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Asher Lowenstein
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The "Speculative Orgy" of Commercial Banks

Intentions and Impact of the Glass-Steagall Act

Asher Lowenstein

Submitted to the Committee on Undergraduate Honors of Baruch College of the City University of New York in partial fulfillment of the requirements for the degree of Bachelor of Arts in Economics with Honors

April 27, 2011

Approved:

Department Committee
Frank Heiland

Department Committee
Ardavan Mobasheri

Department Committee, Chairperson
Michael Carew

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Acknowledgements

I was fortunate to have had the assistance and encouragement of many knowledgeable and kind people in developing this paper. My advisor, Michael Carew, believed in my abilities even when I remained unconvinced. His scholarship and reassurance enabled me to complete the work. Keri Bertino, Heather Samples, and Stephen Franceour were overly generous with their time and patience in reading and commenting on my paper. Their skill and insightfulness can be found on every page. I would also like to thank the other members of our workshop for providing constructive comments and feedback. Frank Heiland and Ardavan Mobasheri agreed to review the paper at the very last moment and provided invaluable suggestions and guidance. I must also thank Susan Locke, head of the committee, for disregarding the initial confusion and assisting me although I managed to miss every possible deadline.

Abstract

This thesis examines the motives for the passage of the Glass-Steagall Act, which established a separation between commercial and investment banking in America for most of the twentieth century. The most common understanding in popular and legal sources is that the act was designed to help avoid the misuse of commercial funds that had led banks to fail in the 1930s. Earlier analyses found that the bill was not actually passed as a result of research that demonstrated the effectiveness of the provisions. In this thesis, it is argued that the bill was not formulated as a response to careful economic analysis of why banks had actually failed. Rather, the proponents of the bill had predetermined ideas about how banks should function and which activities should be allowed—namely, that commercial banks should be occupied with funding the business of the nation and not engage in trading securities.

This conclusion is supported by examination of the establishment of the Federal Reserve System, which involved many of the same sponsors of the passage of the Glass-Steagall act. One of the primary objectives of the Federal Reserve, according to its sponsors, was to limit speculative activities by banks. When this objective was not realized, they looked for new ways to limit how banks operated. Thus, Glass-Steagall was enacted, with the hope that it would reduce speculation and cause banks to operate more closely with actual production. While the act did ultimately succeed in reducing the involvement of banks in securities, it does not appear to have been effective at making bank loans more closely related to economic production, which was its stated goal.

Preface

The Glass-Steagall Act of 1933 defined American banking for much of the twentieth century. Popularly established as a vital component of prudent banking, it was accepted as an important economic safeguard by observers and regulators of the banking system. In the last decades of the twentieth century, however, the efficacy of the act was challenged by new research. This led, ultimately, to the repeal of the act in 1999. In the first decade of the twenty-first century, a movement began to revive the act and reinstitute its provisions.

The act's thirteenth section established one of the defining features of American banking for sixty five years: a separation between commercial and investment banking. This was part of a series of efforts to make banking more secure, and at the time it was passed there was little questioning of the rationale behind the act. It simply made sense to enact changes that would protect depositors from a recurrence of the bank failures of the 1930s.

Predictably, banks felt restricted by the provisions set in place by Glass-Steagall. Over the next few decades, they looked for exceptions to work around the regulations. On two occasions, methods used by banks were reviewed by the Supreme Court, both times resulting in rulings against the banks. Eventually, Congress agreed that the regulations were stifling the banks and not allowing them to compete with non-American financial institutions. On November 12, 1999, the Gramm-Leach-Bliley Act was passed, repealing Glass-Steagall. Banks were now free to engage in activities that had been forbidden to them for over six decades.

It is rare for a regulation to come to a complete end; it is even rarer to soon have calls for its revival. Within a few years, people began to question whether it had been wise to repeal Glass-Steagall. From 2007 to 2009, the United States experienced another financial crisis. Many financial institutions that had acquired subprime mortgage assets had failed or been acquired by the end of 2007.[1] Throughout 2008 there was much concern that the failures could not be contained. The crisis finally subsided but only after claiming some of the most prestigious American financial firms and the largest bank failure in US history. There were no formal studies showing any relation between transactions that were enabled by Gramm-Leach-Bliley and the factors that led to the financial crisis, yet some observers, mostly in journalistic venues, claimed that it had played an important role. According to one report, “economic experts say that Gramm and others are to blame for the current crisis that is shaking Wall Street. Gramm’s successful effort to pass banking reform laws in 1999, which reduced decades-old regulations separating banking, insurance and brokerage activities, helped to create the current economic crisis.”[2] The official report on the crisis, released in January 2011 by the Financial Crisis Inquiry Commission, dedicates several pages to the events leading to Gramm-Leach-Bliley, including the details of how much was spent on lobbying for the repeal.[3]

The assertion of a connection between the repeal of Glass-Steagall and the recent financial crisis begins with an understanding, expressed by journalist Daniel Gross on the website *Slate.com*, of Glass-Steagall as “one of the many necessary measures taken by Franklin Delano Roosevelt and the Democratic Congress to deal with the Great Depression.” These measures were necessary because, as Gross put it, “in the 1920s commercial banks…recklessly plunged into the bull market, making margin loans, underwriting new issues and investment pools, and trading stocks. When the bubble popped in 1929, exposure to Wall Street helped drag down the commercial banks.” This had a deep effect on the economy, and “the results were devastating….The policy response was to erect a wall between investment banking and commercial banking.”[4] It is this understanding of Glass-Steagall that allows a connection to be made between the act’s repeal and the subsequent financial crisis.

[1] *Financial Crisis Report*, 22-23.
[2] Baram, “Who’s Whining Now?”
[3] *Financial Crisis Report*, 52-55.
[4] Gross, “Shattering the Glass-Steagall.”

The trouble with this popular narrative of Glass-Steagall is that in the bank records and hearings leading to the act it is not so clear why the act was passed. In fact, as it will be discussed below, several decades after the Glass Steagall Act there was substantial disagreement among *supporters* of the act about why it had been passed. It may seem logical that reckless activities by banks had devastating effects on the economy and that there should be limits to what banks could do, but not everyone understood that as the problem that Glass-Steagall had been enacted to solve.

Several studies in the 1980s and 1990s analyzed the specific conditions of banks before Glass-Steagall. They found that the bank failures had actually not been caused by banks' reckless activities in the 1920s. From several perspectives, it was shown that there was no obvious link between activities relating to securities and bank failures. Collectively, these studies raised the question of what was, in fact, meant to be accomplished with Glass-Steagall.

There is also some doubt about why the bill's sponsors and supporters thought it necessary. The hearings about bank performance took place in 1931, yet there was no great rush to have the bill passed. There was a banking bill passed in 1932 addressing other banking issues, primarily measures that made it easier for banks to receive funds from the Federal Reserve. In 1933, when Glass-Steagall was introduced, Congress could not find a way to pass it until other events brought more attention to bank regulation. If the activities that the bill addressed were widely understood to have had devastating results on the economy, a much greater sense of urgency in passing the bill would be expected. Subsequently, the sponsor of the bill proposed the removal of some of its restrictions. It would hardly be wise to reintroduce the bank activities that had caused so much devastation. Thus, it would appear that the bill was not generally seen as being so necessary, and perhaps there were other reasons behind its passage.

In the regulation of banks throughout the 1910s and 1920s, there are certain recurring themes. From 1913 when the Federal Reserve System was established, some regulators and politicians were fixated on a nebulous set of activities that they referred to collectively as "speculation." These were activities often related to the stock market, but also to corporate bonds and other types of securities. They objected to the fact that banks were connected to these activities. The opposition to the activities, which seemed to have risen in part from moral considerations, had begun before there was any problem or even reason to think that there would be a problem.

The early history of the Federal Reserve, from 1913 to 1929, has particular relevance. The sponsors of the 1913 bill establishing the Federal Reserve believed that it would reduce speculation by the banks. They continued to be concerned with speculation throughout the next two decades, and there were several attempts to make changes, through the Federal Reserve, that would reduce what they considered speculation. When banks began failing, it was inevitable that those same sponsors would look for ways to hold banks back from speculation and securities.

The way to stop banks from being involved with securities "speculation" was to forbid them from holding those kinds of assets, which is exactly what Glass-Steagall did. In other words, there was no need for evidence that the activities had caused devastation to convince the sponsors that it was a wise measure to enact. The belief that these activities were "evils" made it the most obvious aspect to target for regulation. That is why it has proved so difficult to find empirical support for the arguments supporting the bill.

It is possible that the act was not warranted by the conditions prior to its passage, but that it still had a stabilizing effect on the banking system. Legislation often has effects that were not foreseen or intended, sometimes varying from the goals of those laws. At the end of this paper an attempt will be made to see what the impact was on bank operations. The actual impact is difficult to ascertain from the figures available, since the data were not documented with specific attention to the effect of the act, but perhaps some conclusions can be made based on what is known.

I leave open for future study the issue of what impact the repeal of Glass-Steagall in 1999 had on later financial developments. It is possible that the effect was negligible. As several studies suggested, dealing with securities in the 1920s did not make banks more susceptible to failure.

Similarly, that may have been the case after Glass-Steagall was repealed. On the other hand, it is also possible that permission to engage in a whole host of new activities led banks to recklessly take on new kinds of risk and speculation. It would be necessary to evaluate how banks dealt with the newly permitted areas and how that compared to institutions that had always been permitted to deal with securities of various types. Hopefully, this study will help develop an understanding about the nature of the act and what kind of results could be expected after its repeal that could be used to similarly analyze the repeal of the act in 1999. However, the actual outcome is beyond the scope of this study.

1. Understanding Glass-Steagall

Historical Interpretations of the Act and its Rationale

In 1933, banks were in trouble, and it was recognized that something must be done about it. Beginning in 1929 there were several waves of bank failures. The problem grew to the extent that when President Franklin Roosevelt came into office, he declared a bank holiday on March 6, 1933 during which no banks would open, so that banks could evaluate their assets and attempt to avoid failures. However, that did not stop the banks from failing. In fact, the bank holiday may have exacerbated the problem, as more than 2,000 banks did not reopen after the holiday.[5] The Banking Act of 1933 was passed in response to the banking crisis and made some important changes to the structure and operations of American banks. The act established the Federal Deposit Insurance Corporation (FDIC), to reassure depositors. The act also changed some of the terms by which the Federal Reserve could advance money to banks, making it easier for banks in need to acquire money.

The provision in the act which was perhaps the most controversial became known as the Glass-Steagall Act, named for the sponsors of the act, Senator Carter Glass and Representative Henry B. Steagall. It stipulated that banks that were members of the Federal Reserve System could not deal in investment securities or hold them for their own account. They were not to underwrite the issuing of securities and could purchase them only on behalf of clients. There were also new restrictions on relationships between banks and securities dealers. The act drew a sharp line between the activities of commercial banks in accepting deposits and making loans and activities related to stocks and other securities actions.

The purpose of the bill was to stop the commercial banks from engaging in activities that had not traditionally been considered part of banking. Why that was a desirable goal was not so clear. There are actually several interpretations of the act, but the historical basis for them is tenuous or insubstantial.

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[5] Friedman and Schwartz, *Monetary History*, 330.

The most widespread consensus, originally suggested by the act's sponsors, seems to have been that the banks' activities had somehow led to the stock market crash in 1929, which in turn caused a mass failure of banks and brought on the Great Depression. With such drastic results, it could be readily understood that those activities seen as outside the traditional realm of banks should be stopped. According to this understanding, bank failures had convinced Congress to ban the activities that were seen as having led to the failures.

This enduring view was later expressed by the Supreme Court in a 1971 case *Investment Company Institute v. B. Camp*[6] in which the Court ruled that Glass-Steagall did not allow for accounts that combined investments with deposits. In its explanation for the act's passage, the Court said that "it is apparent from the legislative history of the Act why Congress felt that this drastic step was necessary." That was because "Congress was concerned that commercial banks in general and member banks of the Federal Reserve System in particular had both aggravated and been damaged by stock market decline partly because of their direct and indirect involvement in the trading and ownership of speculative securities." The most sensible way to react to this was to prevent involvement in similar trading. Although Congress understood that there could be positive aspects to banks trading securities, "the Glass-Steagall Act reflected a determination that policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the 'hazards' and 'financial dangers' that arise when commercial banks engage in the activities proscribed by the Act."[7] In the Court's telling, the "drastic step was necessary" since securities-related activities had led to "financial dangers." Banks had both caused damage and been damaged due to their investments in securities. Congress was determined to stop these unnecessary dangers from happening.

The Court's understanding of the act is perhaps most clearly expressed in a 1981 decision,

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[6] 401 US 617, 91 S.Ct. 1091 (1971).
[7] Ibid., 1098.

