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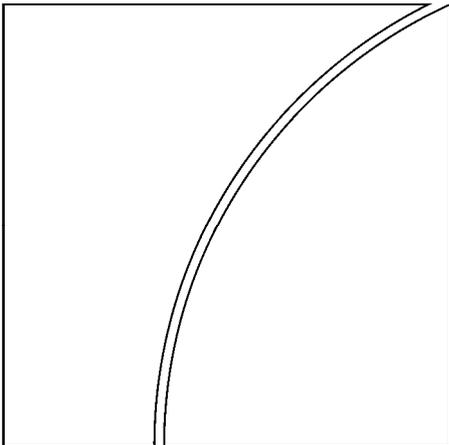
No 328

The Federal Reserve, the Bank of England and the rise of the dollar as an international currency, 1914-39

by Barry Eichengreen and Marc Flandreau

Monetary and Economic Department

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JEL classification: N10, N22, N24, E58, F31, F34

Keywords: Foreign exchange reserves, network externalities, path dependency, money markets

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Foreword

On 24–25 June 2010, the BIS held its Ninth Annual Conference, on “The future of central banking under post-crisis mandates” in Lucerne, Switzerland. The event brought together senior representatives of central banks and academic institutions who exchanged views on this topic. The papers presented at the conference and the discussants’ comments are released as BIS Working Papers 326 to 331. A forthcoming BIS Paper will contain the opening address of Stephen Cecchetti (Economic Adviser, BIS), a keynote address from Baron Alexandre Lamfalussy, and the contributions of the policy panel on “Do central bank governance arrangements need to be altered?”. The participants in the policy panel discussion, chaired by Jaime Caruana (General Manager, BIS), were Mark Carney (Bank of Canada), Andrew Crockett (JP Morgan Chase International), Stefan Ingves (Sveriges Riksbank), Lucas Papademos (Former Vice President, European Central Bank), and Duvvuri Subbarao (Reserve Bank of India).

Conference Programme

Thursday 24 June

Opening remarks

Stephen Cecchetti (BIS)

Session 1:

The future role and mandate of central banks

Paper title:

The changing roles of Central Banks

Chair:

Armando M Tetangco, Jr. (Bangko Sentral ng Pilipinas)

Author:

Charles Goodhart (London School of Economics)

Discussants:

Stanley Fischer (Bank of Israel)
Randall Kroszner (University of Chicago)

Session 2:

International governance

Paper title:

Central banks: between internationalisation
and domestic political control

Chair:

Henrique de Campos Meirelles (Central Bank of Brazil)

Author:

Harold James (Princeton University)
Paper: Central Banks: Between Internationalization and
Domestic Political Control

Discussants:

Gianni Toniolo (Duke University)
Már Gudmundsson (Central Bank of Iceland)

Keynote lecture

Speaker:

Alexandre Lamfalussy

Friday 25 June

Session 3:

Lessons from history for future central bank design

Paper title:

The Federal Reserve, the Bank of England, and the Rise of the
Dollar as an International Currency, 1914-1939

Chair:

Ms Zeti Aziz (Central Bank of Malaysia)

Author:

Barry Eichengreen (University of California) (joint work with
Marc Flandreau)

Discussant:

Robert Keohane (Princeton University)
Leszek Balcerowicz (Warsaw School of Economics)

Session 4:

Lessons from political economy for future central bank design

Paper title:

The Governance of Financial Regulation: Reform Lessons from
the Recent Crisis

Chair:

Christine Cumming (Federal Reserve Bank of New York)

Author:

Ross Levine (Brown University)

Discussants:

Gill Marcus (South African Reserve Bank)
Howard Davies (London School of Economics)

Session 5: Central bank finances: Policy relevant? Politically relevant?

Paper title: Minimizing Monetary Policy
Chair: Zdenek Tuma (Czech National Bank)
Presenting author: Peter Stella (Consultant)
Discussants: Marc Flandreau (Graduate Institute of international and
Developmant Studies)
José De Gregorio (Central Bank of Chile)

Session 6: Are central banks special?

Paper title: Central banks and competition authorities: institutional
comparisons and new concerns
Chair: Masaaki Shirakawa (Bank of Japan)
Presenting author: John Vickers (All Souls College, Oxford)
Discussants: Allan Bollard (Reserve Bank of New Zealand)
Mario Monti (Universita Commerciale Luigi Bocconi)

**Session 7: Panel discussion: "Do central bank governance
arrangements need to be altered?"**

Chair: Jaime Caruana (BIS)
Panellists: Mark Carney (Bank of Canada)
Andrew Crockett (JP Morgan Chase International)
Stefan Ingves (Sveriges Riksbank)
Lucas Papademos (Ex Vice President, European Central Bank)
Duvvuri Subbarao (Reserve Bank of India)

The Federal Reserve, the Bank of England and the rise of the dollar as an international currency, 1914-39

Barry Eichengreen and Marc Flandreau

Abstract

This paper provides new evidence on the rise of the dollar as an international currency, focusing on its role in the conduct of trade and the provision of trade credit. We show that the shift to the dollar occurred much earlier than conventionally supposed: during and immediately after World War I. Not just market forces but also policy support – the Fed in its role as market maker – was important for the dollar's overtaking of sterling as the leading international currency.

On balance, this experience challenges the popular notion of international currency status as being determined mainly by market size.

It suggests that the popular image of strongly increasing returns and pervasive network externalities leaving room for only one monetary technology is misleading.

JEL classification: N10, N22, N24, E58, F31, F34

Keywords: Foreign exchange reserves, network externalities, path dependency, money markets.

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The Federal Reserve, the Bank of England and the rise of the dollar as an international currency, 1914-39¹

Barry Eichengreen and Marc Flandreau

In this paper we consider the role of central banks in shaping financial structures and building financial markets, and how their actions can have implications for the place of those markets in the world. The case on which we focus is the making of a market in dollar-denominated trade credits – the instruments known as “bankers’ acceptances” – in the early 20th century.

This case speaks to several issues that arise in connection with central banking and monetary policy today. A first issue concerns the role of policy, and specifically central bank policy, in fostering local currency securities markets. Since the financial crises of the 1990s, Asian and Latin American countries have made concerted efforts to develop markets in debt instruments denominated in local currency as a way of limiting the currency mismatches that are a source of financial fragility. Governments have issued a range of maturities in the effort to establish benchmark yield curves. Central banks have intervened in the secondary market to provide liquidity. While there has been progress in developing local markets, achievement has not always matched aspiration, especially where internationally traded debt securities are concerned.² Our historical case, where the United States itself sought to solve the same problem, sheds historical light on this current policy issue.

A second topic to which our analysis speaks is international currency competition. It is widely argued that there is only room for one international currency in the global system. The theoretical assertion is that increasing returns to using a national currency in international transactions are strong; network externalities are pronounced. The empirical assertion is that the pound sterling dominated international transactions in the first half of the 20th century, the dollar in its second half. In recent work we have shown that this last assertion is not accurate for foreign exchange reserves. Sterling and the dollar in fact shared the reserve currency role more or less equally in the 1920s and 1930s.³

From a theoretical point of view, it can be objected that network effects are weaker for international reserves than other international currency functions. While it pays for importers and exporters to use the same currency as other importers and exporters when, *inter alia*, invoicing and settling trade, a central bank has no similar incentive to concentrate its reserve portfolio in the same currency as other central banks; to the contrary, it will have an incentive to hold a diversified portfolio of reserves. But here we show that what was true of international reserves (that is, of official use) prior to 1914 was also true of trade credit (that

¹ Prepared for the 9th BIS Annual Conference, Lucerne, 24–25 June 2010. Barry Eichengreen is George C and Helen N Pardee Professor of Economics and Political Science at the University of California, Berkeley. Marc Flandreau is Professor of International History and International Economics at the Graduate Institute of International Studies and Development, Geneva. Many thanks to Olivier Accominotti, Gopalan Balachandran, Peter Ferderer and John James for their generosity in sharing with us data and insights. They are of course absolved from shortcomings that can only be ours. We are grateful to Hassan Malik, Riad Rezzik, Trevin Stratton, Pierre Turgeon for assisting with the data collection. Comments and suggestions by our discussant and from Philip Lane are gratefully acknowledged. We also thank the National Science Foundation and Fondation Banque de France for generous funding.

² On the evidence, see Hausmann and Panizza (2010).

³ Something that has obvious implications for thinking about the future. The recent work in question is Eichengreen and Flandreau (2009).

is, of private use). For the bankers' acceptances used for trade credit, just as for international reserves, sterling and the dollar shared the market.

For those who wish to draw an implication for the 21st century, it is that network effects giving rise to increasing returns have limits.⁴ There is no reason therefore why the dollar and the euro, notwithstanding their respective recent difficulties, cannot both be consequential international currencies.⁵

Related to this is the question of how quickly we should expect China's currency to gain a consequential international role. As we show, the United States went in only 10 years from a position where the dollar had no place as an international currency and New York was a negligible source of finance for international trade to one where the dollar was at least sterling's coequal and New York rivalled London as a source of trade credit.⁶ This is not to assert that the renminbi will necessarily rival the dollar and the euro in 2020. But it does suggest that, if network effects are less powerful than commonly asserted, the renminbi's emergence may be quicker than widely presumed.

