

CLEARING HOUSE CURRENCY

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The Federal Reserve System is no longer just an unconstitutional monetary institution promoting a continuing inflation; it has also become, with quantitative easing, an unauthorized fiscal agent for the U.S. government. The fiat currency and equally fiat bank reserves it creates are much in contrast to the private currency and bank reserves that the commercial banks' clearing house associations provided in the latter half of the 19th century. It is that episode I review here.

The Structure of Commercial Banking after the Civil War

The commercial banking world of the 19th and 20th centuries in the United States had many unstable characteristics, most of them the results of misguided government regulations, both state and federal. Civil War financing added to the problems, most notably, prohibition of bank-note currency issues by state banks. State laws had already restricted state banks' sizes and branching freedom. The National Banking Acts, passed in 1863 and 1864, aggravated many of the problems—one example being the imposition of legal reserve requirements for national banks. Some states had adopted this ill-advised measure even before the Civil War. All told, state and federal laws resulted in a two-tier system, national and state, with built-in rigidities that severely limited all banks' abilities to respond to

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changes in the demand for money and credit (Dowd 1995, McCulloch 1986). Especially, in the latter half of the 19th century and into the 20th, an unusual demand for bank credit could so deplete bank reserves that the supply of bank credit and bank-issued deposits would decline. This perverse elasticity emphasized the system's instability: an increase in the demand for credit and money could result in a decrease in the supply of both. No other industry faced such a problem (Timberlake 1993: 207–9). Bank suspensions and the restriction of cash payments became the standard response to these unusual liquidity demands.

During the period 1865–1910, influential bankers, politicians, and many economists described the banking system's instability as a “currency problem” rather than as a deficiency in the man-made policies governing the commercial banking framework. This judgment substituted symptom for cause. Nonetheless, the system-wide restrictions and regulations on credit activities stimulated the banks to devise an effective defense: clearing house associations operating as lenders of last resort. The associations worked remarkably well and could have endured. However, in 1913–14, the Federal Reserve System replaced the clearing house system.

The Appearance of Clearing House Associations

State and national banking laws—and the widespread practice of demand deposit banking (i.e., the use of checks) after the prohibition of state bank notes—resulted in a large number of relatively small banks. The superfluity of banks stimulated the development of clearing house banks and, subsequently, clearing house associations to economize the humdrum work of check clearing. These institutions first appeared in New York City and then in other large cities. A prominent bank in the financial district would assume the role of a clearing center for all the banks that chose to belong to the local association. Representatives from each bank would then congregate at the clearing bank with similar clerks from all the other banks. Upon a signal, the clerks would carry out their claims and payments from and to each other and strike a balance for the difference.

This practice became so widespread that banks in many cities constructed jointly owned clearing houses. To expedite the daily clearing operation, many banks kept a balance of specie and greenbacks, or

some other form of lawful money, as a reserve deposit in their clearing house accounts. National bank notes served as lawful reserves for some state banks, but not for national banks. When a bank needed to transfer large amounts of dollars, it would withdraw clearing house certificates (CHCs) in the form of certificates of deposit in large denominations, often \$5,000 and \$10,000, from its reserves to satisfy bank creditors in other cities (Timberlake 1993: chap. 14).

Bank panics prompted the clearing house managers to add a lending function to their clearing operations. A member bank facing demands for payments that threatened its reserves could apply for a loan to the clearing house loan committee. If the committee determined that the applying bank was sound, it would arrange for a bank with plentiful reserves to lend, usually at 6 percent annual interest, some of its excess reserves to the needy bank. Today, the fed funds market operates similarly. The borrowing bank conventionally secured its loan with its own collateral paper worth 133 percent of the dollar value of the amount it borrowed. It then used the clearing house loan certificates (CHLCs) it had acquired from the loan to clear its deficiencies at the clearing house, and subsequently paid off the loan when it received remittances for its own outstanding loans. Most of this activity came during the spring and fall of the year when new money was most needed for crop financing, but it became especially important during panics.