Board of Governors of the Federal Reserve System v. Investment Company Institute, which also sought to define what was included in the act.[8] Citing Senator Glass' statement, the Court explained that "it is familiar history that the Glass-Steagall Act was enacted in 1933 to protect bank depositors from any repetition of the widespread bank closings that occurred during the Great Depression." This familiar story was known to Congress, which "was persuaded that speculative activities, partially attributable to the connection between commercial banking and investment banking, had contributed to the rash of bank failures." In fact, the ruling continues, there is strong evidence for this connection, and "the legislative history reveals that securities firms affiliated with banks had engaged in perilous underwriting operations, stock speculation, and maintaining a market for the bank's own stock, often with the bank's resources." Although the earlier decision had failed to mention any evidence, the Court now believed that due to this evidence, "Congress sought to separate national banks, as completely as possible, from affiliates engaged in such activities."[9] Here the Court asserts that the banks' involvement in investment operations had specifically led to the extensive amount of bank failures that took place in the early 1930s. The point of the act was to protect depositors from losing their deposits again in this manner.

In contrast to the Court's understanding, another view held that the act was implemented not to protect bank depositors, but rather to protect the buyers of securities and address the problems in the securities market. An article prepared for a congressional testimony by Federal Reserve Chairman Paul Volcker in 1986 reported that "Congressional hearings on the securities practices of banks disclosed that bank affiliates had underwritten and sold unsound and speculative securities, published deliberately misleading prospectuses, manipulated the price of particular securities, misappropriated corporate opportunities to bank officers, engaged in insider lending practices and unsound transactions with affiliates." Not only were banks promoting risky securities, there were also under pressure to

[8] 450 US 46, 101 S.Ct. 973 (1981).
[9] Ibid., 984.

continue supporting those assets. This in turn caused “confusion by the public as to whether they were dealing with a bank or its securities affiliate” and led to the “loss of confidence in the banking system.” This explains more specifically why banks were more harmful when they sold securities. Banks were different than all other institutions involved in securities, since they were more easily able to defraud the public. Also, banks were invested in companies and had an incentive to make unwise loans to them. The banks were, thus, “deliberately misleading” the investors, who thought they were getting sound investments.[10]

Differing from these explanations, another approach focused on banks’ relationships to their clients and how they could have exploited the trust of the clients. Bank officials were respected by the public for their knowledge on financial matters, and, it was argued, they would convince people who did not know better to buy risky securities that the banks needed to sell. A 1970 brief to the Supreme Court filed in the case of *Investment Company Institute v. B. Camp* described “three well defined evils” that “were found to flow from the combination of investment and commercial banking.” The included the two aforementioned reasons and added that “a commercial bank’s financial interest in the ownership, price, or distribution of securities inevitably tempted bank officials to press their banking customers into investing in securities which the bank itself was under pressure to sell because of its own pecuniary stake in the transaction.”[11] The brief combines all three reasons: the banks were risking depositors’ money; they were also making unsound loans; and they were “inevitably tempted” to push unknowing investors into unwise deals.

Apart from the agreeing that the banks’ securities operations had led to complications, there does not appear to have been much agreement about which conditions led to the act. The Supreme Court felt that investment activities had led to widespread bank failures. Others believed that banks

[10] Appendix A to the Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Government Operations of the United States House of Representatives (June 1986). Cited in Benston, *Separation of Commercial*, 12.

[11] *Brief for Respondent First National City Bank*, 1970 WL 121913 (U.S.) National Association of Securities Dealers, Inc. v. S.E.C., 1970.

were pushed to support bad investments. And others asserted that banks were pressing regular citizens into bad investments. These were all believed to have been behind the decision to ban commercial banks from dealing with securities. It appears that scholars looking back at the act could not find a clear reason for its establishment. There may have been many problems with banks prior to the act, but, as will be discussed later, these were not the reasons given at the time of the act's passage.

Evidence for Explanations

Later researchers, including economists Eugune N. White,[12] George J. Benston,[13] and Randall S. Kroszner and Raghuram Rajan,[14] looking for evidence, that was believed to have been established before the act was passed and would demonstrate problems caused by banks dealing in securities, were unable to verify the alleged problems. They did find that there were many abuses by the banks, and many banks clearly did fail. But it had not been so certainly established that banks' involvement in securities had led to the abuses or the failures. It was also not evident that investments made by commercial banks were any more risky than investments made by other institutions.

The Congressional hearings in 1931 that led to the act investigated many aspects of the banks' operations. Congress was interested in finding all instances when banks had caused unnecessary losses. Yet the hearings did not conclude that investments had caused, even indirectly, those losses. The hearings confirmed that "the wholesale underwriting of securities does tend at times to leave the security affiliates with big unsold commitments that, in times of rapidly declining prices, may result in large losses of at least a temporary nature."[15] All that was actually stated is that the commitments may result in losses. There was no evidence that deposits in banks suffered from those potential losses, nor

[12] White, "Before the Glass-Steagall Act."
[13] Benston, *Separation of Commercial.*
[14] Kroszner and Rajan, "Is the Glass-Steagall Act Justified?"
[15] *Hearings* 1931, 1057-58.

is there any evidence that banks misled their clients. An example was given at the hearings of losses in Bethlehem Steel Corporation common stock. The stock went from a high of $139.50 in August 1929 to a low of $7.25 in June 1932.[16] This was just one example of the extent of losses from investments that went bad. However, the fact that a company could be exposed to losses like Bethlehem Steel is quite logical. Every investment takes on a certain amount of risk, but that does not mean that it was actually a factor in causing bank problems;[17] for that, the hearings offered no evidence.

From all the bank officers who gave testimony at the hearings, there was little connection drawn to actual failures of banks. In *Investment Company Institute v. B. Camp*, the Supreme Court decision cited a specific example of the failure of a bank with investments, the Bank of United States, which was, in fact, the only failed bank that the hearings cited to demonstrate the trouble of holding securities. The Bank of United States, which failed in December 1930, was seen as having failed due to speculative investments with depositors' money. According to the hearings "the failure of the Bank of United States. . .served to center attention upon the fact that banks may make large loans to affiliated corporations which. . .became so unwieldy as to have led to the collapse of the institution."[18] However, a 1985 study of the assets of the bank and its affiliates by economist Joseph Lucia showed that the main holdings were not securities, but real estate.[19] The bank made too many real estate acquisitions at the height of the boom and overpaid for them.[20] The principal officers also tried to manipulate the bank's own stock and assets for their personal gain and to avoid bank examiners. But this was not related to securities activities and would not have been prevented by the Glass-Steagall regulations.[21]

There is no doubt that some banks in the 1920s engaged in abuses and fraud. The hearings produced many instances of investments that went bad and resulted in losses, but there was little

[16] The historical prices were found using Wharton Research Data Services online.
[17] See Benston, *Separation of Commercial*, 27-29.
[18] *Hearings* (1931, p 1017) appendix.
[19] Lucia, "The Failure of the Bank of United States," 402-416.
[20] This is actually the statement of Senator Walcott as an example of abuse of the banks (*Congressional Record* 1933, 9905).
[21] Benston, 31.

evidence that those losses were what caused banks to fail. Economist Eugene N. White tested the claim that securities affiliates were dependent on and thus endangered the banks. In a 1986 study, he found that banks did not become more susceptible to losses when they acquired securities; rather they "increased their liquidity when their affiliates' borrowing rose faster than cash assets."[22] White also performed a study comparing the proportion of banks that dealt in securities to other banks. Based on the allegations made at the Glass hearings about bank activities, it would be expected that banks with securities, which were usually held by wholly owned affiliates dealing specifically with securities, would have had a much higher rate of failure. In fact, White found, that "while 26.3% of all national banks failed in this period, only 6.5% of the 62 banks which had affiliates in 1929 and 7.6% of the 145 banks which conducted large operations through their bond departments closed their doors."[23] White concludes that those banks were actually safer, probably because they were larger and more diversified.

Likewise, the allegations that securities operations produced conflicts of interest have been difficult to substantiate. The Pecora Hearings in 1933, which will be discussed later, revealed many instances of abuse and misconduct by bankers. However, there is little reason to believe that those abuses were caused or exacerbated by the banks' involvement in securities. In 1990 George J. Benston, an economic historian, conducted an exhaustive review of the various claims against the banks and found that "the record does not support the belief that the pre-Glass-Steagall period was one of abuses and conflicts of interest on the part of banks involved with securities transactions."[24]

A 1994 study by economists Randall S. Kroszner and Raghuram G. Rajan compared the quality of investments made by commercial banks and their affiliates to those made by investment banks, which did not have depositors and were not accused of abusing relationships to make fraudulent investments. Their analysis found that securities issued by investment banks from 1921 to 1929 were more likely to default than those made by commercial banks. Whereas 39% of the former defaulted,

[22] Ibid., 48.
[23] White "Before the Glass-Steagall Act," 40.
[24] Benston, *Separation of Commercial*, 107. In chapter 4 Benston details his arguments.

only 28% of the latter did so.[25] This is contrary to what would be expected had the securities operations of commercial banks been the cause of failures, as implied by the Glass-Steagall Act. Kroszner and Rajan used several other methods of analysis and determined that "not only did bank affiliates underwrite higher-quality issues, but also we find that the affiliate-underwritten issues performed better than comparable issues underwritten by independent investment banks."[26]

It would be remiss to exclusively rely on the studies which question the logic behind the Glass-Steagall Act and ignore the well-researched studies which rely on conclusions of the 1931 committee which investigated bank operations. They include detailed examinations of the bank abuses and failures, in addition to the Pecora Hearings, which revealed many abuses in the banking industry.[27] Nevertheless, while one could insist that the alleged problems *may* have indeed occurred, the evidence is far from conclusive that bank investment activities led to major failures or economic difficulties. Bank failures and economic trouble in 1933 seem to have persuaded Congress and the public at the time that bank investments were at fault, but the records do not back up those assertions.

Due to the difficulty in substantiating the reasons given for the Glass-Steagall Act, scholars, such as Benston, have looked for other possibilities. There have been various alternative (or revisionist) explanations for the act. In 1932, Senator Robert Bulkley of Ohio, a member of the Committee on Banking and Currency, described securities activities as antithetical to foundations of banking, "the idea of increased profits. . .diverted from the pride of safe and honest banking service to that of profits, greed, expansion, power, and domination."[28] Benston suggests that this may have been an underlying reason for the act, since others may have shared Bulkley's view that investment is alien to real banking. However if that was truly the reasoning behind the Glass-Steagall Act, it is difficult to understand how Glass, the main sponsor and proponent of the bill, would propose to remove the ban on securities

25 Kroszner and Rajan, "Is the Glass-Steagall Act Justified?" 817.
26 Ibid. 829.
27 Carosso, *Investment Banking*, 346. Seligman, *Transformation of Wall Street*, 28.
28 *Congressional Record*, 1932, 9910.

activities just two years later.[29] Although it was probably an attempt to stimulate the inert underwriting market[30] and would have been only a partial repeal, it does not seem to have been perceived as contrary to the fundamentals of banking. Thus, concerns about diverging from authentic banking do not appear to have been an important motivation behind the act.

[29] See *New York Times* Feb 4, 1935 and July 6, 1935. Roosevelt rejected the idea, and it was removed from discussion. See *New York Times* August 13 and 17, 1935.

[30] See Carosso, *Investment Banking*, 371-372.

2. Federal Reserve as Defense Against Speculation

The Federal Reserve and Bank Speculation

Besides approaches that looked at problems with banks in the 1920s, various other explanations have been proposed for the act. However, as it will be argued in the pages that follow, the proponents of the act felt it apparent that its provisions were necessary years before it was actually suggested. Long before there was a crisis or even reason to fear a crisis, the activities of the banks were already causing much concern. However, rather than a specific type of activity causing concern, it was the fact that banks were seen as involved in speculation, which could potentially include a wide range of activities including any type of buying and selling of stocks and real estate. It will be suggested that rather than the events of the Great Depression and bank abuses, it was these enduring perceptions that led to the passage of the Glass-Steagall Act. The activities of the 1920s did not inevitably cause the failures of the banks. The failures provided an opportunity to implement changes to bank operations that had been conceived many years earlier.

In general, scholars distinguish between investment and speculation. The financial analysts Benjamin Graham and David Dodd, in their 1934 book *Security Analysis*, defined investment as operations based on analysis of the safety and return of the investment. Everything else was considered speculation.[31] Another approach, which is perhaps just an elucidation of Graham's and Dodd's, defines speculation as a purchase with the intention to resell at a later date with the expectation that the price will rise in the meantime.[32] Nevertheless, as Graham acknowledged in a later book *The Intelligent Investor*, published in 1949, all investments have an element of speculation in them.[33]
An assertion that banks or other institutions were engaged in speculation must attempt to define which activities are considered undesirable speculation. This was, however, not performed. It remained a

[31] Graham and Dodd, *Security Analysis*, 34.
[32] Kaldor, "Speculation and Economic Stability," 1.
[33] Graham, *Intelligent Investor*, 1-3.

vague assertion that banks were engaged in speculation without defining it.