Our evidence also highlights the regional dimension of international currency competition.⁷ In the second and third decades of the 20th century, US banks and bankers' acceptances followed US trade, and US trade followed the laws of gravity.⁸ Foreign branching by US banks occurred predominantly in places like Latin America where US trade, for reasons of geography, was most extensive. This gives grounds for thinking that the renminbi's role as an invoicing and settlement currency and China's as a source of trade finance will be greatest in Asia, where China's trade will grow most rapidly.

Finally, there is concern that central banks' extraordinary actions in 2007–09, taken to provide liquidity to distressed financial markets by purchasing commercial paper, mortgage-backed securities and other financial assets outright, created a reservoir of inflationary pressure that will burst when bank lending picks up (in clear, central banks' market-making and market-supporting actions would have created a conflict with their price stability mandate). There are fears that central bank action created a new credit bubble destined to burst, and that their interventions merely disguise problems that will become acute once they exit. There is concern about crowding out: central banks' readiness to step in as market-makers of last resort may discourage other buyers from re-entering the market. There is concern that the indiscriminate purchase of securities by central banks will encourage the renewed issuance of financial instruments of dubious quality, setting the stage for another round of financial excesses and problems. We note that the same criticisms were levied against central banks' market-making activities in the 1920s.⁹ While we do not have definitive answers to all these questions, we offer some food for thought.

The remainder of the paper is organised as follows. In Section 1 we provide some historical and institutional background on the case in question. Section 2 then focuses on the transitional period. It shows how dollar acceptances as an instrument for trade finance expanded rapidly in the 1920s from a position of, essentially, non-existence in 1914, and

⁴ Here we echo a point made by Liebowitz and Margolis (1990) in another context.

⁵ Or why other currencies could not eventually join them.

⁶ With some exaggeration, Alexander Noyes, financial editor of the *New York Times*, argued that the replacement of London by New York and of sterling by the dollar occurred "almost immediately" with the outbreak of World War I (Silber (2007, p 168)).

⁷ See Flandreau and Jobst (2009), who document the influence of trade and geography on currency internationalisation before World War I.

⁸ That is to say, it flowed in the directions and proportions suggested by the gravity model of international trade.

⁹ See Rothbard (1963, pp 117–23).

highlights the actions of the Federal Reserve in promoting the rise of the market. Section 3 turns next to the position of the incumbent, sterling. We present new evidence showing that sterling shared the status of international currency with the dollar all through the 1920s. Section 4, finally, reports evidence on the determinants of individual American banks' position in the acceptance market. It allows us to assess the relative importance of market forces, meaning trade and the general economic environment, and public policy initiatives, meaning the support from, or "private-public partnership" with, the Federal Reserve, in the growth of the market.

We conclude with a summary and some implications for today.

1. Background

Exporters need credit to purchase materials and pay their bills while their merchandise is in transit and payment has not been received. Typical practice prior to 1913 was for an American exporter to go to his bank with documents showing that he had shipped the goods and indicating what he would be paid in the future. If his collateral and credit were good, he could get his money immediately rather than having to wait for the goods to arrive in the foreign market and the buyer's payment to then arrive in the United States.

His bank financed the operation by drawing on a correspondent (or "acceptor") with which it had made prior arrangement. Upon receipt of the bill, which specified the commodities shipped and the name of the drawer (the US bank), the correspondent whose name was mentioned in the document "accepted" the security. The resulting instruments were thus known as "acceptances". Triply guaranteed by the goods, by the drawer and by the acceptor, they could be sold on to other investors. A simple bank-to-customer credit was thereby transformed into a liquid, tradable instrument.

US exports grew faster than those of any other nation in the decades leading up to World War I. By 1912 the United States was the leading trading nation. It is thus striking that virtually no trade credit was provided by US banks or denominated in dollars. Instead, American banks seeking to provide these services did so through correspondent banks in London. These acceptances were denominated in sterling, since that was the currency with which the London banks, the secondary market investors to whom they sold the paper and the Bank of England were all accustomed.

The London market had a number of strengths.¹⁰ It had a well developed population of banks, generically referred to as merchant banks for their origins in helping merchants with the finance of trade in the early 19th century.¹¹ Possessing networks of overseas correspondents, they were able to originate a large volume of acceptances.¹² Having originated acceptances, the banks turned around and distributed this paper on a large secondary market of individual and institutional investors, either individually or in bulk (in packages known as "parcels") through the agency of bill brokers.¹³ In the unusual event that there was no ready purchaser, they could offload them to the Bank of England at the "Bank rate".¹⁴

¹⁰ As contemporaries such as Jacobs (1910) recognized.

¹¹ And also private, joint stock and colonial institutions with international reach.

¹² Over time, the large commercial banks with their substantial international branch networks joined them.

¹³ See King (1936).

¹⁴ They could also secure advances from the central bank against the parcels.

This trio of factors – Britain’s early start as a trading nation, resulting in the merchant banks’ first-mover advantage; a large and active secondary market; and a market-maker of last resort – made for low costs and strongly increasing returns. They explain why London monopolised the provision of trade credit and why sterling was the dominant international currency. They explain why New York and the dollar played no international role. There was room for only one international currency, it is said. And sterling, with its first-mover advantage, was it.¹⁵

But another interpretation of why New York could not break into the market is that regulatory prohibitions and not increasing returns prevented US banks from entering. Under the National Banking Act, American banks were prohibited from branching abroad.¹⁶ Federal legislation prevented banks from dealing in trade acceptances.¹⁷ And the United States lacked a central bank to backstop the market. Given this, it is hardly surprising that the dollar played no international role.

Two pieces of circumstantial evidence are consistent with the alternative view that increasing returns and network effects were limited and that there was room in the market for more than one international currency. First, foreign exchange trading and trade finance went hand in hand, and sterling did not monopolise foreign exchange trading.¹⁸ Second, the use of a currency as central bank reserves and in foreign trade and payments went together, smoothing trade and payments being one reason why central banks hold reserves, and sterling by no means monopolised foreign exchange reserves.¹⁹ This is consistent with the

¹⁵ This narrative was prominent in the debates surrounding the creation of the Federal Reserve System. In a pamphlet written for the National Monetary Commission, for example, Jacobs (1910, p 13) deplored a state of affairs in which US bankers were forced to transact via London, observing how this “adds to the importance of London and militates against the development of New York as a financial center”. John J Arnold, First Vice-President of the First National Bank of Chicago, similarly argued that the “three cornered arrangement” whereby London banks financed American foreign trade could “and should be eliminated” so that a “direct dollar exchange market” be created between the United States and South America and the Orient so as to deny London “the undue advantage which this center has had in the past” (Parrini (1969, p 105)). US business and policy leaders supporting the internationalisation of New York and the US dollar referred to the amount paid annually to British banks in acceptance fees as the “tribute” (see eg Warburg (1910)). Of course the metaphor was flawed: British bankers financed American trade more cheaply than New York bankers would have (Phelps (1927, p 102); Parrini (1969, p 103)). The actual amount involved was a small fraction of U. trade or GDP. In 1927, when US banks had secured a large share of the global market for acceptances, the *Acceptance Bulletin* estimated the annual saving to have been a “material” \$5 million. Even this figure is an upper bound, since it does not subtract the resource cost for US banks to supply the acceptances.

¹⁶ Trust companies could branch abroad, but few did, and those which set up foreign offices did so mainly in order to gather information on foreign bonds, which were attractive assets to add to their portfolios since these matched the maturity of their liabilities to their trustees. Some state charters also allowed state banks to branch abroad, although few if any ever did. There was one specialised institution, the International Banking Corporation, set up by the Remington Arms Company to assist it in its foreign sales, that operated foreign branches but was prohibited from engaging in domestic banking.

¹⁷ Actually the relevant legislation only lacked provisions explicitly authorising banks to engage in this business, but the courts, channelling long-standing American suspicion of concentrated financial power, repeatedly ruled against their efforts to do so. While other forms of short-term credit emerged, they were less liquid than European-style acceptances. One form of short-term negotiable security that came into existence and played some domestic role was the so-called single name “commercial paper”. Commercial paper was issued by industrial and commercial enterprises of substantial standing and traded in organised markets. But while commercial paper paid with “clockwork regularity”, it was relatively illiquid (James (1995, p 224), drawing on Foulke (1931, pp 80, 84–6)).

¹⁸ Flandreau and Jobst (2005) show that bills denominated in sterling, francs and marks had the widest foreign circulation. Those in sterling were traded everywhere, those in francs in 80% of foreign markets, and those in marks in 59%.

¹⁹ According to Lindert (1969), sterling accounted for 51% of identified reserves in 1913, the franc 33%, and the mark 16%.

presumption that sterling was the leading international currency. But it is inconsistent with the belief that it was the only one.

Second, the evidence in Flandreau and Jobst (2009) is inconsistent with strongly increasing returns. The authors construct a model of the pre-1914 international monetary system that allows for strategic externalities. Currencies are traded abroad as a function of their value for users. Value is greater when currencies are liquid. This encourages more users to hold liquid currencies and generates positive feedback. Persistence emerges when the feedback loop is sufficiently powerful. Flandreau and Jobst estimate this model using pre-1914 data and reject the presence of strong lock-in effects. These findings thus cast doubt on popular notions of network externalities being an insurmountable obstacle to the rise of the dollar.

