hold a larger share in the form of securities and call loans. Whenever they came under stress, the banks could then discount the commercial paper with the Fed, thus obviating the need to liquidate securities and transmit stress to the securities market.

While further work is required on corporate financiers’ motivations in supporting the mainstream Democrat design for the Act, one thing seems clear. This strange coalition was not merely the result of shared vision on the financial stability benefits of a lender of last resort. Nor did it necessarily reflect the political—or even the intellectual—capture of mainstream Democrats by corporate financiers. Instead, it appears more reasonable that both positions were shaped to some important degree by their respective distributive agendas. Each camp simply had a different set of predictions as to the implications of lender of last resort on the distribution of credit.

The rhetoric of the real bills doctrine provided a shared language for the strange coalition between corporate financiers and mainstream Democrats. Both camps used the doctrine to justify limiting lender-of-last-resort powers to supporting short-term “self-liquidating” commercial paper. Despite this shared language, corporate financiers never subscribed to mainstream Democrats’ view of disconnecting the securities markets from the banking system.<sup>269</sup> Vanderlip, to take a notable example, felt quite comfortable with commercial banks continuing to make call loans and even holding corporate securities outright.<sup>270</sup>

Thus, corporate financiers were able to brew a seemingly impossible concoction where the orthodox banking idea of “self-liquidating” paper could co-exist with a money supply increasingly funding long-term corporate securities. Agrarian advocates took the exact opposite side of this debate. They wanted the banking system to fund long-term investment in the agricultural periphery, while using real-bills rhetoric to denounce the abnormality of bank funding of call loans. Ironically, despite their differences, what both these camps ultimately desired was the same: harnessing the banking system to facilitate the formation of fixed capital. In the Epilogue below we now move to explore the failure of a corporate-agrarian coalition.

#### *Epilogue: The Unrealized Coalition*

A central theme of the history just told is the role of coalition building and compromise in the shaping up of the Act’s lender-of-last-resort authority. Each of the three groups viewed the new lender-of-last-resort power as a chance to improve their distinct agenda on credit distribution. The central node in the complex process of coalition building between the different agendas was doubtlessly the mainstream Democratic po-

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269. For mainstream Democrats’ assault on the call market, see *supra* Section II.B of this article. One important way in which the difference between mainstream Democrats’ and corporate financiers’ positions manifested was the status of balances kept with correspondents. The Federal Reserve Act revoked the reserve status of bankers’ balances whereas the more corporate friendly Aldrich Plan did not. See *supra* note 133 and accompanying text.

270. For his views on outright holding of securities, see Vanderlip, *supra* note 201, at 4–12. For his views on call loans, see *Banking and Currency Hearings*, *supra* note 102, at 1972–73.



sition. On the one hand, mainstream Democrats forged a coalition with agrarians. This coalition was rooted in a shared anti-corporate sentiment, and made small—through non-trivial—concessions for agrarian accommodation paper. On the other hand, mainstream Democrats entered a second coalition with corporate financiers. This time, the coalition was built on shared commitments to orthodox real bills ideas, though corporate financiers had reasonable grounds to believe these ideas would be far less devastating to corporate finance than Democrats did.

This Democrat-centered coalition structure meant that a third coalition remained largely unrealized: the coalition between the corporate and regional development agendas. At first glance, the potential for such corporate-agrarian cooperation seems unlikely given the enormous divides between these constituencies, differences that are both material and ideological. Then again, the two coalitions formed by mainstream Democrats were themselves rife with tension. What is more, as previously suggested, agrarians and corporate financiers did share an important feature in common: both these groups wished to harness the banking system to provide long-term credit, which is, after all, precisely what mainstream Democrats were trying to prevent. The remaining paragraphs speculate on this potential common ground for a corporate-agrarian coalition, the quintessential “road not taken” for the Act.

One potential ground for corporate-agrarian cooperation was the network of correspondent relations that tied country banks in the periphery to the large banks of the metropolis.<sup>271</sup> This network provided country banks with something Democrats tried to deny them: liquidity support for their accommodation paper.