The concern with speculation on the stock market did not begin with the bank failures at the end of the 1920s. Whenever there was a problem with banks in previous decades, there would inevitably be people blaming the problems on speculation by the banks. The first major reform of the American banking system of the twentieth century was in 1913 with the passage of the Federal Reserve Act. Although it is not commonly recognized by most narratives of the central bank's establishment, the Federal Reserve Act was to a large extent a reaction to perceived speculation and an attempt to constrain the speculation. The methods and regulations of the Federal Reserve System served to aid this goal of containing speculation. It is thus a helpful place to begin looking at the concerns about speculation that eventually brought about the Glass-Steagall Act.

The Glass-Steagall Act, sponsored and advocated by Senator Glass, incorporated his principal concerns with the banking system and was the culmination of his long career in managing the nation's banks and finances. Those same concerns were evident in all his years of involvement with the financial system. His first bill, and the most influential, was passed in 1913 and initially called simply the "Glass Bill," but later became known for the important institution that it spawned, the Federal Reserve. Glass' main conceptions of how banking should operate were included in some form in the Federal Reserve Act, although perhaps not in a very effective manner.

The obvious purpose of the Federal Reserve was to correct the problems that were inherent to the American banking system and led to continual bank failures. With an effective system in place, there should not have been an opportunity for major crises to hit the banks. Therefore, the shocks to the banking system in the early 1930s must inevitably be seen in relation to the Federal Reserve. The failure of the banks was in effect a failure of the Federal Reserve, either in its specific actions or in its general composition. Since the Great Depression, there has been debate about the role of the Federal Reserve in countering the economic crisis. There are some critics, principally the economists Milton Friedman and Anna Schwartz in their 1963 book, *A Monetary History of the United States*, who blamed the failures of the banks on the inactions of the Federal Reserve.[34] Others defended the Federal Reserve and placed the blame on the banks. The problem, they believed, was not in the actions or inactions of the Federal Reserve but in its structure. They argued that the Federal Reserve should have been given the power to prevent the problems from occurring and agree that had the Federal Reserve been organized differently the crisis might have been prevented.[35] Nevertheless, by what it did not or could not do, the Federal Reserve evidently had a major role in the later bank operations and failures.

The purpose and scope of the Federal Reserve cannot be separated from a discussion of the bank failures of the 1930s. The regulations enacted as a result of the failures may be best understood by examining the establishment of the Federal Reserve itself. And the discussion at the time of the passage of the Federal Reserve Act is significant for the impact it had on later issues, eventually leading to the Glass-Steagall Act. Moreover, it will be argued that the reasons given for the Glass-Steagall Act were the same reasons given for establishing the Federal Reserve. The failures of many banks in the early 1930s seemed to undermine the Federal Reserve System. The passage of the Glass-Steagall act can, therefore, be seen as means of protecting the Federal Reserve from actions that were regarded as subverting the objective of the reserve bank.

The second half of the nineteenth century was a turbulent period for American finance, as the United States went through several bank panics. Throughout this period many observers believed that the problem lay in individual offenses and poor judgment rather than in the system. The panic of 1873 began with banks that had made unwise investments in railroad companies, which had expanded prematurely into an undeveloped West and then failed.[36] Similarly, the panic of 1884 could be traced to a steep drop in utilities stocks and the banks that put money in them as well as other speculative ventures.[37] (This episode prompted the London magazine *The Spectator* to call Americans "a nation of

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[34] See Friedman and Schwartz, *Monetary History*, 340-341.

[35] See Temin, *Monetary Forces*, 30. Wigmore argues that there is no justification for assigning responsibility to the Federal Reserve. See Wigmore, *Crash and Aftermath*, 125-127, 212-227, 549-556.

[36] Wicker *Banking Panics*, 19.

[37] Ibid., 59, 35.

the most degenerate gamesters in the world."[38]) And the panic of 1893 was triggered by the collapse of industrial stocks, which led to the failures of many banks.[39]

Although it was possible to blame each event on its own excess speculation, some began to wonder whether the problem with American banks was, in fact, a systemic one. While there had clearly been unwise speculation in many firms, speculation did not necessarily have to lead to bank failures. At each episode, a general panic would ensue among the public, who were worried that all of a bank's funds would be lost. Deprived of their deposits, the banks would fail. But if some way could be devised to make it easier to supply banks with money when their funds were low, the waves of failures could perhaps be avoided. Several plans were put forward focusing on those solutions to provide banks with more funds during times of emergency, including the 1894 Baltimore Plan and, with many variations, the 1897 Indianapolis Plan. These plans were controversial at the time and were never implemented. However, the fact that there were well-publicized plans to change the banking system is evidence that it had become widely acknowledged that there was a problem with the system, rather than just with speculation of individual investors.[40]

In 1907 there was another major banking panic, which was severe enough to remove any doubt about the need for reforming the banking system. An attempt to manipulate the price of a mining company, based on a mistaken stock market calculation, set off a panic. Several related banks were brought down.[41] There was no apparent way out of the crisis as banks continued to close until the efforts of a group of bankers led by J.P. Morgan slowed the runs on banks. They contributed to a pool that could be accessed by other banks in distress.[42] At the time, a bank in need had no means of obtaining immediate funds. These bankers provided what the banking system did not.

Although the actual panic lasted just a few weeks and did not prove to be among the worst such

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[38] Cited in Ahamed, *Lords of Finance*, 270.
[39] Wicker, *Banking Panics*, 59.
[40] West, *Banking Reform*, 43-46.
[41] Bruner and Carr, *Panic of 1907*, 43-45.
[42] Ibid., 89-103.

panics, its impact was felt across the nation. Banks were forced to withhold cash payments and give certificates instead, which people then used to barter for goods. In some cases other items were used instead of cash. Streetcar companies in Omaha and St. Louis paid their employees in nickels from the fare boxes or in fare-tickets. The panic had caused depositors to withdraw their money and hoard it. It is estimated that over $200 million was stashed away, and the demand for deposit boxes spiked.[43] With events like these, the troubles in the banking system could no longer be ignored.

Congress understood that it was necessary to come up with a plan that would be able to provide money at times when the funds of a bank were low.[44] The Aldrich-Vreeland Act, a temporary act passed in May 1908, allowed the banks to issue more money. The act stipulated that, in times of emergency, banks would be allowed to issue more money based on the assets they were holding. In effect, they could simply expand the money supply when necessary.[45]

The act gave a couple of options for obtaining money. Banks were allowed to issue up to 75% of the amount of securities and other non-public assets and up to 90% of public assets; previously they been able to count as assets only deposits. If they felt the money was necessary, they could apply to National Currency Associations that would be established by groups of banks. The associations, in various cities, would determine how much money the banks could issue. These options were, albeit in a different form, the basis of the future reserve banks.

The Aldrich-Vreeland act was invoked on one occasion. In July 1914, when World War I began in Europe, many depositors became anxious about the security of their money. The emergency measures of the act were put into effect, and the runs on banks subsided.[46] The act was successful in preventing a larger crisis.

However, the act was intended only as a temporary device in case of emergency. Rather than

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43 Ibid., 135-136.
44 Friedman and Schwartz, *Monetary History*, 168-169.
45 Ibid., 170. Studenski and Krooss, *Financial History*, 254.
46 Friedman and Schwartz, *Monetary History*, 172.

correcting the system as a whole, it had merely provided some emergency provisions. Congress, though, was intent on making major changes to the banking system and how banks operated; in 1908, it used a provision of the act to establish a committee to study the banking system and how it could be improved. Led by Senator Nelson Aldrich of Rhode Island the committee would be composed of nine senators and nine representatives. Although it would take a few years until the sweeping changes were implemented, the main innovations, which were the establishment of a central banking association and the ability to issue currency backed by any assets, were already embedded in the Aldrich-Vreeland act.[47]

The Aldrich committee took to its task seriously and began to study alternatives to the American banking system. They traveled abroad to interview central bankers, then published reports on their findings.[48] For several years they were unable to come up with a plan for the American system. Finally, in 1911, under pressure to produce something, they proposed the Aldrich Bill. It was the first bill introduced in Congress for reforming the banking system.

The most distinctive aspect of the bill was its regional reserve branches. The Aldrich Bill proposed a group of banks in different cities to be called the National Reserve Association. The banks were to take deposits only from their member banks. There would be no deposits from the government or the public.[49] While the government would appoint some of the members of the board, the majority was to be chosen by the banks. This emphasis on private control of the bank generated much opposition and was part of the reason that the bill failed.[50] However, the main features of the bill were not ignored and were incorporated in later proposals.

In fact, most of what the committee suggested had already been proposed by others in the private sector several years before. Most prominent among them was Paul M. Warburg, a German

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47 See West, *Banking Reform*, 51.
48 An archive of these reports can be found at the website of the St. Louis Federal Reserve http://fraser.stlouisfed.org/historicaldocs/nmc.
49 West, *Banking Reform*, 73.
50 Ibid., 86.

banker who in 1902 had joined a prestigious New York banking firm. His ideas became well known by 1910, as he published several essays and spoke at a number of venues on the subject. Many aspects of his plan were eventually used in the American reserve banks.[51]

According to Warburg's plan, a bank would be located in Washington, with branches in twenty other cities. It would be established by interested banks and have a large deposit of money that could be accessed by its members. Only the member banks and the federal government would be able to deposit in this bank. It would be called the United Reserve Bank, and its directors would be known as governors.[52] Importantly, this bank would be the sole issuer of currency in the United States. This was a major change from the existing system, which allowed any national bank[53] to issue currency. The similarity to the reserve plans is easily apparent. Many elements were used in the Aldrich committee plan and were eventually incorporated into the Federal Reserve Act. The committee and the scholars who had researched the banking system had identified, and seemed to agree on, which reforms would be necessary.

Speculation as Cause of Failures

The main contours of what would become the Federal Reserve System were, thus, known and accepted by 1911. Nevertheless, when the reserve system was finally established, it was seen by its sponsor as something very different from any of the suggestions that had come earlier. This may be because it represented other goals and a different understanding of the problems in the system. A different perception of the trouble with the American banking system could, therefore, lead to a different understanding of what a reserve bank should accomplish. Thus, Glass may have been justified in believing that the reserve system that was realized, although it shared the main characteristics of the earlier plans, had a different goal and was really a different kind of system.

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[51] Ibid., 59.
[52] Ibid., 57-58
[53] These were banks with national charters as opposed to state charters. The national banks were not allowed to operate in more than one state.

There appeared to be an agreement, among most observers, that the problem lay in the structure of the American banking system. Each bank was on its own when it needed to raise funds. Much of the focus was therefore on structuring banks in such a way that they would have access to funds when it was necessary. The success of Morgan and the other bankers at supplying emergency funds and restoring order was a clear indicator that the banking system needed its own method of similarly supplying funds to banks. But there was another approach to the problem that posited the blame not on the system, but on the bankers. If the bankers had not made reckless investments, it was argued, the banks would not have needed the emergency funds.

In the aftermath of the 1907 panic, banks found themselves blamed for the crisis. President Theodore Roosevelt called for federal regulations on speculation and margin trading. And New York’s Governor Hughes appointed a committee in 1908 to investigate how speculation could be prevented. However, the committee was stopped by a problem shared by everyone who analyzed speculation. They found that it was easier to decry speculation than to identify it and that it would be difficult to ban speculation without also affecting necessary activities. They complained about "the practical impossibility of distinguishing what is virtually gambling from legitimate speculation."[54] These attempts to change how banks operated were not successful and were soon forgotten.

However the tendency to criticize the banks persisted. Along with Wall Street, the efforts at reforming the banking system were also criticized. The various plans that had been proposed for a reserve bank were denounced for giving the banks more opportunities to speculate rather than reining them in. Woodrow Wilson took up the issue and made the opposition to Wall Street part of his 1912 presidential campaign.[55] There was clearly popular opposition to how banks operated.

This opposition soon led to criticism of other areas of the financial sector. It was believed that bankers simply had too much power. The fact that bankers had come together in 1907 and saved other

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[54] Ibid., 133-134.
[55] Ibid., 90.

banks was seen as part of the problem. It was an indication of the great power that was in the hands of a small group of people. In fact, a senator accused the bankers of having "brought on the late panic, to serve their own ends." In this suspicious environment, fears were raised that a group of people controlled the entire system and were perhaps running a “money trust,” through which they would manipulate businesses so that they would profit while denying opportunities to others.[56] A committee was established in late 1913 to investigate the actions of Wall Street.[57]

The chairman of the committee was Congressman Arsene Pujo, of Louisiana, who had until then been a member of the Aldrich committee that was looking for banking solutions. In early 1913 after Wilson’s election and the Democrats’ taking control of both houses, he left to head the committee that would investigate what bankers did. Its specific goal was to ascertain whether a “money trust” existed in which a group of people held an inordinate amount of power over the economy. It also addressed some of the larger questions about the nation’s financial and monetary conditions.[58] It was both a sign and a catalyst of a deep distrust in the nation’s banks.