The 1920s permit a more direct test. The Federal Reserve Act of 1913 created a US central bank authorised to discount and purchase trade acceptances as a mechanism for smoothing interest rates and managing credit conditions. It removed the prohibition on foreign branching and authorised banks to deal in trade acceptances.²⁰ World War I then disrupted the provision of trade credit by London and the other European financial centres, giving the New York market an opportunity to get up and running.

One can thus imagine three hypotheses for what one should expect to see in the 1920s.

- Network effects and increasing returns were sufficiently powerful that London retained its first-mover advantage. Lock-in being strong, the equilibrium would not shift even if an alternative was more efficient for the world as a whole.²¹
- While network effects and increasing returns were strong, central banks as architects could shift the system between equilibria. Although New York lacked a secondary market of individual and institutional investors for much of the period, the Fed provided resources to shift to the new equilibrium (a policy analogous to “big push” in models of underdevelopment with multiple equilibria). The Fed acted as market-maker of last resort, allowing the dollar to supplant sterling as the currency used for trade finance already in the 1920s.²²
- Increasing returns were not strong enough to give one currency a natural monopoly, and network effects were not sufficiently pervasive for strong lock-in. As a result of

²⁰ One motive for the act was precisely to create a market in trade acceptances in New York, the belief being that a market in securities backed by receivables would be more stable than one dominated by speculative stock market transactions – this having been a popular explanation for the 1907 financial crisis.

²¹ This is essentially the QWERTY story of strong lock-in (David (1985)). This presumption is found in some recent historical literature, in which it is argued that sterling remained the leading international currency until after World War II, as well as in accounts by economists. Modern accounts assert that, once established, London’s first-mover advantage was difficult, even impossible, to overturn. For example, Roberts and Kynaston (2000, p 192) argue that “the lesson of history is that – once established – leading financial centres retain their primacy until toppled by an external shock”. Michie (2007, p 78) similarly argues that World War I was a major shock for London’s supremacy, but was “insufficient to destroy the strong position it had established in the years before 1914”. Others like Aliber (1966) and, more recently, Chinn and Frankel (2008), have echoed Triffin (1960) in suggesting that the dollar only overtook sterling after World War II.

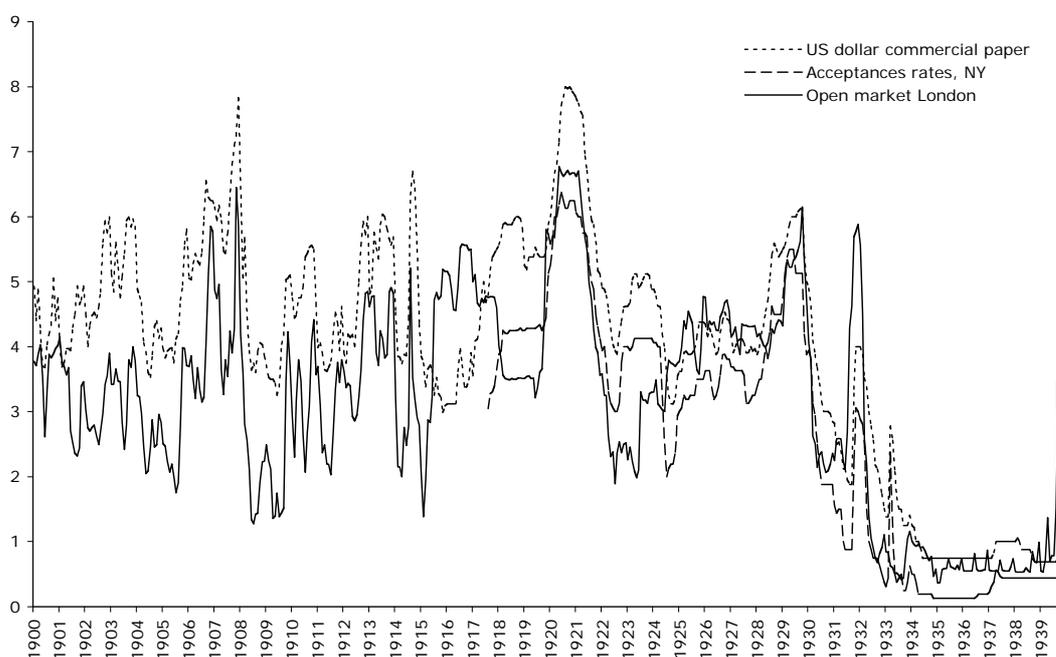
²² Previous students of strategic externalities (Liebowitz and Margolis (1990)) have argued that the strong lock-in suggested by the QWERTY hypothesis is unlikely. In the conventional tale, large players are able to subsidise adoption of the new standard and, once it is adopted, agents coordinate on it and the subsidy is no longer needed. In our context, these players would be central banks or possibly public-private partnership of banks and policymakers. In this spirit, Ferderer (2003, p 666) argues that “Federal Reserve Banks played a key role by reducing the risk borne by private dealers and propelling the [dollar acceptances] market to a high-liquidity equilibrium.” Silber (2007, p 168) praises the steps taken by Treasury Secretary McAdoo at the onset of World War I to keep the dollar on gold, persuading markets of its credibility. Had this policy not been implemented, he concludes, “Britain could have easily remained the undisputed, if somewhat battered, champion of international finance until the Second World War. It almost happened.”

both market forces and policy intervention, monopoly gave way to duopoly. Sterling and the dollar could and did share the international currency role in the 1920s.

2. The rise of New York

The Federal Reserve System played a key role in fostering the international role of the dollar. It did so as a carrier of regulatory reform. But, in addition, it actively promoted the new market.²³

Figure 1
London and New York money market rates, 1900–39



Source: See text.

Figure 1 uses interest rates to measure the competitiveness of the London and New York markets. While the cost of acceptance credit had other components (taxes, the bank's commission, exchange risk insurance etc), the interest rate was the largest part.²⁴ The rate for London is the open market rate – the rate at which acceptances were bought by investors. We compare it to the open market rate on US acceptances when possible. But since US rates for acceptances only become available in January 1917, we also show prime US commercial paper rates (ie the rate on prime short-term credit instruments issued by corporate borrowers of high standing), which begin earlier.²⁵

²³ While the first effect was permanent, the second was more transient, the Fed withdrawing from the market after the summer of 1931.

²⁴ This makes the interest differential a fair approximation of the relative cost of financing a shipment in the alternative centres and currencies. See Vigreux (1932), p 121.

²⁵ This is an appropriate comparison, since commercial paper benefited in similar fashion from the new arrangements. The Federal Reserve Act was intended to promote the commercial paper market, and Federal

Until World War I, the U.S. commercial paper rate was continually above the open market rate in London, sometimes by as much as 200 basis points. The creation of the Federal Reserve was followed by a sharp reduction in the differential. By 1915 the commercial paper rate was 100 basis points below the London open market rate. In 1917, when dollar acceptance rates become available, they are even lower than commercial paper rates.

The period centred on 1915 thus saw a revolution in the relative position of London and New York. Figure 2 shows that the total outstanding acceptances of US banks began rising that same year.²⁶ The Guaranty Trust Company claims to have been first to begin originating acceptances and allowing foreign correspondents to draw on it. Our data support this, showing \$18.2 million of acceptances in its December 1914 balance sheet, a date when the market was probably not much bigger than that.²⁷ Over the course of 1915, more banks then began entering the market. This is when the interest differential in Figure 1 reverses. These changes may have been due not to the advent of the Fed, of course, but to the dislocations of the war and limited sterling convertibility. However, whereas the latter presumably would have had only transitory effects, the shift in London-New York interest differentials was permanent. While this is consistent with both our second and third hypotheses above, it is inconsistent with the first (emphasising the overwhelming importance of first-mover advantage).

Figure 2 highlights the role of the Fed in nurturing the infant industry; it shows acceptances in the Fed's custody from 1915 through 1939. The Fed's *Annual Report* for 1915 points to this year as when the market for acceptances first showed signs of life. It describes how the Federal Reserve Bank of Boston made "every effort to further and develop that business", buying acceptances from Massachusetts banking institutions engaged in financing "hides and wool from South America and cotton and jute from the orient and other sections of the world" in the early months of 1915, trade that had previously been financed "through credits drawn on European centres".²⁸

Further evidence can be garnered from the minutes of the Open Market Investment Committee.²⁹ For instance, a statement pertaining to the policy adopted in the April 1923 meeting compared the alleged hands-off policy of the Bank of England (allowing the maintenance of a spread between the open market rate and the rediscount rate) and recommended a more aggressive policy for the Fed: "A Policy as drastic as that of the Bank of England, for instance, which always aims to make the market pay a penalty rate upon recourse to the bank, is not always suited to the American bill market, and if applied might have an adverse effect upon the establishment of dollar credit and dollar bills in overseas trade and world markets, and it seems reasonably certain that the sterling credit would

Reserve rediscount rates on commercial paper were close to, if slightly higher than, the rate on acceptances. As recalled by James (1995, p 227), the Federal Reserve Act was defined as "An Act to provide for the Establishment of Federal Reserve Banks ... and to afford means of rediscounting commercial paper". As for information on dollar acceptances, the editors of the *Acceptance Bulletin* constructed monthly series from material submitted by reporting banks. The resulting series is available January 1917 to April 1936 (the *Bulletin* having been discontinued at that point). From 1917 onward, the *Bulletin* also distinguished acceptances created to finance exports, imports, shipments and goods stored in foreign countries, domestic shipments, domestic warehouse credits and dollar exchange. Federal Reserve reports and bulletins then provide information on acceptances between 1936 and 1939.