Clearing Houses Become Lenders of Last Resort

Each successive panic from 1857 to 1907 saw an extension of clearing house currency issues. More important, the clearing house itself became a fractional reserve lending institution. Clearing house managers, with the approval of their loan committees, began making short-term loans to reserve-deficient banks without the constraint of any dollar-for-dollar deposit in the clearing house. CHLCs so issued extended the clearing houses' liabilities to values exceeding their reserves, and promoted the clearing house into a *private, market-directed central bank*.

The CHLCs were identical to the CHCs but had the word "loan" in their heading. Even though they were redeemable to clear adverse credit balances at the clearing house, the CHLCs were not, at first, a currency that could be used at the local grocery store. They, too,

were in denominations of \$5,000 and \$10,000 and acceptable only for check- and note-clearing operations at the clearing house.

As time and panics went on, the number of clearing houses increased, as did the loans and certificates that deficient banks needed. Gradually, the efficacy of filling credit needs during a panic stimulated the formation of clearing houses in small towns that had only a few banks where the issues of CHLCs would never have been needed just for clearing operations. One such clearing house appeared in Willacoochee, Georgia, which had only one bank. These new clearing houses began endorsing other items as CHLCs, such as certified checks, cashier's checks, and low-denomination certificates of deposit. All these currencies were formally acceptable only as remittances at the clearing houses. However, as the practice became ubiquitous, the issues and their denominations became small enough to be used in many places to fill the transaction needs of hand-to-hand currency. The guarantee of redemption at the clearing house was sufficient for their common acceptability.

During the Panic of 1907, clearing house currency innovations became quantitatively significant. Also by this time, their widespread existence came to be a political and economic issue. Many bankers, economists, and political scientists weighed in on both their evolution and their legality.

Professional Opinions of Clearing House Currencies

A. Piatt Andrew, a professor of economics at Harvard University, wrote three articles about the 1907 Panic, one of which measured the dollar quantity of clearing house certificates and other substitutes for legal reserves, frequently called "cash." Andrew (1908: 434) called the suspension of cash payments "the most extensive and prolonged breakdown of the country's credit mechanism which has occurred since the establishment of the national banking system." All this currency, he concluded, "was an inconvertible paper money issued without the sanction of law, an anachronism in our time, yet necessitated by conditions for which our banking laws did not provide. During the period of apprehension, . . . it worked effectively and doubtless prevented multitudes of bankruptcies which otherwise would have occurred" (Andrew 1908: 459).

Indeed, the banking laws did not provide solutions; they were the problem. Clearing house supplies of bank monies fulfilled an unusual

demand for additional means of payment that the formal monetary system of lawful money, or cash, could not meet. They were the only means of providing elasticity to the banking and monetary system.

As the Panic of 1907 played out, Edwin Seligman, a professor of political economy at Columbia University, organized a series of lectures, one each week, “to contribute to the understanding of the crisis of 1907, and to lay down some principles which might be of service in the reconstruction of our currency system” (Seligman 1908: ix). The lecturers, Seligman excepted, were prominent bankers or financiers.

In the introductory lecture, Seligman reviewed the country’s monetary and industrial history, seeking to determine whether the recent panic occurred due to real or monetary causes. He emphasized the inflation of about 2 percent per year that had occurred under the gold standard since 1896. Monetary increases based on gold discoveries, he observed, enabled the banks to expand credit to all agricultural and commercial enterprises. Liquidation of capital values, he concluded, “by checking the movement of exaltation retarded the increase” (Seligman 1908: xxiii).