At the hearings, the leading investment bankers were called upon to testify and excuse their actions. The committee eventually reached the conclusion that there was in fact a group of people, based in the large Northeastern cities, who were manipulating the economy to their benefit. They declared that “the powerful grip of these gentlemen is upon the throttle that controls the wheels of credit and upon their signal those wheels will turn or stop.”[59] As it was later presented by Justice Louis Brandeis,[60] there was an inner group that had control, not only over financial institutions but also over the nation’s largest transportation and industrial companies.[61] Banks were apparently always finding ways to reap profits from other people’s work and money.

The hearings went beyond general economic activity and also touched on investment

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56 Carosso, *Investment Banking*, 131.
57 Ibid., 135-136.
58 Ibid., 138.
59 Money Trust Investigation: Report, 132.
60 Brandeis, *Other People’s Money,* 19-20.
61 Carosso, *Investment Banking*, 142-144.

operations. The committee voiced its disapproval of banks' investments and asserted that "it is unquestionable that only a small part of the transactions upon the exchange is of an investment character; a substantial part may be characterized as virtually gambling…In its nature it is in the same class with gambling upon the race track or at the roulette table."[62] Various cases of alleged stock manipulation were analyzed.[63] In a recurring theme, buying and selling securities were seen as being identical to gambling in its methods, results, and social desirability. The conclusion was that large portions of investments were pure speculation and had caused many of the bank crises.

The committee's recommendations touched on many issues. One is of particular relevance. It was recommended that Congress prohibit national banks from buying, selling, or lending stocks, so that banks would not use their "facilities for gambling."[64] Moreover, banks should not be allowed to have ties with securities affiliates because "the temptation would be great at times to use the bank's funds to finance the speculative operations of the holding company. . .whether under the guise of a mere lender of money or underwriter or purchaser of securities."[65] In fact, the first section of the bill introduced in Congress was about banning banks from securities operations.[66] This points to a widespread suspicion of stock market activity, especially when performed by a familiar institution such as a bank.

None of the Pujo committee's twenty or so recommendations were enacted.[67] The findings of the committee were apparently not very convincing. Nevertheless it had an impact in other ways. Even if the existence of a money trust was not so apparent, there was a widespread feeling that bankers were not operating in a manner that was best for the nation. It seemed that a public institution could do a better job than the private bankers had done. This supported the idea that a central bank should supervise the activities of private banks to ensure that they did not engage in harmful behavior. [68]

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[62] Money Trust Investigation: Report, 43.
[63] Ibid., 46-52.
[64] Ibid., 125
[65] Carosso, *Investment Banking*, 155, 164.
[66] Ibid., 166.
[67] Ibid., 176.
[68] Ibid., 177.

The Glass Bill and Its Objectives

At the same time that the Pujo committee was established, another subcommittee of the House Banking and Currency committee was set up, chaired by Congressman Carter Glass, of Virginia. It was tasked with examining the options for an American central bank, the same issues that the Aldrich committee had spent several years on. Glass saw it as literally being part of the same mission as the Pujo committee. It was simply that “Chairman Pujo divided his committee into two sections, one to go after ‘the Money Devil’ and the other to pursue the constructive work of revising the currency system.”[69] It is significant that the chairman of the committee that would establish an American central bank saw his committee as part of a movement against banking overreach and abuses. This would understandably have an effect on the kind of central bank he would try to produce.

One of the themes that Glass repeated was that his task was to create a system that was different from Aldrich’s. He announced at the beginning of the hearings that “it is nevertheless a fact that we must recognize and deal with that the party of the majority members has specifically declared against what is known as the Aldrich bill.”[70] The Aldrich bill was seen as being too accommodating to bankers. Glass later reiterated that the Democratic Party had declared conclusively against that plan, so that any part of it must be precluded from consideration.[71] Every part of the Glass bill would be scrutinized to see whether it was similar to the Aldrich bill.

This was a difficult feat to accomplish. The Aldrich bill had, after all, been an attempt to set up a system that would have pooled reserves and acted as lender of last resort. It would be difficult to avoid everything associated with Aldrich and still accomplish the same goal. This is what Paul Warburg in his testimony to the committee tried to convey somewhat humorously, saying, “do not forget that the Aldrich plan contains some things which are simply fundamental rules of banking. Those you will have

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[69] Glass, *Adventure in Constructive Finance*, 68.
[70] *Hearings*, 1913, 3.
[71] Ibid., 73.

to include in every plan, and I think that the Democratic Party would make a great mistake, if I may say so, to say, 'Because Senator Aldrich ate his soup with a spoon we are not going to eat with spoons but must use forks.'"[72] Nevertheless, Glass maintained that his plan was to be radically different from Aldrich's.

There was one conceptual point that Glass was most concerned about. The essence of the Aldrich plan, according to Glass, which had been rejected by the Democrats, was its idea of a central bank. It called for the establishment of a single bank that would manage the reserves of the nation's banks. There would be branches in several cities, but there would be one location that would control all the reserves. Glass did not like the idea of a central bank taking the power to decide away from the people. He felt that it would continue the existing problems by concentrating too much power in the financial centers. What the American system needed was a bank that did not make decisions centrally.

His proposal was to create regional banks, which would represent the interests of their respective regions. They would each have their own reserves and would be linked by monetary policies directed by a central board. As it was later described "the Glass bill is modelled [sic] upon our federal political system. It establishes a group of independent but affiliated and sympathetic sovereignties, working on their own responsibility in local affairs, but united in national affairs by a superior body which is conducted from the national point of view. The regional banks are the states and the Federal Reserve Board is the Congress."[73]

The purpose of regional banks was more than just to keep the power away from a central entity. An advantage of a regional bank was that it could have an understanding in the local conditions and set policy accordingly.[74] Instead of making decisions based on conditions in the financial centers, each region could proceed with policies best for itself. It would also allow for easier oversight of what the banks were doing with the money. Since all the reserves would be handled by a regional bank, that

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[72] Ibid.
[73] Glass. *Adventure in Constructive Finance*, 173-174.
[74] *Hearings*, 1913, 665-667.

reserve bank could pay close attention to how the money was dispensed. Regular investigation was seen as an important function of the reserve banks.[75]

Establishing these regional banks was apparently, for Glass, the most important aspect of the bill. As his subcommittee expert, Glass chose Henry Parker Willis, a professor at Washington and Lee University. Glass explained that “the selection indicated was made by the chairman only after the latter in quite a few intimate talks was convinced that Dr. Willis entertained views akin to his own definite idea of establishing a system of regional banks authorized to issue notes on the basis of commercial transactions.”[76] The regional banks and their ability to regularly investigate what banks did were at the core of Glass’ bill.

There was such interest in monitoring what banks did because there was evidently concern about the legitimacy of some of the activities. In particular, the idea that banks were too involved in speculation came up frequently. Some of the witnesses at the hearings explained that what had been called speculation was really just a normal method of buying and selling. One compared the stock activity to a whiskey merchant who might decide to order more whiskey than usual, hoping that the customers would be interested in buying more. It could later turn out to have been an unwise decision. But that is part of the regular operation of a business.[77] Another witness tried to clearly define the difference between speculation and gambling.[78] Nevertheless, the committee was not convinced by these arguments and remained determined to stop that kind of activity.

It was not clear that Glass’ new system could actually work. In fact, critics of the bill were opposed to precisely the part that Glass was so fond of. If the purpose of establishing a “reserve” bank was to hold the nation’s reserves and make them accessible to banks in need of funds, then that would

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75 Section 21 of the Federal Reserve Act required regular examinations of every member bank of the Federal Reserve and gave the right to conduct inspections as frequently as necessary. West (*Banking Reform,* 109) notes that the Aldrich plan gave similar powers of inspection. But it did not *require* any examinations. Clearly this aspect was more important in the Glass bill.

76 Glass, *Adventure in Constructive Finance,* 69-70.

77 *Hearings,* 1913, 461.

78 Ibid., 530.

be better served by having a single bank handle all the reserves. In addition, others argued, the reserve banks in the smaller regions would be too small to raise the money necessary to support their member banks.[79]

At the same time, opponents of the bill wondered in what way it was not actually a central bank. The main policy decisions were left in the hands of board in Washington. Some congressmen argued that Glass gave more power to the board than Aldrich had. "This plan is much more centralized, autocratic, and tyrannical than the Aldrich plan. It is true that we are to have 12 regional banks….The power is not with them; they are not in any material matter given the right of independent action; they must obey orders from Washington."[80] There was no general agreement that the regional system was the best way to set up reserve banks.

Nevertheless, the bill was pushed through generally in agreement with Glass's ideas. It stated that there would be between eight and twelve banks in different cities. All national banks were required to remit their reserves to one of the banks. It also specified how many members would be in the Federal Reserve Board in Washington and what its powers were. Guidelines were given as to what was considered proper bank assets. And the regional banks were given power to deal on the market. The bill was signed into law in December 1913, with the name "Federal Reserve Act." With some minor exceptions, Congress established a reserve system that adhered to the main objectives that Glass believed would save the banking systems from its previous problems.

It is, however, difficult to deny that the bill was very similar to the Aldrich Bill and incorporated elements from the other plans that had been published in the preceding years. In fact, even the idea of regional banks had been proposed by a scholar in the private sector, Victor Morawetz, a New York corporate lawyer who was also trained in economics, in 1909.[81] Notwithstanding the similarities, Glass felt that his bill was utterly distinct from anything that had been proposed earlier and insisted that "the

[79] West, *Banking Reform*, 107.
[80] Ibid., 118-123.
[81] Glass later denied it had any influence on him. See West, *Banking Reform*, 59-65, 95.

Federal Reserve Act has no relationship to the Aldrich plan beyond a common use in some cases of indispensable banking technique and nomenclature."[82] Furthermore, Willis, the subcommittee expert, claimed that "[i]t was not derived from, or modeled after, or influenced even in the most remote way by other bills or proposals currently put forward from private sources, but, on the contrary, it was itself the pattern from which a host of imitators sought to copy."[83] It would be simple to dismiss this all as Glass' attempt to portray his own work as creative and original. However, there is one aspect of the act that is fundamentally different from the suggestions that preceded it, even if the practical implications may not have been very consequential. The motives for establishing the reserve banks and, thus, the goals set for them were conceived of differently by Glass: rather than being a method to make bank operations safer, he saw the reserve banks as a means to change how commercial banks operated.

The basic reason for having reserve banks was to have a lender of last resort. The Aldrich plan and the other suggestions were a response to the lack of a central facility to hold reserves, and the goal was to set up a system that would allow banks in need to access funds. The Glass plan on the other hand was concerned with another aspect of banks. One of its underlying themes was the tendency of banks to engage in activities that, instead of promoting business, were a source of risk and failure. It concerned itself not only with what facilities banks were missing but also with what banks were doing wrong. Therefore, it sought not only to provide banks with funds when necessary, but also to deprive them of excess funds when not needed for business operations.

In 1927 Carter Glass published *An Adventure in Constructive Finance*, which was his attempt to correct various conceptions about the Federal Reserve and its establishment that he felt were mistaken. His description of the purpose of the Federal Reserve is particularly relevant to this discussion and provides a look into the reasoning behind the Federal Reserve. He describes a banking system that "handicapped" the United States for fifty years. One of the main problems, or "Siamese twins of

[82] Glass, *Adventure in Constructive Finance*, 239.
[83] Willis, *Federal Reserve System*, 523.

disorder," was that there was no official reserve system. Banks in rural areas would often have an influx of deposits during quiet farming seasons. These banks did not want the deposits lying around and serving no purpose, so they would send them to the large banks in the cities, which would pay interest and use the funds for their own investments. According to Glass, "the consequence was that the sum total of the idle bank funds of the nation was congested at the money centres [sic] for purely speculative purposes." The purpose of the Federal Reserve Act was to "revolutionize" the "wretched system"[84] by setting up reserve banks where the rural banks could place their excess funds.