²⁶ From Federal Reserve statistics and the *Acceptance Bulletin*.

²⁷ It complains, however, that the acceptances it originated failed to find ready buyers, forcing it to hold its own paper (Guaranty Trust (1919)).

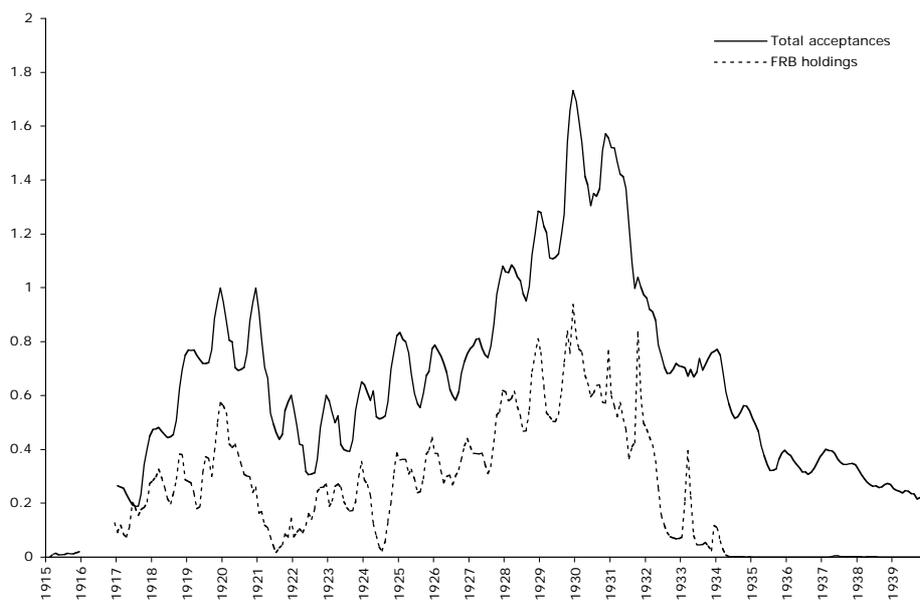
²⁸ The report also mentions that seven additional banks in the area had moved into the acceptance business (Federal Reserve System, *Annual Report for 1915*, p 136).

²⁹ A body created in 1923 to monitor the Fed's investment and money market policy and operations.

quickly drive the dollar credit from those markets. It is probable therefore that we must continue for some time a somewhat paternalistic attitude towards the market for dollar bills in this country.”³⁰ Other passages point in the same direction. Together they suggest that during the 1910s and 1920s, the Fed made a sustained effort to render dollar acceptances more attractive relative to their sterling competitors.

Figure 2
**Total outstanding acceptances and amounts held by the
 Federal Reserve Board (own account or for account
 of foreign correspondents)**

In billions of US dollars



Source: See text.

We see in Figure 2 that the market in acceptances experienced two boom-and-bust cycles. There was a sharp increase towards the end of World War I, coincident with the increase in US trade associated with direct American military involvement. The peak reached in 1919–20 was then followed by a sharp decline. The second expansion started in 1922–3 and peaked after the stock market and the economy in 1929. The subsequent decline in the volume of acceptances persisted through the 1930s.

Looking at total acceptances in conjunction with Fed holdings directs one’s attention to periods like 1917 when the central bank was evidently the only purchaser on the secondary market.³¹ On average the Fed held between a quarter and two thirds of outstanding acceptances.³² Suggestively, the withdrawal of the Fed from the market coincides with the decline of the industry in the early 1930s.

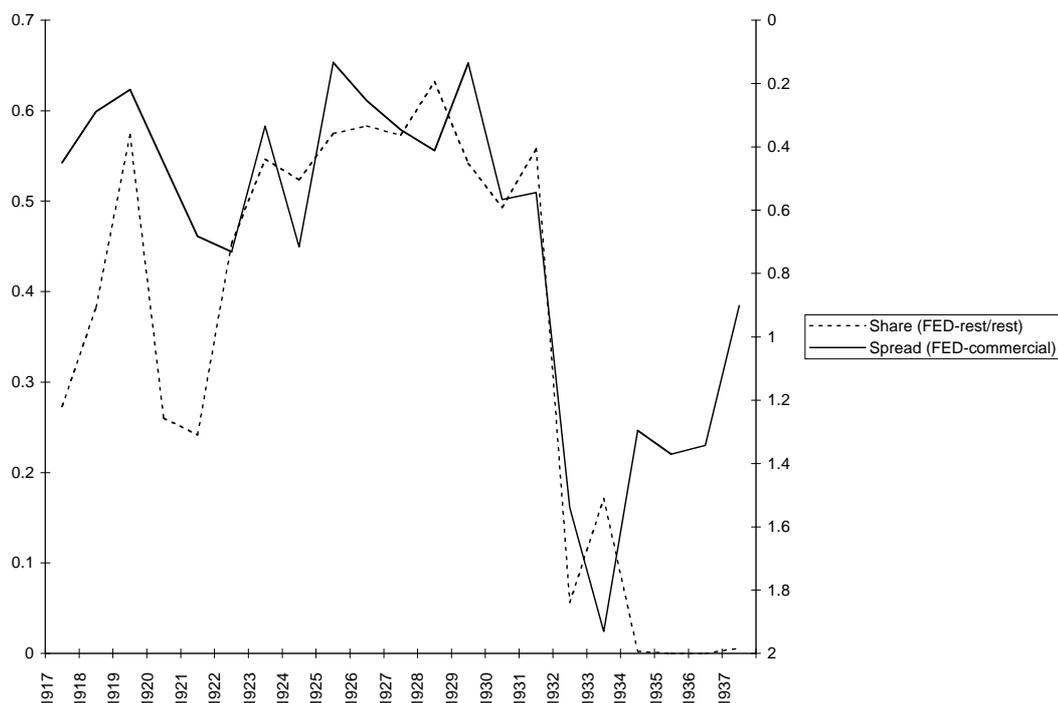
³⁰ Federal Reserve Archival System for Economic Research, Federal Reserve Open Market Investment Committee (Open Market Policy Conference), Excerpts, 1923 to 1928. Quote taken from “Excerpts of the Federal Open Market Investment Committee during 1923”, p 5.

³¹ Holdings are measured here as total holdings, ie holdings for its own account and for the account of foreign customers, mostly central banks.

³² Again, either on its own account or on that of foreign central banks holding deposits with it.

Figure 3

Share of the Fed in the acceptance market and relative interest rates



Source: Authors' computations from sources in text.

Figure 3 juxtaposes two indicators of official support for the market. The first is the Fed's holdings as a share of outstanding acceptances. The second is the spread between the Federal Reserve and market rates for acceptances. The narrower the spread, the stronger the support (a lower spread suggesting that the Fed was more anxious to step into the market). With the notable exception of the wake of the two trade busts (1921 and 1931), the Fed kept its rate close to the market rate and purchased a substantial fraction of acceptances outstanding. Again, this is consistent with the view that the US central bank played an active and, indeed, critical role in fostering the new market in dollar-denominated trade credit.

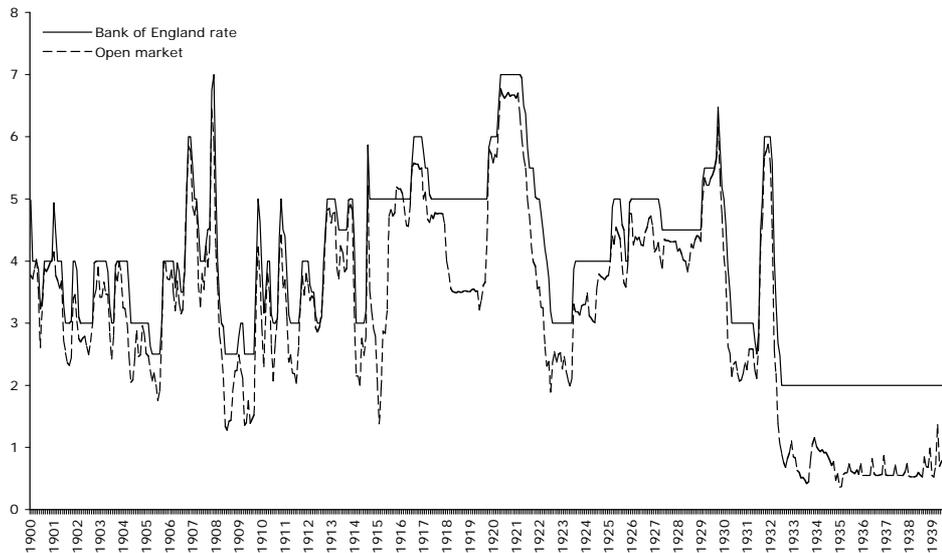
3. The Empire strikes back

We turn next to conditions on the London market. Figure 4 shows the correlation between Bank rate (the Bank of England's rediscount rate) and the open market discount rate before and after 1914 (analogous to Figure 3 for the United States). The correlation loosens during and after the war, suggesting that the Bank of England, grappling with a weak sterling exchange rate, could not support the market as freely (it faced a trade-off between market support and protection of its gold reserves).³³

³³ See Sayers (1968) for a discussion of the conflicts created by the multiplicity of policy objectives during the 1920s and the partial remedies found to deal with it.