A. Barton Hepburn, former comptroller of the currency and author of a comprehensive monetary history, also gave a lecture, which he titled “Government Currency vs. Bank Currency.” In his lecture, Hepburn provided a largely accurate history of U.S. money and banking. He also added a gratuitous opinion: “Judged from an historical and scientific standpoint,” he observed, “the currency system of a country can best be administered through the instrumentality of a central bank of issue” (Hepburn, in Seligman 1908: 57). The central bank would have a board of directors appointed by the government and be much like the Reichsbank in Germany, the Banque de France, and the Bank of England. It would earn a modest return on its capital, “but at the same time,” noted Hepburn (1908: 59), “the altruistic influences, personated [sic] by the government would largely control. . . . Why will not a government-controlled central bank of issue, where the banks of the country in good credit can . . . discount their receivables, receiving the proceeds thereof in bank notes, afford the best solution to the currency question?”

Five years earlier, in his banking history, Hepburn had discussed the CHLCs and other private, clearing house currencies that had appeared spontaneously during the Panic of 1893. Except for the high-denomination CHLCs, he argued, all the currencies and the

substitutes for currency were illegal. His perplexed conclusion was: "This temporary currency . . . performed so valuable a service . . . in moving the crops and keeping business machinery in motion that the government, after due deliberations, wisely forbore to prosecute. . . . It is worthy of note," he concluded, "that no loss resulted from this make-shift currency" (Hepburn [1903] 1924: 352).

Hepburn, a learned banker and historian, argued that privately issued money, though illegal, performed an invaluable service without appreciable cost. The laws, not the "make-shift currency," were obviously the problem and what needed changing, so that what was done spontaneously and privately could be legal.

The next lecturer, Albert Strauss, a banker-financier, after a lengthy discussion of gold and foreign exchange, noted the inelasticity of the American monetary system, which he likened to an "old rubber band." He argued that "national bank-note circulation will expand a certain limited distance, but neither the old rubber bands nor our bank-note circulation will contract." To provide the proper elasticity, Strauss favored a central bank. He believed "a form of organization can be devised for such a bank that will effectually protect it from the danger of political control or influence" (in Seligman 1908: 85–86). However, he did not provide any answers as to how such dangers could be avoided.

Paul Warburg, another prominent banker of the day agreed with Strauss. His lecture, "American and European Banking Methods and Bank Legislation Compared," contrasted the European banking systems, which featured central banks, with that of the United States, which did not. He described an "ideal banking system" as one that "provides for the maximum use of credit and the minimum use of cash," by which he meant currency and bank reserves (i.e., base money). Such a system, he thought, would avoid "all violent convulsions." He saw European central banking as coming "very near" the ideal, but considered the U.S. system as being "palpably inefficient." The Panic of 1907 reflected "a disgraceful state of temporary insolvency." His principal argument was that the European central banks managed their countries' credit systems dispassionately and wisely, while the U.S. banking system was "wrong from top to bottom" (Warburg, in Seligman 1908: 132). He also emphasized the extensive branching capabilities in European banking systems, but did not treat analytically the lack thereof in the American system.

Warburg (1908: 138) noted the incongruity between the bounteous reserves that the American banks held and the reluctance of the banks to use them: "While one thousand millions of dollars were lying idle in our banks and trust companies as so-called reserves, this money, by virtue of the law, could scarcely be touched!" However, he gave no suggestions as to how that problem might be remedied, beyond the prescription that all banks' reserves should be kept by the hoped-for central bank.

Both Strauss and Warburg thought of central banks as semi-independent institutions with very little government participation or ownership, and with a gold standard constraining the whole system. To his credit, Warburg (1908: 142, 149) severely criticized the usury laws that, he correctly charged, prevented borrowing at critical times.

Amazingly enough, near the end of his lecture Warburg (1908: 150) recommended, "a central clearing house, with power to issue against clearing-house certificates, notes to be guaranteed by the United States." He thought that this organization "would form the best solution for the time being." However, his "central clearing house" seemed to be no more than a less-than-optimal surrogate for the central bank he advocated.