In addition to providing a reserve bank, the Federal Reserve Act also kept the money away from the larger banks that, Glass, asserted, had been a "breeder of panics."[85] When the city banks had all those excess funds, they would use it for loans "on call, for speculation." Then, "with stock gambling in full blast," the rural banks would find that they suddenly needed funds for customers who had become busy again. The rural banks would turn to city banks and demand their funds back. However, the "speculative loans" had been "extended beyond all capacity to pay," and when banks needed money but could not obtain it, this "would create consternation." Along with the general concern, there would be specific consequences as "interest charges would quickly jump higher and higher," and "panic would seize gambler and banker alike." This panic would have an effect on the entire economy since "banks would cease payments; merchants would suspend activities; cars would become idle; crops would rot in the fields and labour [sic] would be deprived of its wage." This was the main fault in the banking system and Glass proudly noted that "it had never been attempted before," and the result was that "we [the sponsors of the bill and Congress] rescued the reserve fund from this evil use." The almost-apocalyptic terms used by Glass suggest that he was interested in more than just supporting banks and the economy; it was some kind of mission to control "the Siamese twins of disorder" so they could not disrupt the business of merchants and laborers.

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[84] Glass, *Adventure in Constructive Finance*, 59-60.
[85] Ibid., 61-62.

The principal innovation of the reserve system was the fact that there was now a lender of last resort. When rural or city banks found themselves short on funds, they could reach out to the reserve bank for what they needed. This would have been the case regardless of what the banks had previously done with excess funds; they would now be able to obtain what they needed. It is noteworthy that Glass felt not only that banking operations had been part of the problem, but also the that the Federal Reserve was intended to stop banks from those operations. This was done in part by taking away the reserves from private hands as Glass explained, "we cured this financial cancer by establishing regional reserve banks and making them, instead of private banks in the money centres [sic], custodians of the reserve funds of the nation."[86] With this accomplished, finally, "the country banks were made free. Business was unshackled. Aspiration and enterprise were loosed. Never again was there to be a money panic." In order to be freed and unshackled, the country had to be cured of the "evils" and "cancers" that had been brought upon it. The removal of the disease was an achievement on its own, and it would enable the nation to flourish as it could previously not.

Federal Reserve Funds as Real Bills

The claim in 1927 that there would never again be a money panic was soon to be proved wildly optimistic and erroneous. In the early 1930s there were several waves of bank failures. This was seen by Glass as undermining the Federal Reserve System, which had been established to prevent another banking panic. It would once again be blamed on speculation by the banks, and he would again look for ways to stop it. But it must first be seen how the Federal Reserve System was understood to be a system that would prevent speculation by the banks.

The task that Glass saw for the Federal Reserve included the two seemingly contradictory goals of both supplying and withholding funds. It would provide reserves and funds for the banks that needed to make loans for business. And it would also hold back funds from banks that were not using it to

[86] Ibid., 64.

make loans. But the reserve bank could not know what the banks would do with the funds that were supplied to them. There had to be methods which would enable the proper dispensation of funds.

Part of the solution seemed to be quite straightforward. As Glass explained, it was believed that simply by having the extra funds in reserve at public banks, rather than at private banks which bought and sold securities, the problem would be solved. The country banks were often in need of money, and they would be able to obtain whatever was necessary from the reserve bank. The banks in the large cities had too much money, and that would not be the case anymore since they would not hold the funds of the country banks. That could be easily accomplished if all the money at the city banks came from the surplus of country banks. However, there is no way to be certain that banks would have no other source of funds, which they could use for speculation. So there had to be a way of ensuring that banks had access only to legitimate funds and would not be able to speculate as before.

The primary method to ensure that money was used properly was by using the real bills theory to regulate what banks could use as assets. The real bills theory, or doctrine, was originally developed as a method of keeping the money supply in check, containing inflation. According to the real bills theory, banks would be able to issue currency only when it was backed by real bills, that is, bills or promissory notes that usually came along with evidence showing that it was backed, and would be repaid, by sales or production of goods. This was supposed to result in having the right amount of currency in circulation. The money supply would expand as commerce expanded, but not at a quicker pace than the commerce itself.[87]

At the end of the nineteenth century this theory was extended to include all bank assets, not just currency notes. When banks give credit and make loans it is backed to an extent by assets the banks possess. It was argued that bank assets should be based only on real bills. That way banks would have assets that were as reliable as possible. All bank loans were assumed to be most stable if they were based on real bills. The concern now was not merely to strengthen the value of currency, but also to

[87] West, *Banking Reform*, 136-139, 155.

ensure that banks had dependable assets.[88]

This theory was incorporated to varying degrees in most of the bank reform plans. But it was extended even further with the Federal Reserve Act. The drafters of the act saw in the real bills doctrine a way to stop the speculation of the banks. If bank assets must be based on bills related to actual activity in the economy, then banks were not free to issue credit and speculate at will. A Federal Reserve bank, Willis stated, "under the terms of the Federal Reserve Act...must keep its cash invested in very short-time paper—that is to say, it makes no long investments, and endeavors to discount and liquidate only that paper which is of exceptional quality and responsibility, and which grows out of commercial, agricultural, and industrial transactions."[89] By limiting banks to using real bills for discount at the Federal Reserve banks, those banks would not be able to make the large amounts of the speculative loans they previously had. They would be discouraged from lending against "speculative" bills and would mostly lend against "real" bills related to actual commerce.

However, in addition to the problems inherent in the doctrine itself,[90] basing assets on real bills would be feasible only in a banking environment that relied primarily on those bills. Although every bank would be expected to have many different types of assets, the Federal Reserve banks would not accept assets other than commercial bills for rediscount. It would therefore be necessary for banks to have a sufficient amount of their assets in these bills in order to meet the requirements of the Federal Reserve. A large proportion of the assets was expected to be of the real bills type. As Willis explains, even though banks would have other assets, there would be a sufficient amount of real bills, since "in every bank which does a commercial banking business. . .there will be found a large element of paper which is of pure commercial type. If this were not true, the bank would not be a bank in the proper sense of the term."[91] To be a bank, Willis says, is to have a large amount of real bills.

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[88] Ibid., 142-146.
[89] Willis, *The Federal Reserve*, 18.
[90] See West, *Banking Reform*, 138-139, 148-151.
[91] Willis, *The Federal Reserve*, 185

This relates to a conception of banking espoused by Willis and evidently incorporated in the Federal Reserve Act. Banking, according to Willis, is about guaranteeing the credit of individuals. A bank enables people to promise payments to each other since a note of payment will be honored by, and redeemed through, the bank. Facilitating such payments is the foundation of banking. Engaging in those payments, "and proper protection of the bank's notes and deposits issued or granted so that the holder may get cash at sight, is commercial banking."[92] A bank allows business deals between individual parties to proceed by backing the credit of those individuals.

Once banking was defined in this manner, it became apparent that a banking system should work to enhance these operations, but not anything else. Therefore, Willis concluded that "the Federal reserve system is intended to provide just this means," and not more than that. It would not be used for others types of assets, which might relate to more speculative activities, since "it is not a method of supplying capital to borrowers for investment." The only assets that could possibly be recognized are those that adhere to the principles of banking, which are "to enable persons who have debts to pay to get the funds with which to meet them."[93] The debts referred to here are clearly those of the "pure commercial type." So a bank would end up with two types of assets: the commercial type, which the Federal Reserve would accept; and other assets that they have acquired but do not really relate to the business of banking and would not be accepted.[94] Banks would not be able to unduly expand their speculative activity, because they would not be able to use these for the required rediscounting at the Federal Reserve. As most banking operations were assumed to be based on these types of activities, banks would have ample assets, and they would be of the proper type.

[92] Ibid., 9-10.
[93] Ibid., 190.
[94] Ibid.

Changes in Bank Operations

The trouble was that banking practices were changing. The system was predicated on the notion that the essential bank business was conducted with commercial paper. This was, however, increasingly not how banks actually operated. As economic historian Robert C. West showed in his 1974 study on the Federal Reserve, by 1913 businesses had decreased their use of commercial bills.[95] Although those bills had once been the standard method of procuring payment, merchants came to dislike the uncertainty of the promissory note. The bills came to be seen as a tool that was used to collect bad debts, rather than as a regular function of business.[96] If banks did not use real bills anymore, then some of the methods used for achieving the goals of the Federal Reserve were no longer relevant.

The changes in banking also related to the changes in how businesses operated. The commercial bills had developed because retailers and other purchasers had to buy large quantities of inventory each time. It was impractical and too expensive to have very frequent deliveries. However, the money was not available at the time of delivery, since the merchandise would be sold over a period of several months. So the commercial bill came about to enable the buyer to pay over a longer period, which was often three months. By the end of the nineteenth century this had begun to change. New methods of transportation enabled suppliers to make deliveries more frequently. They now expected to be paid immediately for the merchandise. This contributed to the decline of the use of commercial bills.[97]

There were other changes that related more directly to what banks did. In fact, the ways businesses raised money had changed. In the nineteenth century, when companies wished to raise money, they could either borrow from various sources or they could issue bonds. But this left them in debt, and they found that their earnings could be compromised due to the outstanding debt. When alternative methods presented themselves, businesses were eager to take advantage. The growth of the

[95] West, *Banking Reform*, 156-162.
[96] Ibid.
[97] Peach, *Security Affiliates*, 24, and West, *Banking Reform*, 157. Peach notes that this factor is inadequate to explain the decline. But he does include it as a minor factor.

stock market that began at the end of the nineteenth century gave companies opportunities to raise capital by issuing stock. The need for commercial bills declined as these methods spread.[98] Along with commercial bills, the need for banks to be involved in the transactions declined.

As borrowing practices changed, banks began to lose their traditional sources of profit and needed new sources. And they were learning how to profit in new ways. During the First World War, the government financed the war by issuing Liberty Bonds. More than 50% were distributed to the public by banks. In an early study on banks and securities, published in 1941, economist W. Nelson Peach suggests that this gave the banks experience in dealing with securities.[99] At the same time, the public had grown accustomed to buying securities. Previously, many people had been hesitant to invest in bonds. But after the war, when they had already sampled the investments, they were more inclined to try it again. And when they were looking for advice on investments, it was logical that they would approach their bankers, whom they trusted with their money.[100]

Banking was changing in ways that the sponsors of the Federal Reserve Act had not foreseen. They had assumed that by limiting legitimate assets to commercial bills, they would prevent banks from getting involved in securities. But commercial bills became a less important aspect of banking in the years following the Federal Reserve Act. Securities, on the contrary, had become more important to bank operations. The goal that had been set of reducing activities related to securities was clearly not being attained.

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98 Peach. *Security Affiliates*, 25-26.
99 Ibid., 31-33.
100 Ibid., 29, 33.

3. Speculation by the Public

Unease With Securities Speculation After the War

That securities-related activities had not diminished became evident after a few years, and the Federal Reserve officers began discussing their concerns about speculation and what could be done about it. At the end of the war in September 1918 the New York Federal Reserve asked the New York Stock Exchange to collect reports detailing how borrowing was done in the exchange. After reviewing these reports, the bank felt that call money was too accessible and decided to raise the margin requirements for call money. The members of the exchange became frustrated with the restrictions and started lobbying for them to be removed. A letter from H. G. S. Noble, president of the New York Stock Exchange, in January 1919 claimed that "today there is nothing to indicate the probability of a speculative movement that would absorb large amounts of money…The present restrictions have largely killed the buying power in the market." The restrictions were then removed and brokers resumed dealing as earlier.[101] Judging from the complaints of brokers, the restrictions on brokers seem to have been successful at slowing down the call market.

However, this method was not attempted again by the New York Federal Reserve. In fact, over the next decade the bank would resist pressure to work at slowing down the call market. Benjamin Strong, the governor of the New York reserve bank (the title was changed to "president" in 1935), later wrote that, "had it been possible for us to have continued that type of arbitrary control, it would have been a good thing to do it." It appears that he felt that Federal Reserve did not have the legal authority to impose such limits. But he probably also believed, as he later said, that it was not the jurisdiction of the Federal Reserve to deal with the stock market. That would explain why he did not seek to be granted the power to regulate the market.[102] That is also why he later resisted pressure to enact measures to contain the stock market. What went on in the stock market was seen as something that

[101] Chandler, *Benjamin Strong*, 125-130.
[102] Ibid., 131-132.

should not concern the Federal Reserve.

Others, especially the Federal Reserve Board in Washington, disagreed and felt that the Federal Reserve banks should work to ensure that commercial banks did not use funds for speculative purposes. Thus, a dispute, which lasted at least a decade, emerged among the officers of the Federal Reserve on how to achieve their goals. Strong, representing the New York bank, felt that there should not be actions specifically for the sake of the containing the stock market. If steps were to be taken, they should be ones which relate to all aspects of the economy. In September 1919, Strong began to argue for higher discount rates. The problem with higher rates was that it would affect not only the stock market, but all types of borrowing. Nevertheless, Strong felt that it was the only way to contain excess borrowing for stock purchases.[103] But Glass, then in his position as Secretary of the Treasury, was against the idea. He was very concerned about speculation and, along with the board, believed that measures should be taken that would directly affect activity on the stock market. Glass wrote on November 5, 1919, "I hope that the Federal Reserve Board will not allow the Governors of the Federal Reserve Banks to rely wholly or too heavily, for the prevention of the abuse of the facilities of the Federal Reserve System, upon the increase in rates now established with the approval of the Board, myself included." He was hoping that they would make other moves against speculation and not rely on rate increases, as Strong suggested. The concern about stock market activity was apparently not shared by all sides equally, with the New York bank not overly worried. But even if there was a problem, there was a fundamental debate about what should be done to deal with it.