Figure 4

Bank of England rediscount rate and open market rate 1900–39



Source: NBER Historical Macro Database.

Notwithstanding those difficulties, the Bank of England and the UK government made a determined effort not just to maintain London's position but to expand its reach.³⁴ The war created an opportunity to address the challenge from German banks and the potential challenge from the United States.

In 1916, a blueprint for a postwar UK-centred international economic system was described at the Paris Economic Conference. Market access and shipping privileges would be used to reward allies and punish enemies and neutrals – meaning Germany and the United States, respectively. Reliance on the Empire, together with selective Continental alliances, would provide the critical mass for a London-centred European commercial and financial system.³⁵

International, overseas and merchant banks were encouraged to expand their geographical reach and received active official support. The British government seized the London branch of the Anglo-Austrian Bank, a leading Vienna-based institution with links to Germany. Once the government and its friends in the private sector acquired its records and correspondence, they could see how its affiliated institutions operated in Central Europe. This knowledge "eased the way for private British interests to seize control of the Anglo-Austrian network".³⁶ After the war, such expropriations were justified under Article 248 of the Versailles Treaty permitting the organisation, in 1922, under the aegis of the Bank of England of the "new" Anglo-Austrian Bank, which in turn controlled the new Anglo-Czech Bank, formed to take over the branches of the former Anglo-Austrian Bank in Czechoslovakia. Similar policies were adopted for Turkey, where German banks had had a prominent role before World War I and which like the Habsburg Empire had been an ally of Germany.

³⁴ See Robinson (1923), Baster (1937) and Jones (1995).

³⁵ Parrini argues that the US declaration of war and Wilson's sponsoring of the League of Nations were direct responses to this challenge. They led Britain to revise earlier plans and offer the United States "co-chairmanship" of the global trading and financial system (Parrini (1969)).

³⁶ Parrini (1969), p.129.

To what extent did these policies extend sterling's reach? Consider Latin America, a region where Britain's financial leadership was actively disputed by the United States. Before World War I, the role of the mark in financing Latin trade had expanded on the basis of growing German industrial exports. Integral to this process were German overseas banks: the Banco Alemán Transatlántico, the Deutsch-Südamerikanische Bank, Brasilianische Bank für Deutschland and the Bank für Chile und Deutschland, which were active primarily in Argentina, Brazil and Chile.³⁷ Most were controlled by or affiliated with the "great banks" that were the pillars of the German banking system.³⁸

With the outbreak of the war, the British authorities sought to limit Germany's capacity to trade and the German banks' ability to extend trade finance. The Latin and London branches of German overseas banks were shut down or expropriated.³⁹ Utilising information obtained through these expropriations, British merchant and overseas banks moved to fill the void. Table 1 shows data for 1913 and 1921 assembled from *Bankers' Almanac*. We compare Germany's four Latin American banks with three British rivals. As can be seen, German overseas banks lost their parent connections in London and were replaced by British merchant banks. The merchant houses that moved, Kleinworts, Schrodgers and Seligmans, were well established London institutions and active in the sterling area.⁴⁰ Where the capital and balance sheets of British and German banks operating in Latin America had been comparable in 1913, British banks were much larger in 1921.⁴¹ We take this as indicating that accounts suggesting that the war was good for the United States but bad for Britain lack balance. The use of political means to eliminate German competition could and in some cases did reinforce the position of London.⁴²

What was the net effect on the sterling and dollar acceptance markets? Figure 5 shows their evolution.⁴³ We use here the most comprehensive definition of sterling acceptances, meaning both those drawn abroad and those drawn domestically, and the corresponding US totals.⁴⁴ The value of dollar and sterling acceptances was quite close in the late 1920s. This

³⁷ See Battilossi (2006) and Briones and Villela (2006).

³⁸ The Deutsche Bank, the Disconto-Gesellschaft, or the Dresdner Bank. Such arrangements were not specific to Latin America. The Deutsch-Asiatische Bank for instance was active in China.

³⁹ In 1914, the Allies forced the Deutsch-Asiatische Bank branches in China to shut down. These branches were barely able to resume their operation in 1918. See King (1989) and Horesh (2008).

⁴⁰ And of German origin and with a strong German information base.

⁴¹ Inflation played a role in the reduction in the capital base, but geopolitical dislocations were decisive. Had shareholders of German overseas banks felt that recapitalisation would bring revenues, they would have supplied the needed resources.

⁴² We also find the grabbing hand where we did not expect it, with the United Kingdom and United States stripping Germany of its banking system and taking advantage of the war to expand dramatically.

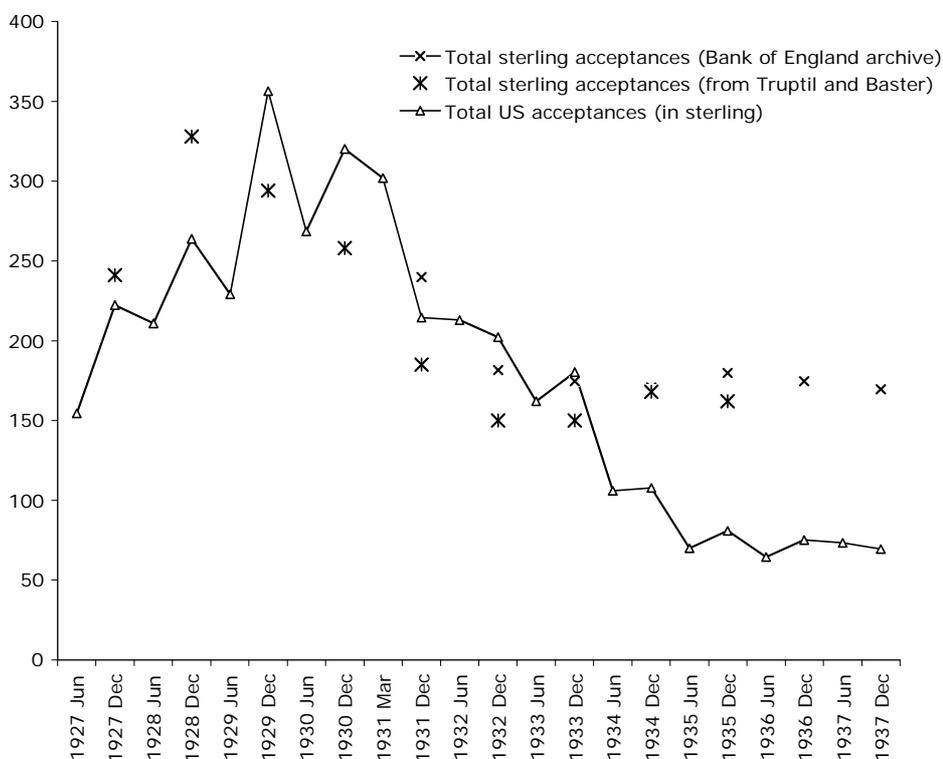
⁴³ There is no British equivalent of the *Acceptance Bulletin* (no central body collected relevant information). The figures we report are for the sub-period 1927–37. Truutil (1936, pp 159 ff) used material from the Committee on Finance and Industry (1931) together with assumptions about the stability of various types of banks' proportions in totals to impute missing information. Baster (1937) then extended Truutil's estimates. We have also drawn on unpublished estimates by the Bank of England. Starting in the 1930s the Bank provided estimates of the volume of acceptances (Bank of England Archive EID4/86). We thank Olivier Accominotti for this material.

⁴⁴ This seems to be the best way to go: because domestic trade could also be financed by domestic drafts, trying to disentangle domestic and foreign drafts is hopeless. Statisticians of British acceptances typically attempt to identify acceptances from banks' balance sheets, as the publishers of the *Acceptance Bulletin* did for the United States.

figure for private international claims resembles to a striking degree the findings of Eichengreen and Flandreau (2009) for official international reserve holdings.⁴⁵

Again as with official reserves, the dollar's share then shrank in the economic crisis of the 1930s. Where the nominal value of sterling acceptances fell by half between the peak in 1929 and the middle of the 1930s, dollar acceptances in 1935 were barely a seventh of what they had been in 1929. Again, this parallels what we have found for changes in the composition of international reserve holdings between the 1920s and 1930s. In the case of acceptances (as in the case of reserves), the fact that the US depression was more severe and that US trade contracted more rapidly than British trade is part of the story, but only a part. We return to this.