All of the lecturers so far considered seemed to accept the technical aspects of the banking system as given. None called for the elimination of legal reserve requirements, although a few recommended branch banking. Most supported the notion of a central bank, but one limited by strict rules. They also took for granted, without saying so, the commanding presence of a gold standard.

Only one of the lecturers seemed to recognize the great virtue that the clearing house system had rendered during the panics of the era. That man was James Graham Cannon, who at the time was vice president of the Fourth National Bank of New York. His lecture, "Clearing Houses and the Currency," fairly well summarized the major arguments that appeared in his book, *Clearing Houses*, which the National Monetary Commission published in 1910.

In his lecture at Columbia, Cannon (1908) first gave a detailed report of how the clearing house system worked. He then discussed a banking crisis marked by a severe increase in the banks' and public's demand for "cash" or "lawful money" (again, monetary base items) that exclusively fulfilled the role of bank reserves. At the onset of a crisis, he observed, banks sequestered reserves to protect their legal requirements, and especially to counter a popular attempt to

convert bank notes or demand deposits into base-money currency, such as, gold, greenbacks, silver certificates, and to some extent national bank notes (for nonnational banks). This attempt, he argued, was bound to fail because bank reserves were all fractional, and the fraction averaged only about 15 percent of total demand obligations.

To counter the stringency arising from reserve money being “hoarded,” Cannon explained, clearing houses began the practice of issuing CHLCs, which were based on short-term paper deposited by the borrowing banks as collateral. These certificates extended the base money of the financial system and filled the immediate need for more currency, but could only be used to pay off balances due at the clearing house. Since the ratio of balances to clearings was between 2 and 5 percent, this newly created monetary base effectively substituted for “lawful money” reserves and thereby kept that much more real lawful money available as currency and reserves for banks threatened by bank runs (see Cannon 1910: 221).

The practice of the clearing houses in the major cities to issue large-denomination certificates as balancing media at the clearing house spread to other cities, as noted earlier, then to small cities, towns, and villages. When only, say, two or three banks are located in a small town, the directors get together at one of them and clear balances while having afternoon coffee. During the Panics of 1893 and 1907, however, banks in many such towns and villages issued quasi-currencies in the form of cashiers’ checks and other credit items stamped “payable only at the clearing house.” Since the notes were stamped “payable,” retailers and consumers, not knowing anything about check clearings, could believe that some respectable institution was going to redeem them, so they must be “good.” Cannon (1908: 111, 116) cited James Eckels, a comptroller of the currency, who had labeled them “due bills,” when the question of their legitimacy arose and was decided in a court of law. After the 1893 panic, Eckels (U.S. Comptroller of the Currency 1893: 15) observed: “The service rendered by [clearing house certificates] was invaluable, . . . and to their timely issuance . . . is due the fact that the year’s record of suspensions and failures is not greatly augmented.” The judge had ruled that the CHLCs were not money.

Cannon (1908: 114) concluded that the CHLCs issued in the Panics of 1893 and 1907, were “the solution of the problem.” The CHLCs “allow[ed] banks to take to the Clearing House their fixed

[dollar, interest-bearing] assets and convert them into a medium of exchange between themselves, thus allowing an extension of further credit, which credit was utilized by their depositors through the Clearing House.” To penalize the banks for their use, Cannon (1908: 116) noted, “would have been not only a serious blow to one of the most effective and ingenious contrivances for the deliverance of the country from the throes of panic that has yet been devised, but would also have been a direct violation of the spirit of the law.”

At the end of his lecture, Cannon (1908: 115) suggested that the laws should be changed to permit CHLCs to become a part of the monetary base (although he did not use this term), which “would be secured beyond peradventure. [Their] retirement would be provided for promptly, and when outstanding . . . would be covered by ample collaterals or by lawful moneys of the United States.” His final recommendation was for the incorporation of the clearing house system by the United States government in order to legitimize the entire operation. Nonetheless, he insisted that the clearing houses should be in charge of all the lending activity that panic conditions demanded.