There were also theoretical roots to this controversy. While the debate centered on the question of what effect the raising of rates would have on the economy, it was based on a disagreement over the proper role of the Federal Reserve banks. Glass wanted the reserve banks to be deeply involved in the activities of their member banks. They should know for what purpose the members were borrowing. As he wrote, "I believe it to be of prime importance that the Federal Reserve Board should insist upon and

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[103] Friedman and Schwartz, *Monetary History,* 225-226.

that the Governors of the Banks should exercise a firm discrimination in making loans to prevent abuse of the facilities of the Federal Reserve System in support of the reckless speculation in stocks."[104] On the other hand, the New York Federal Reserve under Strong resisted the idea that they should have to continuously monitor all of the member banks. They felt that their task was to ensure the general wellbeing of the banks, rather than all the individual transactions. This disagreement over the proper role of the Federal Reserve was behind the long controversy.

In response to the pressure from Washington to prevent banks from lending for stock purchases, Strong argued that it would not work. If all the banks were stopped from such lending, he worried that it would result in too much money flowing out of New York. And if limits were placed on just New York banks, nothing would stop out of town banks from making those same loans. Many of those banks had other ways of obtaining funds aside from the Federal Reserve System. As he wrote on November 28, 1919, it would serve only to shift the activities from smaller institutions to larger ones with sufficient capital to manage higher rates. In addition, he argued that the Federal Reserve did not have authority to deal with the speculators directly.[105] The controversy, however, continued as Glass persisted in his demands that the New York bank control speculation in the New York stock market.

At this time Glass did not explain how the Federal Reserve banks would stop those loans from taking place. But in 1927, he wrote that the idea had been "to have the Governors of the various regional banks admonish the individual banks to curtail loans for stock and commodity speculative purposes."[106] This seemed to Glass to be a logical extension of the powers given to the banks to examine their member banks. They should therefore be able to easily discern when the banks were using money for speculative purposes. Then they could "admonish" those banks. However, it seems difficult to imagine how this admonishment would stop the banks from activities they were accustomed to and found profitable.

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[104] Chandler, *Benjamin Strong,* 153.
[105] Ibid., 157-158.
[106] Ibid., 164.

This enforcement by admonishment may have made sense in theory. But in reality, as Strong later argued, it was not so simple to find out what the banks were doing with the funds. And there was no guarantee that the banks would decide to obey the admonishment. It would later become clear that banks could continue to engage in activities although they knew the Federal Reserve disapproved. Thus, aside from the arguments Strong raised against the pressure from Washington, he seems to have worried that he would not be able to successfully implement measures that would control banks' activities.

The Rise of the Public Stock Market

Stock market activity and the public's relationship to the stock market changed in the 1920s. It was a prosperous decade for American corporations. However, people were not depositing their money in bank accounts anymore. Bank deposits went up only slightly. Demand deposits rose about 17% from $8.7 billion in 1921 to $10.5 billion in 1929.[107] Instead the profits were going into stock investments. Stock prices were meanwhile skyrocketing, rising about 22% in 1925 and about 30% in both 1928 and 1929.[108] This would explain the new emphasis that was placed on making profits in the stock market.

The economy changed as the stock market became part of the everyday discussion. The spread of investing to all sectors of the public was seen as an important financial development that was changing domestic and foreign industries. It was also seen as an important social phenomenon, with some hoping that it would help relieve social tension.[109] The stock market became a national obsession. In 1929, a magazine report on how Americans had become familiar with stocks noted that a modern housewife reads about stocks "just as she does that fresh fish is now on the market."[110] For people who were wary of investing in the stock market, there was a lot of reason for concern.

[107] Studenski and Krooss, *Financial History*, 337.
[108] Carosso, *Investment Banking*, 244.
[109] Ibid., 250-251.
[110] Galbraith, *The Great Crash*, 76.

This does not necessarily mean that what was happening in the stock market was all reckless speculation. Historian Robert Sobel argues, in a 1968 study of the 1920s stock market, that the rise in the stock market may have been justified since it came along with a huge spurt in economic growth. The trouble was in the methods used to foster the rise in stocks, such as brokers' loans and the participation of large corporations with large amounts of funds; this caused more volatility than there would otherwise have been.[111] Notwithstanding the economic rationalization, an image of uncontained gambling was created, and it raised concerns among many observers of the economy. More than the actual stock market activity, the perception of speculation and gambling among the general public prompted calls for regulation.

There was a growing sense among observers of American banks that the Federal Reserve Act had not succeeded in tempering banks' stock market investments. In 1923, Willis published *The Federal Reserve System: Legislation, Organization and Operation*, his second review of the system. He acknowledged that the system had not worked out as its founders had hoped it would. He observed that one of the main tenets of the system had failed since the nation apparently did not have enough commercial paper to allow the Federal Reserve banks to operate as intended. Member banks would discount with the Federal Reserve the appropriate assets and then keep their other assets for dealings with other parties. However the Federal Reserve was slow to realize how the banks actually worked.[112] Willis had been aware earlier that banks would have two kinds of assets. But apparently he and the other drafters of the act had hoped that banks would somehow come to rely more heavily on commercial paper. It was becoming clear that banks did not need a large proportion of their assets in commercial paper in order to operate and rediscount adequately with the Federal Reserve.

More importantly, the system had not changed the behavior of banks towards the stock market. As Willis remarked, "The working of the federal reserve system has apparently not succeeded in

[111] Sobel, *Great Bull Market*, 123.
[112] Willis, *Federal Reserve System*, 905, 911, 953.

withdrawing from the stock market the overplus or surplus of funds belonging to banks and previously employed in stock market speculation."[113] Despite all intentions, the Federal Reserve had not succeeded in tempering the speculation. It was especially disappointing that, "in this particular, then, which before the adoption of the Federal Reserve Act was by many spoken of as a feature of the financial situation which called most earnestly for correction, the federal reserve system has been largely without result." What had been thought of as one of the principal achievements of the act had turned out not to have been achieved.

Willis seems to have had doubts about what was accomplished with the Federal Reserve plan. He felt that it had provided security for the nation's banks. As he saw the system, "it has provided a bulwark against the recurrent suspensions and 'panics' which were in large measure the outgrowth of the previously existing state of things. It has rendered readily available an emergency remedy which could be used to correct the immediate results of the evils referred to." The plan was not completely successful, since "it has not, as many expected it to do, undermined or eradicated the evils themselves." The results were not what had been hoped for. The unhappy upshot was that "altogether. . . the establishment of the reserve system must be looked upon as having been decidedly disappointing in its relation to stock speculation."[114] This may be as close as one can expect someone so involved with establishing the Federal Reserve System to say that it had failed.

Not everyone was ready to admit that the Federal Reserve had failed at controlling the banks in this area. In 1927 Glass maintained, as mentioned earlier, that the Federal Reserve Act had cured the financial system of its "evils" and "cancers." Willis, who had a more intimate knowledge with bank operations, recognized by 1923 that not all of the problems had been solved. At the end of the book, he summarizes his main points and reckons that "outstanding among these conclusions is the fact that the

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[113] Ibid., 1512.
[114] Ibid., 1513-1514.

federal reserve system has not accomplished the main objects for which it was intended."[115] Perhaps other observers of the Federal Reserve could have, like Willis, noticed that the system would not be able to contain stock market speculation; it was, however, still regarded as an important goal of the Federal Reserve.

After 1920, relations between the board and the New York Federal Reserve appear to have relaxed. But in October 1925 the issue of speculation rose again, with Washington recommending direct pressure on banks which were loaning for speculative purposes. Governor Strong again refused to comply and rejected any form of this pressure, saying that denying services to banks carrying discount loans would mean rationing of credit and would be "disastrous."[116] He again preferred a policy of raising discount rates, although he was also not pleased with the effect such an action would have on the economy. As he wrote on November 7, "It seems a shame that the best sort of plans can be handicapped by a speculative orgy, and yet the temperament of the people of this country is such that these situations cannot be avoided." But he also expressed doubt about the efficacy of the actions in a November 20th letter, "My feeling has been that having the New York Bank raise its rate first, the bad news would be out, and, after a severe shock to the stock market, it would go off on its merry way again."[117] Strong agreed that the rampant speculation was detrimental to the economy and caused by a psychological condition that led to the "orgy," but he was still not convinced that raising interest would have a real effect on stock market speculation.

Renewed Concern with Speculation

When the stock market did not collapse in catastrophe in 1925, concerns seem to have relaxed again. Then in late 1927, the Federal Reserve board became increasingly concerned about the stock market. This time they would not relax until the market had actually crashed. Strong still insisted that

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115 Ibid., 1525.
116 Friedman and Schwartz, *Monetary History*, 254
117 Chandler, *Benjamin Strong*, 329.

the Federal Reserve could not get involved in the dealings of the stock market. As he wrote on August 18, 1927 the bank could not continuously worry about speculation since "orgy will always be with us and if the Federal Reserve System is to be run solely with a view to regulating stock speculation instead of being devoted to the interests of the industry and commerce of the country, then its policy will degenerate simply to regulating the affairs of gamblers."[118] His views had not changed much since 1919, and he still felt that dealing with stock market affairs was not the responsibility of the Federal Reserve.

The problem that had vexed all those who tried to stop speculation, from the first attempts to contain speculation in 1908, remained. There was no easy means of determining when a price is appropriate and when it was bloated due to simple speculation. And since there was no ideal price, the only thing that could be done was to attempt to lower all prices. But, as Strong explained in September 1927, "an attempt to reduce the prices of stocks cannot be effected without an increase in the cost of credit employed in carrying stocks." In other words, all other areas of the economy would be affected, and it "will be found to have a widespread and somewhat similar effect in other directions, mostly to the detriment of the healthy prosperity of this country."[119] There was no known way, other than the admonishment that Glass had hoped for, to regulate just stock prices.

Meanwhile the stock market was continuing to expand. By early 1928, the Federal Reserve Board was becoming even more concerned about the continued speculation on rising stock prices. In May 1928, Adolph Miller, the economist on the Board, demanded that executives of the large New York banks be gathered and warned that they must reduce the speculative activities.[120] Strong, in New York, was reluctant to perform that sort of action and skeptical that it would make a difference. He wrote on August 3 that the problem was not really about the prices of stocks or of how much credit was available. Even if those could somehow be changed, the problem would remain, since "it is really a

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[118] Ibid., 444.
[119] Ibid., 425.
[120] Friedman and Schwartz, *Monetary History*, 254.

problem of psychology. The country's state of mind has been highly speculative, advancing prices have been based upon a realization of the wealth and prosperity of the country, and consequently speculative tendencies are all the more difficult to deal with." Having diagnosed the problem as a psychological one, Strong felt that it was useless to try to do anything about it.

However there was actually now even more reason to doubt that the Federal Reserve could stop speculation. The stock market had begun to find other sources of money. Increasingly, corporations began to lend directly to stock brokers. By early 1929, loans for the stock market from corporations and other non-banking sources were approximately equal to those from banks.[121] Even if the Board's directives to stop banks from making these loans had been followed, there were other sources of money to continue all the activity.

More significantly, perhaps, Strong was not very concerned about the possibility of disaster resulting from the stock market speculation. He believed that Federal Reserve had the tools necessary to deal with possible future problems and "that the very existence of the Federal Reserve System is a safeguard against anything like a calamity growing out of money rates." If problems did come up, the Federal Reserve was capable of flooding the market with money and preventing crises. But even more important was the fact that the Federal Reserve existed. In the past, people had panicked and caused runs on banks. Now they were aware that the Federal Reserve was able to deal with problems and would not panic. Therefore, Strong concluded, "mob panic, and consequently mob disaster, is less likely to arise."[122] Even the board seems to have been more concerned about the existence of speculation than about possible negative outcomes. There was clearly no sense of urgency about future troubles.