Figure 5
Dollar and sterling acceptances 1927–37
 In millions of pounds sterling



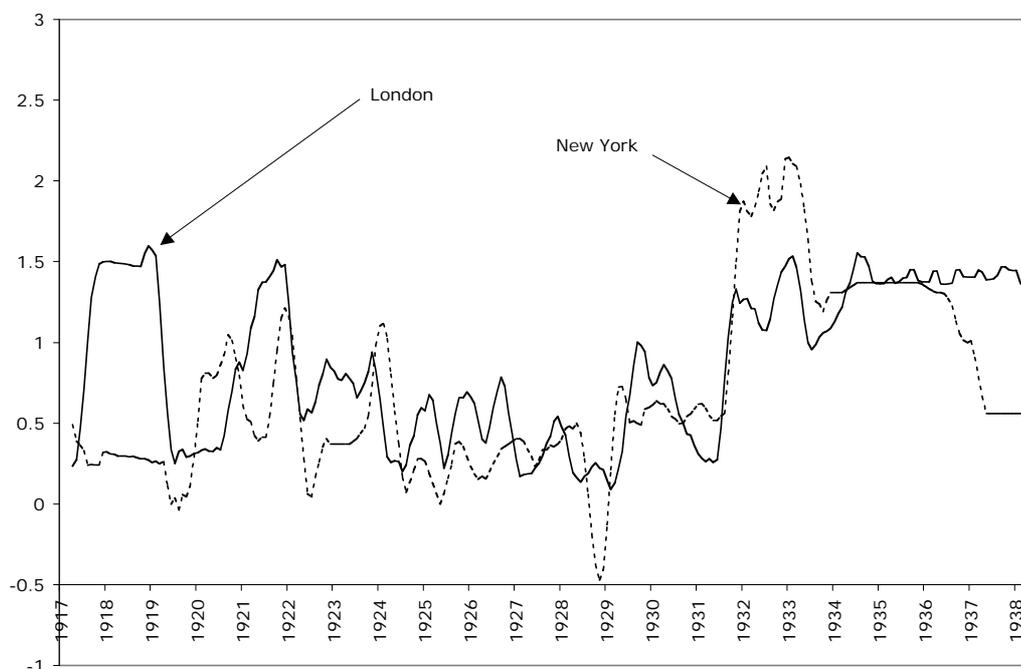
Source: Authors' estimates based on documents described in the text.

The picture that emerges from this section is one of competition between two international currencies, not the dominance of one. Reinforcing the point, Figure 6 compares the market-bank spreads for London and New York. After 1922, spreads in the two markets are comparable. Insofar as the spread between official and market rates is indicative of central bank support, Figure 6 tells us that central banks and currencies competed with one another.

⁴⁵ This is only half surprising of course since central bank foreign exchange reserves mostly comprised bills (or acceptances), deposits and government bonds. In the Fed's case foreign deposits were reinvested in acceptances, thus establishing a direct link between demand and supply.

The 1930s then saw both central banks walk away from the market, the Fed even more so than the Bank of England. There is a striking correlation with Figure 5, which shows total US acceptances declining much more dramatically than total British acceptances.

Figure 6
**Spreads between official and market rates
 in London and New York 1917–39**



Source: NBER Historical Macro Database.

4. The supply of acceptances: evidence from panel data

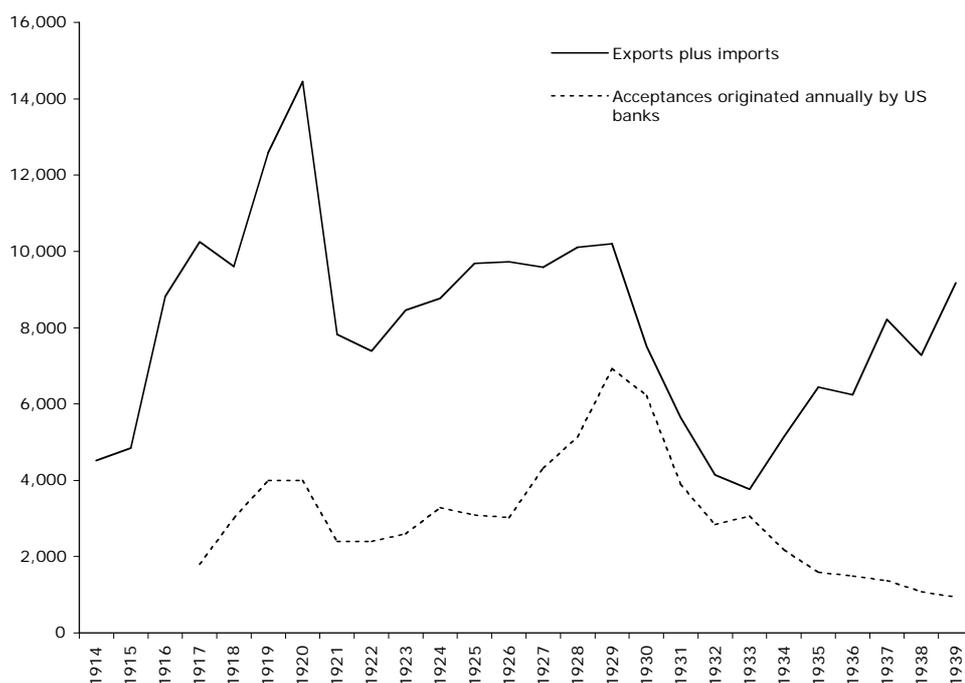
In this section we look more closely at the growth of the dollar acceptance market in the 1920s. A first interpretation of this phenomenon is that it was market-led. US banks were capable of entering the market; they only had to be freed of regulatory restrictions. A second interpretation is that the transition was government-led. It would not have occurred had the Fed not substituted for the missing secondary market.

One can identify two variants of the market-led hypothesis. One emphasises branching. Overseas branches were needed to gather information on foreign markets of the sort that the London banks had traditionally. They were needed in order to be able to conveniently attract the business of merchants who did not reside in the United States. This is the dominant view in much previous historical research as well as contemporary policy debate. Exporters, in particular, insisted on a US system of branches that would handle US trade and US trade secrets.⁴⁶

⁴⁶ See Phelps (1927), Lewis (1938), Parrini (1969), Cleveland and Huertas (1985), Stallings (1987) and more recently, Cattani and Tschoegl (2002).

The other variant is that US banks, once liberated from restrictions on dealing in trade credit, could build on their existing connections with importers and exporters. It was foreign trade and not foreign branches on which the new acceptance business rested. Previous scholars have paid less attention to this hypothesis, but Figure 7 (which compares annual US trade – imports plus exports – with the total amount of acceptances originated annually) is at least not inconsistent with it.

Figure 7
**US trade (imports plus exports) and
 total acceptances originated annually**
 In millions of US dollars



Source: See text. Total acceptances originated annually are obtained by assuming typical acceptances have a three months' maturity.

Who did branch and when? Table 2 summarises the extent of branching.⁴⁷ The number of banks that developed networks of foreign branches, either directly or through subsidiaries, was limited. National City Bank, First National Bank of Boston, Guaranty Trust and Chase dominate the list. Other institutions boasted “representative offices”, but these

⁴⁷ On the surface previous estimates differ, although on closer inspection discrepancies can be explained away. This we did by constructing our own estimates from the *Bankers' Almanac*. Phelps provides a table with the number of branches by bank in some benchmark years (1913, 1920, 1926) and another one with banks by region in 1926 (Phelps (1927, pp 211–12). Lewis (1938) expands Phelps' table for branching to 1919, 1924, 1929, 1933 and 1935. Parrini (1969, p 116) offers a decomposition of branching in 1920 by country and banking “family” (the National City-International Banking Corporation conglomerate vs the Morgan affiliates. Cleveland and Huertas (1985, pp 324–5) provide a table describing National City Bank/Citigroup per region. Finally Stallings (1987, p 70) tracks US branches in Latin America between 1914 and 1930. *Bankers' Almanac* gives for each city a list of institutions in operation. This being a British source, it may however have undercounted U.S. banks.. Where Phelps and Lewis list 57 National City Company branches in 1920 when Cleveland and Huertas have 81. As shown in the table, Cleveland and Huertas must be considering all the branches of the National City complex.

representatives (sometimes single individuals) in other countries were not branches proper. This is not inconsistent with industrialists' complaints (Parrini (1969)) that banks were not doing enough.

Table 3 shows the value of acceptances originated by bank.⁴⁸ While banks with foreign branches usually ranked at the top, it appears that the acceptance market was quite competitive. Data published by Kniffin (1920) for 1 May 1917 enable us to compute a Herfindahl-Hirschman acceptance market concentration index. We find 0.47 a low figure that is consistent with the null hypothesis of a competitive market. Using league tables in the *Acceptance Bulletin* and data from banks' balance sheets, we find that the top four banks accounted for 30% of the market at the end of 1927, a substantial but not overwhelming fraction; to get 85%, one must consider 40 banks.⁴⁹ Given the fact that a fair number of banks with few or no foreign branches appear to have been active in the market, one can question the conventional view that branching was key. The alternative interpretation would be that in order to increase acceptances one only needed good correspondents abroad, competitive discount rates, reasonable transaction costs making the drawing of drafts on New York attractive, and ready access to a sufficiently large clientele.

We now analyse these factors more systematically. Each bank, we assume, originates acceptances in proportion to capital and reserves (to which acceptances were tied through regulation or balance sheet).⁵⁰ The bank's acceptance business was also influenced by the total size of the market (the demand for trade credit), as captured by the value of acceptances or total US trade (imports plus exports). Finally, we ask if branches matter.