Another Harvard economist, O.M.W. Sprague, in discussing the Panic of 1907 a few years after it occurred, emphasized the fact that since the New York banks held a significant amount of reserves for the reserve city banks, and for most of the larger banks in the rest of the country, they had calls from banks everywhere for cash remittances of lawful money that they could not meet. Their reserves were central for the entire banking system. If they paid out such moneys, only some form of unlawful moneys, “redeemable at the clearing-house,” would come back (Sprague 1910: 257).

Sprague, however, had another answer for what was wrong. He noted that “undue importance has come to be attached to the maintenance at all costs of a certain minimum [legal] ratio between reserve and deposit liabilities. . . . Without exaggeration,” he argued, “this arithmetical ratio of reserves can only be adequately characterized as a sort of fetich [sic] to which every maxim of sound banking policy is blindly sacrificed.” The New York banks “were primarily responsible because of their position as the central reserve banks of the country” (Sprague 1910: 280)” To correct this reserve-ratio problem, Sprague (pp. 319–20) offered the following solution: “Somewhere in the banking system of a country there should be a reserve of lending power, and it should be found in the

central money market [in New York]. . . . Provision for such reserve power may doubtless be made in a number of different ways.” However, he did not suggest any of the possibilities that he implied, or seem to be aware that “the reserve of banking power” he thought so necessary was already in place. The banks had plenty of reserves to service the liquidity needs of their depositors, but the *legal reserve requirements* that applied to all the national banks, and to many state banks, immobilized the reserves. If banks trench on their reserves, thereby reducing the ratio to a value below the legal minimum, everyone hears about it. Newspapers jump on the fact and publicize it as an object of opprobrium, fueling further demands for cash by frightened depositors. The offending bank usually becomes subject to significant penalties for the amount of the deficiency and is precluded from extending any further credit for whatever reason. Furthermore, any given ratio is a one-size-fits-all for a given class of banks.

The reserve necessities banks face vary from day to day, week to week, and season to season. Banks, if left alone, condition themselves to meet those varying demands. But if their reserves are rendered immobile by strict legal requirements, they lose their reserve flexibility.

Clearing Houses as Lenders of Last Resort

Privately owned and managed clearing house associations emerged during the 19th century as effective antidotes to the money and credit crises resulting from ill-conceived banking laws of the period. Most noteworthy is the fact that the clearing house system proved to be a perfect example of spontaneous order in monetary affairs and was especially compatible with the existing gold standard. The laws should have been changed so that the banks could have provided their own defenses more routinely. First, legal reserve requirements should have been abolished. Second, branch banking should have been encouraged, not prohibited. Third, banks should have been allowed to issue any demand liabilities that they and their customers agreed to—such as, hand-to-hand currencies, post notes, and due bills.

Unlike the Federal Reserve System that took its place in 1913, the clearing house system, in tandem with the operational gold standard, could not initiate inflation. No one ever imagined the possibility

because the incentives that put the clearing house machinery in motion occurred only when the demand for money, defined by rising interest rates and liquidity shortfalls, manifested itself. The incentives for action were all market-directed by thousands of people making thousands of decisions in competitive markets.

By way of contrast with the Federal Reserve System, the clearing houses' money-creating activities never resulted in any losses due to defaults on the loans that created them or any systemic losses from inflation. No personalities issuing public statements about "irrational exuberance" made the headlines. No goals, such as "planned inflation," accompanied by monetary tsunamis, labeled "QE 1, 2, 3," happened, or could have happened. (How can a central bank fail its "mandate," if it plans inflation? Inflation is the natural and logical result of all central bank policies.)

No central bank-treasury collaboration to expand the government's fiscal footprint was possible. The front door of the Treasury could not become the back door of the central bank. Removing the restrictive laws that prevent efficient competitive banking with a privately managed clearing house system would have promoted stable money and encouraged productive enterprise.

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