On the eve of the Act, it was common practice for the large correspondent banks to act as a private lender of last resort to the country banks that kept bankers’ balances with them. As Oliver Lockhart documented, correspondents of-

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271. Indeed, Democrats like Untermeyer repeatedly complained that large correspondent banks were inducing country banks to oppose the bill. *See, e.g., Banking and Currency Hearings, supra* note 102, at 1288–1369 (statement of Samuel Untermeyer). These complaints were not without foundation. *See, e.g., id.* at 1542–45 (statement of H.A. Moelenpah). At the same time, these efforts seem to have left country bankers frustrated and did not manage to create a robust coalition.

ferred their country bank customers "credit lines" secured by accommodation paper. According to these credit line arrangements, a country bank that kept an average balance in New York throughout the year was entitled to draw up to five times the amount of that average in time of need.<sup>272</sup> The city correspondents, in other words, were accepting precisely the type of collateral that men like Glass and Parker Willis were struggling to keep out of section 13.

Viewed from this point of view, mainstream Democrats' assault on the "pyramiding of reserves" was actually a source of concern for many country bankers. As we have seen, section 19 of the Act cancelled the reserve status of balances kept with correspondents and required those balances to be transferred to the Fed.<sup>273</sup> This meant a reduction in the average size of balances kept with correspondents and, consequently, a shrinking of credit lines for country banks. With section 13 in place, the Federal Reserve banks, of course, were much more restrictive in the collateral they accepted than the correspondent banks.<sup>274</sup> Many country bankers dreaded the tightening of credit that might result from the transfer. As one country banker from Lawrence, Massachusetts, complained before the Senate Committee:

This bill disturbs, if it does not disrupt the relations—I will not call them pleasant relations, although they are—present relations of collection and accommodation [i.e., lending] between a country bank and its city banker. The city banker, the reserve agent, and the country banker are very closely connected and

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272. See Oliver C. Lockhart, *Interbank Borrowing in the National System*, 29 J. POL. ECON. 138, 156 (1921). Lockhart also mentioned that the paper securing the loan are typically shorter than six months though the loans themselves can be extended. *Id.* at 157.

273. See *supra* Section II.C.

274. Large correspondent banks were under considerable pressure to offer credit lines to their country bank customers. The large clearing banks of New York and other financial centers were loath to compete with each other in price terms, that is, by offering higher interest rates on the bankers' balances kept with the bank. See Brian C. Gendreau, *The Implicit Return on Bankers' Balances*, 15 J. MONEY, CREDIT & BANKING 411, 413 (1983). In fact, since the mid-1890s, the NYCHA prohibited banks from paying in excess of 2% on bankers' balances. Clearing banks competed instead through the services they offered their country bank customers, including the credit lines they extended.

must be. There is no way of divorcing them if we are to carry on a successful system of banking.<sup>275</sup>

A second potential site for corporate–agrarian cooperation was the agrarian plea to broaden access to farm mortgage credit by engineering new monetary solutions.<sup>276</sup> To be sure, corporate financiers opposed these agrarian demands as much as mainstream Democrats, but their position was, in a sense, puzzling. After all, the crowning achievement of corporate financiers was precisely in mobilizing call loan credit for long-term capital formation. The agrarian “heretics” were asking for no more than to adapt for their own ends the same apparatus corporate financiers have been using for decades.

A most striking moment in this respect occurred in the Senate Committee in an exchange between Frank Vanderlip and the agrarian Senator Joseph Bristow (R, Kansas). The backdrop to this exchange was Vanderlip’s attempt to convince the senators that making commercial paper eligible for Fed discounting would favor Main Street commercial borrowers. In line with the mainstream Democrat’s theory, Vanderlip promised that once the Fed supported commercial paper as a lender of last resort, his bank would shift a portion of its call loans into commercial paper.<sup>277</sup> Having grasped the principle, Bristow seized the moment and tried to apply it to favor peripheral credit need instead of urban ones<sup>278</sup> asking, “[s]uppose the farm mortgage could be cashed [i.e., used as collateral for a loan] in those Federal reserve banks just the same at any time you wanted to. Would that be desirable?”<sup>279</sup>

Vanderlip’s attitude was dismissive, channeling the orthodox emphasis on short-term paper he shared with mainstream Democrats: “It would be most undesirable, just as it is most undesirable to permit those banks to rediscount loans made on stock exchange collateral . . . . There is nothing liquidating about a farm loan.”<sup>280</sup> Dismissive as his response was, Vander-

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275. *Banking and Currency Hearings*, *supra* note 102, at 1249 (statement of Justin Varney).

276. The 1916 Federal Farm Loan Act was a significant—though limited—step for this agrarian agenda. *See supra* note 187.

277. *Banking and Currency*, *supra* note 102, at 1941 (statement of Frank Vanderlip).

278. *Id.* at 1961 (statement of Joseph Bristow).