Data come from balance sheets for the period 1915–39 for 20 banks.⁵¹ In the illustrative example below (Figure 8), the exact same figure for acceptances (\$6,482,165.72) appears both on the asset side (they are claims on customers) and on the liability side (the bank has committed itself to pay the amount at maturity).⁵² Balance sheets were also used to gather figures for other bank attributes (capital, reserves, total assets etc). US trade is from the NBER database, and total acceptances are from the *Acceptance Bulletin* and the Federal Reserve's *Banking and Monetary Statistics*. All variables are in logs.

We use a simple dummy variable for branches. While some banks branched more heavily than others, it is hard to know how to weigh a single branch in Paris against several branches in Cuba. Reassuringly, results were not affected by alternative specifications.⁵³

The panel is unbalanced owing to missing observations (some banks were merged, others were closed). We provide two sets of panel estimates, with and without clustering of the standard errors. The latter may be more appropriate, since we are combining bank-level and macroeconomic variables (Moulton (1990)).

⁴⁸ This is assembled from the *Acceptance Bulletin's* league tables for the value of acceptances originated.

⁴⁹ *Acceptance Bulletin* (January 1928), pp 3–4.

⁵⁰ The Federal Reserve Act authorised national banks to purchase or discount acceptances up to 50% of capital. The ceiling was raised to 100% subsequently.

⁵¹ They come from the Baker Library at Harvard, Columbia's Online Digital Collection, the British Library and the Graduate Institute collection of banks' balance sheets. See the Appendix.

⁵² Real-life situations tend to be more complex. Occasionally, acceptances on the liability side are mixed with related securities like credit lines. It was generally possible to get fairly reliable numbers, which were checked against the rankings in the *Acceptance Bulletin's* league tables.

⁵³ We abstract from reverse causation. It could be, of course, that branching does not add more acceptances, but that banks that did a number of things had more acceptances and had then to branch in order to meet customers' needs. However, considering this would weaken the case for branches, and, given our later finding, this is not essential for us as it would only strengthen our conclusions.

Figure 8

Looking for acceptance data in banks' balance sheets

ASSETS.		LIABILITIES.	
U. S. Bonds to secure circulation	\$450,000.00	Capital Stock	\$10,000,000.00
U. S. Bonds	100,000.00	Surplus	10,000,000.00
Bonds and Stocks	42,327,941.59	Undivided Profits,	1,814,113.05
Customers Liability account of Acceptances	6,482,165.72		\$21,814,113.05
Customers Liability under Letters of Credit	392,900.00	Circulation	450,000.00
Bills discounted	32,865,816.69	Deposits, viz:	
Time loans on collaterals	60,109,196.29	Individuals	157,063,108.87
Discounted loans on collaterals	\$77,829,082.39	Banks	128,433,374.39
Due from banks	13,018,365.23		286,416,500.26
Exchanges for Clearing-House	39,832,151.26	Acceptances based on Imports and Exports	6,482,165.72
Five per cent. fund	22,500.00	Letters of Credit	418,170.00
Legal tender notes	4,865,888.00	Reserved for Taxes	160,347.09
Treasury silver certificates	2,467,007.00		\$315,741,296.12
Gold	18,144,405.00		
Federal Reserve Bank	16,834,196.95		
	173,013,595.83		
	\$315,741,296.12		

Source: Kniffin (1920, p 81).

Table 4 shows the results. Bank size, whether measured by total assets or capital, is generally significant and has a positive effect.⁵⁴ The macro variables – total acceptances and total trade – are significant and positive.⁵⁵ Finally, branching is in general significant. The existence of branches is associated with a 60% (upper bound estimate) increase in outstanding acceptances.

But magnitudes matter: what do the estimates imply for the role of branching in the growth of the market? Recall that the top four banks controlled about 30% of the total market for acceptances in 1928. Our estimates imply that, had it not been for their branches, they would have had only 20% of the market, a noticeable but not ruinous decline. The conclusion, therefore, is that branches helped but were not indispensable to the growth of the acceptance market. Banks that did not go overseas were still able to enter the market, making use of their established connections with US importers and exporters.

Tables 5 and 6 assess the contribution of the Fed. Table 5 considers a narrow definition of Fed support: total acceptances held on the Fed's own account. This variable tends to be statistically significant at conventional confidence levels even when it is included together with total acceptances outstanding and US trade, with which it is collinear.⁵⁶ The point estimates move around (as a function of which control variables are included), but they uniformly suggest that Fed purchases were as important as the aggregate growth of the market for individual bank behaviour. Knowing that it might be possible to lay off acceptances on the Fed caused individual banks to respond roughly twice as fast to market growth as otherwise. This makes sense: acceptances brought revenue while immobilising close to zero capital. Banks thus were prepared to issue as many as they would be sure to sell (subject to regulatory constraints that tied acceptances to capital and reserves). If by contrast there

⁵⁴ Introducing capital and total assets together creates a problem of multicollinearity, as one would expect.

⁵⁵ Although, again, multicollinearity is an issue.

⁵⁶ In this table and the one that follows we continue to cluster the standard errors.

were fewer buyers and banks faced the risk of having to buy their own paper, the cost of underwriting more acceptances rose, rendering banks more reluctant to originate them.

The narrow definition of support may not be the best one. The Fed also received deposits from foreign central banks (prominently from the Bank of France) which it then parked as acceptances, again in part to foster the growth of the market. While the Fed did not determine the amounts deposited, it certainly decided what it would do with them – that it would recycle them as acceptances as opposed to other investments (it might have invested in Treasuries, for instance). In Table 6 we therefore add these acceptances held by the Fed for the account of others to acceptances purchased for its own account. The official-purchases variable is now even more significant than before, reinforcing the conclusion that they played an important market-making role.

The results from Tables 5 and 6 suggest that, to the extent that the Federal Reserve helped the market through active purchases during the 1920s, it must by definition have penalised it when it withdrew in the 1930s. Evidently, the failure of the Fed to support the market after 1931 was an important factor in its absolute and relative decline. Reasons for this failure should be the topic of future research. A contemporary line, echoed in a recent monograph by Mehrling (2010), is that in driving up the price and driving down the return on acceptances the Fed made them less attractive for private investors to hold. Banks in particular were encouraged to invest instead in more rewarding over-the-counter securities repurchase agreements and loans to stockbrokers. When crisis hit, the Fed then found itself having to choose between defending the dollar's gold parity and providing support to the banks, which were heavily invested in government securities on the one hand, and continuing to support the nascent market in acceptances on the other. Forced to choose, it opted to sacrifice the acceptances' "infant industry", which at that time had barely evolved beyond the juvenile stage.

We undertook a number of robustness checks of these results. In Table 7 we substitute an alternative measure of Fed support for the market, namely the spread between the official and commercial discount rates on acceptances. The results are as before; these strongly support the notion that official support mattered. In Table 8 we address the concern that Fed investments in acceptances and total investments in acceptances are simultaneously determined by redefining the dependent variable as the market share of an individual bank in an individual year. The results are again consistent with what we found before, except that the effect of branching is now somewhat larger. The second panel of the table, where we include the Fed's share as an explanatory variable, suggests that official support for the market favoured the big players disproportionately (big banks dominating our sample).

5. Conclusion

This paper has offered new evidence on the rise of the dollar as an international currency during World War I and the interwar years. As a heuristic we have used the analogy between international currencies and network effects in the adoption of technologies. The question is whether the international monetary and financial system was subject to strong lock-in and irreversibility, whether it could in fact be shifted from one equilibrium to another by large shocks and the actions of large players like central banks, or whether there were in fact limits on increasing returns and network externalities, permitting several monetary technologies to coexist.

Much previous literature emphasises the first hypothesis, and a good deal favours the second. It is argued that sterling remained the dominant currency in private as well as official international transactions until after World War II, long after the United States surpassed Britain as the largest economy and leading trading nation. It is said that this lag between shifts in economic and monetary circumstances reflected the strength of increasing returns,

network externalities and London's first-mover advantage. When the shift finally occurred, it reflected the shock of the war and the support provided by the Fed. To the extent that market forces played a role, they were mediated by the foreign branching of US banks.

In this paper we have challenged this conventional wisdom. We show that the shift actually occurred much earlier, during and after World War I. As early as the 1920s, the dollar rivalled and, indeed, surpassed sterling as a source of trade credit. This finding parallels what we found previously for the official use of international currencies, that is, for the composition of central bank reserves.

We show next that it was not merely the growth of foreign branches but also the growth of US trade that allowed American banks to enter the market. Increased trade fostered the growth of a network of correspondents abroad that enabled American banks to enter the acceptance market as soon as they were endowed with competitive discount rates and freed from regulatory restrictions.

We show third that not just market forces (the actions of American commercial banks and trust companies) but also public support – the Fed's role as architect – played a role in the dollar's rapid catch-up and brief overtaking of sterling as the leading international currency. This occurred before a liquid secondary market of private and institutional investors to which the acceptances originated by US banks and trust companies could be resold was built.⁵⁷ The mechanism that enabled this stage to be skipped was the Fed, which stepped in as secondary market-maker of last resort. Our estimates suggest that the US market in trade acceptances grew significantly faster than it would have in the absence of this official support. There is a message here for governments like China's seeking to promote the international use of their currency.⁵⁸

We show fourth that when central banks stepped out of the market for acceptances in the 1930s, the market in dollar acceptances collapsed all but completely, whereas the market in sterling acceptances did not. Evidently the task of building a new secondary market of individual and institutional investors, analogous to what London had already done in the 19th century, was more difficult than supposed. Indeed, the Fed's aggressive intervention as buyer of last resort may have stifled rather than fostered the development of that market.