Benjamin Strong, as governor of the New York Federal Reserve, was the most influential figure in the system. On October 16, 1928, Strong died at the age of fifty-five. Strong's death led to a standoff

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[121] Galbraith, *The Great Crash*, 31.
[122] Chandler, *Benjamin Strong*, 460-461.

between the New York bank and the Board in Washington. The Board believed that the Federal Reserve should perform examinations on the banks' activities and make sure that they were not fueling the speculation. But the New York bank, sticking to Strong's position, did not think they could start meddling in the affairs of the banks and that the best way to stop speculation was to raise the discount rates, which would make it more expensive to borrow money. Between February 1929 and May 1929, the directors of the New York Federal Reserve voted eleven times to raise discount rates, and each time the Board disapproved.[123] Finally in August 1929 the Board approved a rate increase. The need to do something about the rates does not seem to have been disputed. But quarrels had prevented action from being taken.

Meanwhile, the stock market continued to rise in 1929, and the Board began meeting almost daily to discuss how to contain the stock market. In late March 1929, investors began to worry about what the Board might do. On March 25 and 26, the market started to retreat, reflecting this new worry. At that point Charles E. Mitchell, the president of the National City Bank, the largest commercial bank, and a director of the New York Federal Reserve, announced that his bank was prepared to lend out up to $25 million for the call market. Investors were assured that they would continue to have funds, and the market started rising again. The Federal Reserve Board was learning that actually stopping the stock market was not easily accomplished.

The Board was furious at having been thwarted by the banks, especially by someone who was a director of one of the Federal Reserve banks. Senator Glass charged that Mitchell was "guilty of slapping the Federal Reserve Board 'squarely in the face.'" Glass called for Mitchell's resignation from the Federal Reserve.[124] But there were no more major attempts to deal with the stock market. This effectively ended the Board's efforts at regulating the market in 1929.

This state continued until the whole financial system was disrupted. Tuesday, October 29, 1929

[123] Friedman and Schwartz, *Monetary History,* 254-259.
[124] Ibid., 260-261. Galbraith, *The Great Crash*, 35-39.

is considered to be the day on which the stock market crashed. Although the market had already been declining since early September, there seemed to have been hope among investors that the market would rebound. But on October 29, the optimism appears to have vanished. One widely used index dropped so much on that day that it closed lower than it had a year earlier and erased all of the gains of the previous year.[125] The stock market could not sustain the level of optimism that the public expressed.

[125] Galbraith, *The Great Crash*, 84, 111-112.

4. Failures and Passage of the Act

Crash and Regulation Attempts

However, a stock market crash does not have to have a catastrophic impact on the entire economy. In fact, as historian Robert Sobel notes, “no causal relationship between the events of late October 1929 and the Great Depression has ever been shown through the use of empirical evidence.”[126] Economist Christina Romer, who argued that there was a partial link between the crash and the Great Depression, explains that the crash was connected to the subsequent depression since it caused consumers to lose confidence in future income. However, the loss in value of assets effected by the crash was a distinct event and did not directly lead to the depression.[127] That is not what would be assumed considering all the concerns of the Federal Reserve Board leading up to the stock crash and the allegations made afterwards. However, there was no particular weakening of banks or failures in 1929. People did not panic and run to claim their deposits, and the money stock stayed relatively steady.[128] The economy at that time went into a recession, which is when the money stock began to decline, not after the crash.[129] It was not until October 1930, a full year after the crash, that a wave of banks failed. Another wave of failures took place in mid-1931. The banks appeared to have stabilized,

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[126] Sobel, *Great Bull Market,* 147.
[127] Romer, “Crash and Onset,” 597-598.
[128] See graph in Friedman and Schwartz, *Monetary History,* 302.
[129] According to Koo the stock market crash was the cause of the depression that followed. This is based on his theory of balance sheet recessions, which compel firms to reduce debt rather than invest. He explains that due to the unprecedented levels of borrowing “it would not be surprising if firms…rushed to reduce debt…tipping the economy into a balance sheet recession…sparking the vicious depression cycle” (*Holy Grail,* 100-101). His main argument is that the decline in money supply could not have been caused principally by bank failures since losses by depositors accounted for only 15% of the drop (97). However, this is based on the Federal Reserve's estimates of depositors' actual losses and fails to consider that every failed bank has much more in deposits than what is actually lost. When the bank fails, all of its deposits are removed from the money supply. But a more significant point that Koo ignores is the drop in deposits in banks that did not fail. A period of extensive bank failures can cause the public to lose confidence in the banking system and convert deposits to currency. This is well documented for the period of the Great Depression; as Friedman and Schwartz note (*Monetary History,* 333, 342) the currency-deposit ratio dropped by more than half between 1929 and 1933. Koo also fails to explain why the most significant drop began at the end of 1930, which was when bank failures became a significant problem. In addition to these points that Koo fails to mention, some concern can be raised about his methodology. Koo explains that a balance sheet recession occurs when firms have too much debt but don't want to reveal their problems. Therefore the issues are “silent and invisible,” and hidden by the management of the firms to avoid rumors about insolvency (44). With this kind of reasoning it would be difficult to refute any arguments or, indeed, find any evidence for the phenomenon. [AL 6/14/11]

until January 1933 when the largest wave of bank failures occurred.[130] As the failures continued, a movement began to make changes to the banking system, although there was little consensus that the problem lay in the system. There seems not to have been widespread support for drastic changes at the time. Apparently it was not that obvious that the problem had been caused by the banks.

However, to people such as Glass, who had always been nervous about the stock market and speculation, the indication was clear that speculation had caused all the trouble. In early 1931, right after the first wave of bank failures, the Senate Banking and Currency Committee set up a subcommittee to investigate the "operation of the national and federal banking systems," with Senator Carter Glass as its chairman. The subcommittee was pursuant to Senate resolution 71, "to provide for a more effective operation of the national and Federal reserve banking systems of the country." The conclusion that the problem lay in the operation of the system seems to have been accepted before the hearings began. Its goals were even more specific. The resolution called for an inquiry into the "banking systems with respect to the use of their facilities for trading in and carrying speculative securities" and the effect it had on the system.

There was also another topic they would examine, which seemed minor at the time but ended up derailing the entire plan. The inquiry was to look into the advantages of branch banking. The American banking system had generally not allowed banks to set up branches. This was to prevent banks from growing too large. But that was also thought to be one of the reasons that U.S. banks failed so often.[131] If the large banks could set up branches in rural areas, those banks would be better funded than the small, independent banks that were prone to failures. The discussion of branch banking ended up covering most of the hearings, with relatively little time devoted to studying what had caused bank failures.

That bank speculation had led to failures seems to have already been determined by the second

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[130] Friedman and Schwartz, *Monetary History*, 307-308, 313-314, 324-326.
[131] See *Hearings* 1931, 49, 53, 79.

day, although it was just the first of several rounds of hearings into bank operations. On January 20, the second day of the hearings, the subcommittee heard testimony from George L. Harrison, the successor to Strong as the governor of the New York Federal Reserve. The dialogue between Glass and Harrison must be seen in the context of their relationship the previous several years. Glass, a member of the Federal Reserve Board, had been a proponent of paying closer attention to the activities of the banks and not allowing them to make loans that would be used for the stock market. This approach was opposed by Harrison and the New York Federal Reserve. It was a contentious issue and was brought up many times during the hearings.

This was perhaps the first time that the positions of the Board and the New York Bank were discussed publicly, and the antagonism was apparent. The committee asked Harrison why the banks had not been prevented from loaning for the stock market. Harrison explained that banks do not come to the Federal Reserve asking for money that they will use for a specific purpose. Banks have many divisions working concurrently on unrelated operations. They do not know how much they will need to get from their reserves until they tally all the various activities. If they see that there is a need for money, they proceed to the Federal Reserve. Indeed, if the Federal Reserve would ask the banks what they would do with the money, "the bank would probably say to us, 'We do not know; we are just filling up the void that has occurred as the result of the total of our day's transactions."[132] The officers of the banks would not be able to say that the money is for a particular operation, since they review all of their divisions in aggregate.

Glass felt that the loans could have been supervised and was clearly upset about this. He pressed Harrison, insisting that the sole purpose of the Federal Reserve had been to enable commerce and business to operate. And since the Federal Reserve Act had specified that only paper related to actual business could be discounted, there should have been no other activities at the banks. To this Harrison pointed out that the act had said nothing about what the banks were doing. It merely stipulated what

[132] *Hearings* 1931, 48.

kind of paper could be used at the Federal Reserve. In other words, the act was concerned with the integrity of the assets at the Federal Reserve. There was no mention of how member banks were to operate and what they were allowed to do with loans.

This was not how Glass had understood the act. He continued questioning Harrison: “you think then that this law is practically futile and a dead letter? In other words, you think that a member bank that wants to engage in the business of making loans for the purchase and carrying of stocks on the market has a right to do so?”[133] Harrison explained that even before the recent wild speculation on the stock market, it had been an important activity of the banks to provide loans for stock purchases. If Congress had intended to eliminate such an important aspect of the banks, explicit mention should have been made of this. Since the act did not say anything about bank activities, that could not have been a great concern at the time.

However, this understanding of the Federal Reserve Act contradicted the understanding of its main sponsor and advocate, Senator Glass. And he persisted with his view at the hearings, “I want to adduce your opinion as to the intent of that prohibition of the law there. What had the proponents of the Federal reserve system in mind when they inserted that prohibition in the law?. . . Was not the intent clearly to prohibit the use of Federal reserve banking facilities for that purpose?”[134] Harrison seemed to be truly confused by this, because, as he said, there was no indication in the act that the purpose had been to stop bank loans for the stock market. And if that was the intent, the methods for enforcing such a policy were not included in the act. He stated, “I do not think it was intended to control or even prohibit speculation upon the part of the American people.” Rather, the limiting of permissible assets was meant to strengthen the holdings of the Federal Reserve. But that would not prevent the banks from providing money for stock market purchases.[135]

The committee did not accept these arguments and submitted its report to the Senate on April

[133] Ibid., 51.
[134] Ibid.
[135] Ibid., 47-51.

22, 1932. It advised that the reforms should be passed immediately, because they "include[d] the correction of evils which reached a peak of danger in 1929 and abuses which have gradually grown up within the banking system itself."[136] A great inflation of bank credit had taken place after 1925 which was not related to an enlargement of demand by businesses. Instead, the report said, "it is now evident that the increase in deposit credit" went to other purposes, including "the carrying and inflating of the prices of securities, especially common stocks."[137]

According to the report, there had been too much money available to the banks. Because of surplus reserves and gold imports, banks had more than was necessary for lending to commercial activities. In large part these extra funds were created due to securities issued by businesses. The public which purchased these securities had to get the funds from somewhere, and this "was unquestionably obtained from the banks." These funds obtained by the businesses then "went into the stock market and fostered excessive speculation." [138]

This mention of extra funds at the banks was meant to explain what had fueled the stock speculation of the recent years. As the report pointed out, however, in addition to enabling unnecessary speculation the banks themselves suffered from it. They had been invested in securities, which mature over a long period, rather than staying with commercial paper, which matures in a shorter term. As a result, "a very fruitful cause of bank failures, especially within the past two years, has been the fact that the funds of the various institutions have been so extensively 'tied up' in long-term investments." This undermined the purpose of the banks, since "national banks were never intended to undertake investment banking business on a large scale."[139] Not only had banks caused the speculation, but they had also ruined their own operations and were no longer able to fulfill their obligations.

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[136] *Operation of the National and Federal Reserve Banking Systems. Report No. 584 to accompany S. 4412, April 22, 1932,* 2.
[137] Ibid., 3.
[138] Ibid., 4.
[139] Ibid., 8

Defeat and Renewal

The committee proposed several regulations to rectify the problems. The main suggestion was to separate banks as far as possible from securities and the stock market. The examination powers of the Federal Reserve were to be expanded. It now would have the authority to supervise all relations and transactions of member banks. There would also be changes to laws on bank branches, which would allow banks to establish branches in the home state and sometimes also in a neighboring state. The regulations would thus limit the scope of bank operations, while at the same allowing for expansion of permitted operations.

The provision allowing banks to establish branches proved to be the most controversial aspect of the Act. Senator Peter Norbeck of South Dakota, chairman of the Senate Banking and Currency committee, submitted a dissenting report. The dissenting senators were particularly upset about the potential effects of allowing branch banking. The report stated that "the unit banker has had a most prominent place in the development of the United States… It has been through his foresight, strength of character, and belief in these great United States of ours that our country has become the foremost in commerce and industry." Allowing banks to grow large and centralized would have dismal results, because "the history of our country might have been different if our banking system had been controlled from Washington or New York."[140] This idealized description of bankers imparted a message that tampering with them would risk losing all that was valuable to the nation.

Branch banking, it was argued, would lead to only more problems in the system. The idea was "part of the preconceived plan for…placing the control of our banking structure in financial centers." This would place responsibility for the banks in the hands of those who might disregard the interests of the people, since "when banking and credit are centralized in a few hands, it is easier for the powerful to get control of such corporations."[141] These were actually the same arguments that had been used by

[140] Ibid. *Part II*, 4.
[141] Ibid.