279. *Id.*

280. *Id.* (statement of Frank Vanderlip)

lip's analogy between farm mortgages and call loans demonstrated their implicit affinity. The ensuing discussion, while brief, showed the kind of conceptual puzzles contemporaries faced in trying to draw the lines between "legitimate" and "illegitimate" loans: those that were self-liquidating—and hence, eligible for Fed discounting—and those that were not.

Was commercial paper self-liquidating thanks to its intrinsic qualities or owing to its eligibility for Fed discount? Bristow wondered that much aloud. If the liquidity of commercial paper was intrinsic, why was Fed discounting required in the first place?<sup>281</sup> On the other hand, if call loans were not self-liquidating in theory, how did they come to be so liquid in practice? Perhaps it was, because there was a ready market for stocks and bonds, whereas no such market existed for farm mortgages. As Senator Knute Nelson (R, Minnesota) noted, "[i]f you had that same market for farm mortgages as you have for stocks and bonds on the NYSE, then I should regard farm mortgages as liquid as those others (i.e., call loans)."<sup>282</sup>

Perhaps, then, one should establish a liquid market for farm mortgages? This promising exercise in institutional design was soon aborted with further resuscitation of the real bills doctrine.

#### CONCLUSION

Exchanges like those between Bristow, Nelson, and Vanderlip reveal some of the roads not taken for the Fed's role as a lender of last resort. As that interlude hints, all credit instruments ultimately rely for their liquidity on institutional arrangements in the markets where they trade. Revising those institutional arrangements is precisely the task faced by reformers. What then, we might ask, determines the choice between one set of institutional arrangements and another?

Participants in the debate on lenders of last resort since the Global Financial Crisis have implicitly responded to this question by making their arguments in the language of finan-

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281. Warburg himself, though a strong supporter of a liquid commercial paper market, made a closely related point. See *Reform Hearings*, *supra* note 155, at 63 (statement of Paul Warburg); see also Moulton, *supra* note 143.

282. *Banking and Currency Hearings*, *supra* note 102, at 1962 (statement of Frank Vanderlip). The views expressed by Senator Nelson later in the discussion relapse into the real bills emphasis on "self-liquidating" paper.

cial stability. My argument here has been that in the original debate over lenders of last resort, the different groups' agendas on credit distribution were as influential as their views on financial stability.

Today, one of the most important contexts for making these distributive stakes explicit is the debate over the "shadow banking" system. Modern shadow banking is strikingly similar to the call loans discussed in this article. Shadow banks are institutions—like broker-dealers and hedge funds—that use short-term borrowing to fund long-term securities. The stresses experienced by this system during the crisis were the backdrop for the unprecedented expansion of the Fed's role as a lender of last resort.<sup>283</sup> The Fed's policies have supported not only new institutions—broker-dealers and money market funds—but also entire markets, most importantly, the market for asset backed securities.<sup>284</sup>

As hinted in the Introduction, the Fed has become the subject of considerable controversy, and even has led to certain legislative reforms in the 2010 Dodd-Frank Act.<sup>285</sup> While a discussion of these reforms is beyond our current scope, my central concern is with the way participants in the modern debate neglected to consider the implications of their positions for credit distribution. After all, in deciding whether the shadow banking system—or parts of it—is deserving of lender-of-last-resort support, it should matter a great deal what segments of the economy that system serves. That analysis has never been made, with participants instead making their arguments purely on grounds of financial stability.

It would be an exaggeration to say that theories of financial stability—be they modern theories or the now ancient real bills doctrine—are merely an ideological gloss over participants' underlying distributive preferences. Financial stability considerations are obviously important, and lobbying efforts aside, those who raise them often act out of a genuine sense of urgency. At the same time, one does not need to argue that financial stability considerations mask distributive agendas in order to appreciate the importance of making the distributive stakes explicit. As the history of the Act reveals, one's views of

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283. See Fleming, *supra* note 5.

284. *Id.*; see also Mehrling, *supra* note 34.

285. See *supra* note 13.

financial stability are themselves inevitably embedded within a broader vision of social stability. The type of credit promoting one's own agenda tends to feel wholesome and deserving of institutional support while credit promoting another's agenda appears speculative and irresponsible. The result of such reform efforts is as much a political negotiation—at times with very uneven results—as it is a careful elucidation of some doctrine on financial stability. For those interested in a fairer distribution of credit and opportunity, the lender of last resort remains a ripe context for legal reform.