Andrew Jackson and throughout the nineteenth century in opposition to a central bank. Some people felt that the structure of the Federal Reserve System had avoided the main problems, but with branch banking those fears would be realized.

The bill submitted by Glass and co-sponsored by Representative Henry Steagall of Alabama was not admired by all of Congress. It came up several times in the first half of 1932, each time failing to receive enough votes to pass, until the Senate decided to remove it from the calendar in June.[142] Instead a minor banking act, also co-sponsored by Glass and Steagall, was passed on February 27, 1932, providing more methods for troubled banks to receive funds. The main issues of contention with the bill were the provisions on branch banking. But some were also skeptical of Glass' ambition to rectify the system. Norbeck wrote that Glass "seems determined to work out a 'perfect banking system' before he leaves the stage. He may know what that means, but I am sure that neither you nor I do."[143] Aside from the opposition to bank branches, the measure to separate commercial banks from investment activity did not seem to be very significant to the senators. If it was seen as vital to reducing bank failures, there would presumably have been discussion and focus on those measures.

However, the bill was not yet dead. In the election of 1932, Roosevelt and the Democratic Party campaigned against Wall Street and financial interests. And the bill again came up for debate on January 5, 1933, with Glass attempting to impress on his fellow senators the urgency of its passage. He argued that small banks were "choked with immobile, and in many cases, worthless securities." The banks had refused to write off their losses, and were likely to fail if the bill was not accepted.[144] But many senators were still unhappy about the provision allowing bank branches.

The bill was eventually defeated due to that opposition. Senator Huey Long of Louisiana was particularly instrumental in its defeat. On January 10, he began a filibuster of the bill, reading from two

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142 Smith and Beasley, *Carter Glass*, 306.
143 Perino, *Hellhound of Wall Street*, 65.
144 Ibid.

bibles and claiming that "the Lord himself" opposed branch banking.[145] The Senate failed to override the filibuster, and the Glass-Steagall bill was again removed on January 25. Presenting traditional banking as a divine institution seems to have deterred the Senate from acting. It is hardly likely that such an argument would have been effective if the legislation in question was understood to be vital to the nation. Clearly, the separation of commercial banks from securities was still not seen as an urgent matter.[146]

Capitalizing on the resistance towards Wall Street, in January 1933 Norbeck established a committee to investigate the practices of banks, especially regarding stock operations. The investigations, headed by Ferdinand Pecora, a lawyer who had been called the "most brilliant cross-examiner in New York,"[147] began in February. The Pecora Commission, which became famous for its exposure of the abuses and crimes of prominent Wall Street figures, lasted into 1934. But the most significant damage to the image of banks was done during the first few days of the hearings, at the end of February 1933.

Those first few days left the public with a picture of financial institutions as criminal and decadent. Charles Mitchell, chairman of National City Bank, was one of the first to testify. Under Pecora's questioning, it emerged that Mitchell had evaded taxes, and his bank had sold stocks that Mitchell regretted.[148] Over the next few days, Pecora managed to expose various other unseemly behaviors by bank directors. By the end of the week, Mitchell, who had once been one of the most prominent figures in the financial community, had resigned.[149] Public opinion was disgusted with the banks, with one newspaper saying that it was a "group that whooped up the stock market boom, diverted credit from legitimate business, exercised a controlling hand at Washington, and took the

[145] Ibid., 67.
[146] Ibid., 68.
[147] Ibid., 40.
[148] Ibid., 164-166.
[149] Ibid., 155.

American people for the greatest buggy ride in their history during the last decade."[150] Any confidence that people may have had in banks was shattered, particularly regarding their stock market operations.

In this environment, there seemed to be a greater chance of the Glass-Steagall Act being passed. On March 9, 1933, Glass reintroduced the bill. This time, even some of the bankers supported the bill, hoping to clear their reputations. One banker announced that "the spirit of speculation should be eradicated from the management of commercial banks."[151] There was no filibuster this time, and the bill was approved on June 16, 1933. It became part of the array of resolutions passed in Roosevelt's first hundred days.

As mentioned earlier, there was very little evidence supporting the need for the act. On the contrary, studies have shown that banks with securities affiliates—the activities of which were commonly referred to as speculation—were actually safer. But the abuses and excesses were also real and politically very damaging. It became easy to rally people to oppose the activities of banks, especially when they were framed as speculation and gambling.

There was much effort expended on examining the claims of the committees and banks, to see what the basis for the act was. And many people looked, and continue to look, to the events of 1929 to explain what had inspired the act, as mentioned earlier. But the act was actually based on conceptions that dated much earlier than 1929. Those same ideas had in fact been part of the impetus that spurred the creation of the Federal Reserve System, as seen in several of the references cited above. For the people who shared those ideas, namely Glass and his advisors, there was no need to look at the record of the 1920s to decide what action should be taken. It was already known that any actions necessary to prevent what they felt was speculation should be taken. The stock market crash and subsequent bank failures served only to validate what they already took for granted.

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[150] Ibid., 225, 221.
[151] Ibid., 289.

Impact of Glass-Steagall

What kind of effect, if any, did the regulations of Glass-Steagall have on bank operations? The act included provisions that led to the formation of the Federal Deposit Insurance Corporation, which insures commercial deposits and may have had a significant impact in reducing bank failures.[152] However, the most well-known provision of the act attempted to change how banks operated; the intent was to change the lending from activities that were seen as speculative to lending that was closely related to commercial activity. An important question when examining any sort of regulation is whether it had the intended effect.

The main objective, which was to have solved many of the problems, was to reduce speculation, and it would be most beneficial to measure whether speculation was changed. Unfortunately, in this context there is no way to really measure speculation. As mentioned earlier, Glass never gave a clear definition of what activities were considered speculation and, thus, were intended to be eliminated. Therefore it is not clear how one would gauge whether there was more or less speculation.

The other goal of the bill, which had also been a goal of the Federal Reserve Act, was to integrate banks more with the commercial needs of the country. The intent was that when companies needed funds for industrial or commercial activities, they should be able to borrow from banks. Therefore, there was anxiety about the amount of bank funds that were used to finance stock market purchases rather than "real" commercial activity.

Changes in how banks allocated funds are something which can perhaps be measured. As demonstrated in Table 1, the percentage of loans that were used for securities diminished in the years following the Glass-Steagall Act, which would seem to indicate that the act had been successful in reducing securities-related loans. The trouble with this comparison is that not all that went under the rubric "securities" was prohibited by Glass-Steagall. A large portion was related to operations of

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[152] See Friedman and Schwartz, *Monetary History*, 434, and Cottrell, Lawlor, and Wood, "Connections," 163.

Table 1.

	Loans for Securities 1928-1938 (in millions of dollars)		
	Total Loans	Loans on securities	Percentage of total loans
1928	24,325	8,545	35.1%
1929	25,658	9,759	38.0%
1930	25,214	10,425	41.3%
1931	21,816	8,334	38.2%
1932	16,587	5,570	33.6%
1933	12,858	4,704	36.6%
1934	12,523	4,598	36.7%
1935	11,928	4,098	34.4%
1936	12,542	4,209	33.6%
1937	14,285	4,365	30.6%
1938	12,938	3,316	25.6%

Source: Federal Reserve Board, *Banking and Monetary Statistics* 1914-1941, 76, 79.

businesses, both commercial and agricultural. This can be observed by looking at later figures. After 1938, banks began reporting the figures differently, splitting the securities into different categories.[153] Some of the loans, related to commerce and agriculture, would not have been affected by Glass-Steagall.[154] Therefore, the reduction in securities may have been from those areas that were not affected by the act. Nevertheless, although it is difficult to rely on these figures for accurate changes caused by the bill, a general trend of diminished involvement in securities can be seen.

Another aspect to look at is what kind of assets banks held instead of securities. If it could be shown what proportion of bank loans went to commercial activities and what proportion went to stock brokers, it would perhaps be possible to measure how banks changed. The trouble is that before 1940 banks did not distinguish which among their loans were for the purpose of stock market purchases, except under the general securities category.

This may not be a major concern since securities activities were greatly reduced throughout the Great Depression and Second World War. The period that would best reflect changes in bank operations

[153] *Banking and Monetary Statistics 1914-1941*, 62.
[154] This is not noted in Studenski and Krooss (*Financial History*, 337) where they list increases in security loans. In fact some of these securities loans were just another way of lending to businesses.

Table 2.							
	Loans by class (in thousands of dollars)						
	Total loans and discounts	Commercial loans*	Percentage of Total	Total loans for Securities	Percentage of Total	Consumer loans	Percentage of Total
1939	9,043,632	4,395,392	48.6%	729,329	8.1%	n/a	n/a
1941	11,751,792	6,398,829	54.4%	590,169	5.0%	n/a	n/a
1943	10,133,532	5,604,814	55.3%	949,453	9.4%	n/a	n/a
1945	13,948,042	6,388,969	45.8%	3,418,499	24.5%	1,096,453	7.9%
1947	21,480,457	11,892,157	55.4%	998,015	4.6%	3,128,783	14.6%
1949	23,928,293	11,955,199	50.0%	1,184,564	5.0%	4,452,842	18.6%
1951	32,423,777	17,673,425	54.5%	1,206,126	3.7%	5,802,445	17.9%
1953	37,944,146	18,971,297	50.0%	1,658,765	4.4%	8,123,980	21.4%
1955	43,559,726	20,417,583	46.9%	1,840,602	4.2%	9,409,571	21.6%
1957	50,502,277	24,117,863	47.8%	1,800,744	3.6%	11,227,130	22.2%
1959	59,961,989	24,740,446	41.3%	1,951,249	3.3%	13,469,652	22.5%
	*Commercial, Industrial and Agricultural (including open market)						
	Source: *Annual Report of the Comptroller of the Currency,* 1940-1959						

would be the later 1940s and early 1950s. As these figures show (table 2), there were changes in bank loans, with a much smaller proportion of loans going towards securities-related lending. This could be interpreted as a success of Glass-Stegall.

However, the proportionate reduction of loans for securities did not reflect a simultaneous rise in loans for commerce. In fact, commercial and agricultural loans also diminished over the period in Table 2. Instead, a new type of loan, called consumer, or expenditure loans, emerged. These might not be considered speculative loans, in the context discussed here, since they were not related to the stock market. But they were also not loans that were backed by any sort of paper relating to a real business transaction. It seems, therefore, that as loans for securities diminished, a new kind of loan emerged that was no more closely linked to commercial activity than securities were. A simple test comparing the decline in securities loans to the rise in consumer loans (over the entire period, not just the years in Table 2) shows a correlation of -0.81261, indicating that there might be a relation between the decline of one and the rise of the other.

An observation might therefore be made that a restriction on transactions that banks are allowed to perform will not necessarily redirect the funds towards transactions that might be preferred. It is reasonable to assume that a new venue for banks to invest in will later emerge that is not specifically prohibited but also not the type of investment that was intended. That appears to be what occurred in the aftermath of the Glass-Steagall Act.

Conclusions

This paper has examined the ideas and attitudes that led to the passage of the Glass-Steagall Act in 1933. The provisions separating commercial and investment banking may seem to have little relevance to banking and legislation after the act was repealed in 1999. However, as mentioned earlier, in 2008 there were calls to revive the act, based on the understanding that Glass-Steagall was formulated drawing on analysis into conditions and failures of banks and, in fact, prevented a recurrence of those failures.

In this paper it was argued that the rationale was not actually based on bank operations and conditions. Rather, the act was passed due to a combination of ideological and moral positions predetermined to any problems. The success of the act is also questionable, since the banking trends in the decades immediately following the act do not seem to have achieved what was expected. From this it might be decided that reviving Glass-Steagall will not be effective.

However, it is possible, while not likely, that contrary to what occurred when the act was passed, this time it is really warranted and will somehow succeed in tempering the “speculative devils.” Conditions may have changed, such that banks’ involvement in securities will actually cause harm and perhaps failures. The types of securities traded today are much more complex and prone to miscalculation than securities traded in the 1920s. Furthermore, one could argue that the effort to regulate is worthwhile on its own. Regulation should be based on current circumstances and logical solutions. What happened decades ago, it could be said, should not dictate how banks are regulated today.

Perhaps there is a more profound lesson that can be learned from Glass-Steagall. The effects of regulations cannot always be anticipated. What seems to be logical and justified at the time of crisis may later prove to be entirely different. The results may be not realized as hoped for, and the motives may not be what they were thought to be. Major changes passed during a crisis will often have unpredicted outcomes. While there is no alternative to empirical analysis of situations and causes, when regulations do not change conditions as expected, it might be best to return and reevaluate the original rationale and evidence for the regulations. The circumstances often look quite different after a longer period and with different methods of analysis.

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