We show finally that the image of strongly increasing returns and pervasive network externalities leaving room for only one monetary technology is misleading. There were limits to these network effects. There was room for both sterling and the dollar and for both London and New York all through the 1920s. This suggests that there will be room for more than one international currency in the 21st century. It is not a winner-take-all game.

⁵⁷ As explained by the industry's advocate, the American Acceptance Council, the investor "would have to be educated, first as to the nature of a bankers' acceptance, second as to its attractiveness as an investment, and third, owing to its quality as a doubly secured risk [that it was guaranteed both by the original issuer and the accepting bank], that it would be offered at a lower rate than he had been accustomed to, when buying the best single name commercial paper". American Acceptance Council (1931, p 17).

⁵⁸ China has already begun moving in this direction by encouraging limited use of the renminbi for trade settlements. It is negotiating arrangements with Brazil whereby the two countries can use their own currency in bilateral transactions. It has allowed select banks to issue renminbi-denominated bonds in Hong Kong and done a sovereign bond issue in renminbi there itself. It has allowed the multilaterals to issue renminbi-denominated securities in Shanghai.

Table 1
German and British overseas banks in Latin America 1913 vs 1921

In millions of 1913 pounds sterling

	Main London agent		Total assets		Capital	
	1913	1921	1913	1921	1913	1921
<i>German foreign banks in Latin America</i>						
Banco Alemán Transat.	Deutsche Bk	Kleinwort	14.0	7.0	2.0	0.1
Deutsch-Sudam. Bk	Dresdner Bk	Kleinw., Shrod., Japhet	7.0	1.9	1.0	0.1
Bk für Chile und Deutsch.	Disconto ¹	None ²	3.0	0.2	0.2	0.0
Bras. Bank für Deutsch.	Disconto ¹	None ²	7.0	0.8	0.5	0.1
TOTAL			30.9	10	3.5	0.4
<i>Main British overseas banks in Latin America</i>						
Anglo-South American	own	own	14.0	57.6	1.3	3.5
London and River Plate	own	own	35.0	41.7	1.2	1.4
London and Brazilian Bank	own	own	20.0	25.7	1.0	1.0
Total			69.0	125.0	3.5	5.9

¹ Disconto-Gesellschaft. ² *Banker's Almanac* literally reported " – ". This is obviously curious in view of the fact that the whole point of the *Almanac* was to provide information regarding London correspondents.

Source: Authors, from *Bankers' Almanac*. Conversions into 1913 sterling made using price indices from B R Mitchell's *European Historical Statistics* (1921 prices converted into 1913 prices) and the 1913 sterling parity of £1 = 20.4 M.

Table 2
Branching by US banks

	1913		1920–21			1924		1930–31			1935		1941	
	L	BA	L	BA	O	L	O	L	BA	O	L	O	BA	O
National City Bank (total) of which:	16	17	86	78	81	74	90	94	105	97	84	71	54	49
<i>National City Bank (plus Paris subsid.)</i> ¹	0	0	57	46	–	42	–	74	82	–	69	–	52	–
<i>National City Company</i>	–	0	–	0	–	–	–	–	8	–	–	–	0	–
<i>International Banking Corporation</i>	16	17	29	32	–	32	–	9	3	–	3	–	2	–
<i>Bank of Haiti Inc.</i> ²	0	0	0	0	–	–	–	11	12	–	12	–	–	–
Chase National Bank/Chase Bank	0	0	0	0	–	–	–	3	13	–	10	–	13	–
Equitable Trust Co.														
(and Equit. East. Bk. Corp) ³	2	2	2	2	–	6	–	2	3	–	0	–	0	–
First National Bank of Boston	0	0	1	1	–	2	–	4	6	–	12	–	6	–
Bk of America Nat'l Trust & Savings Ass. SF	0	0	0	0	–	–	–	0	1	–	1	–	1	–
Bankers Trust Co	0	0	1	1	–	2	–	2	2	–	1	–	0	–
Farmers Loan and Trust	2	2	2	2	–	1	–	0	0	–	0	–	0	–
Guaranty Trust	0	0	7	10	–	8	–	8	8	–	8	–	5	–
Empire Trust Co	1	1	1	1	–	1	–	1	1	–	1	–	0	–
American Trust Co	0	0	0	0	–	0	–	1	0	–	0	–	0	–
International Trust	–	–	–	–	–	–	–	–	1	–	–	–	–	–
Continental Guaranty Corporation	–	–	–	1	–	–	–	–	0	–	–	–	0	–
City Bank Farmers Trust Cy	–	0	–	0	–	–	–	–	1	–	–	–	0	–
Dillon Reed Corporation	–	0	–	0	–	–	–	–	1	–	–	–	0	–
Total American Banks and Trusts	21	22	100	96	–	94	–	115	142	–	117	–	79	–
American Foreign Banking Corporation	0	0	19	7	–	3	–	–	–	–	–	–	–	–
American International Corporation	–	–	–	1	–	–	–	–	–	–	–	–	–	–
Asia Banking Corporation	0	0	9	9	–	–	–	–	–	–	–	–	–	–
Bank of Central and South America	0	0	0	0	–	23	–	–	–	–	–	–	–	–
Continental Banking and Trust	4	0	4	0	–	–	–	–	–	–	–	–	–	–
Mercantile Bank of the Americas ⁴	0	0	45	3	–	–	–	–	–	–	–	–	–	–
Park-Union Foreign Banking Corporation	0	0	4	4	–	–	–	–	–	–	–	–	–	–
Total American Foreign Banking Corporations	4	0	81	23	–	26	–	–	–	–	–	–	–	–
American Express	–	15	–	35	–	–	–	–	57	–	–	–	23	–
United States Express Cy	–	2	–	2	–	–	–	–	–	–	–	–	–	–
American Trading Cy	–	0	–	29	–	–	–	–	–	–	–	–	–	–
General Motors Acceptance Corporation	–	0	–	2	–	–	–	–	34	–	–	–	–	–
Total American Trading Outfits	–	17	–	68	–	–	–	–	91	–	–	–	23	–

¹ For BA 1930–31, in order to have consistency with other years, we have counted only one Cuba City branch for this date. ² Lewis, (1938, p. 197) indicates that Bank of Haiti was sold to Haiti government in 1935. While Bank of Haiti still in BA, we thus no longer record it as a provider of branches for National City in BA 1941. ³ Equitable Eastern Banking Corporation was a subsidiary of Equitable Trust. This is according to Federal Reserve Board *Annual Report*, 1920, p 26. The Eastern Banking Corporation was set up in 1920. It was owned by Chase which used it as a startup for its foreign branches. ⁴ The spread between Lewis and *Bankers' Almanac* in 1920–21 numbers owes to Lewis's inclusion of the local branches owned by the Mercantile Bank, which were subsequently disposed of.

Sources: BA: authors' own estimates, from *Bankers' Almanac*; L: Lewis (1938); O: other estimates for National City Bank grouping (Cleveland and Huertas (1985) and Federal Reserve Board Annual Reports). BA for 1920–21 is *Bankers' Almanac*, 1921–22; Lewis figures for 1930–31 correspond to 1929; BA 1930–31 is *Bankers' Almanac*, 1931–32.

Table 3
Acceptances league table

	Place	1917	1922	1923	1927	1928	1929	1930	1931	1932	1933	1934	1935	1936
Commercial banks and trusts														
National City														
National City Bk	NYC	4	2	2	1	1	2	3	2	3	3	3	3	1
Farm. Loan & Tr.	NYC	n.a.	48	41	26	28	x	x	x	x	x	x	x	x
Chase														
Chase National	NYC	6	8	10	3	2	3	1	1	1	2	2	2	2
Nat'l Park Bank	NYC	8	29	[19]	31	22	x	x	x	x	x	x	x	x
Equit. Trust Cy	NYC	n.a.	4	4	5	9	5	x	x	x	x	x	x	x
Seaboard Nat'l Tr.	NYC	60	30	15	14	19	x	x	x	x	x	x	x	x
Guaranty														
Guaranty Trust	NYC	n.a.	1	1	4	3	1	2	3	2	1	1	1	3
Nat'l Bk. of Com.	NYC	2	5	6	6	4	x	x	x	x	x	x	x	x
First Nat'l Bk of B.	Bost.	1	7	8	8	7	7	8	9	11	10	7	5	5
Irving Trust														
Irving Nat'l Bk ¹	NYC	13	6	6	7	6	6	5	4	6	6	5	7	7
Ameri. Exch Nat'l	NYC	7	21	25	x	x	x	x	x	x	x	x	x	x
National Shawmut	Bost.	5	9	13	11	12	15	17	16	14	16	15	14	12
Bankers' Trust	NYC	-	12	12	13	14	13	15	5	5	5	6	21	18
Old Colony Trust	Bost.	3	22	26	40	-	[42]	-	-	-	-	-	-	-
Mech. Metals Nat'l	NYC	9	26	24	-	-	-	-	-	-	-	-	-	-
JP Morgan & Cy	NYC	x	x	x	x	x	x	x	x	x	x	11	19	38
Private banks														
Brown														
- Brown Brothers ²	NYC	n.a.	n.a.	n.a.	12	15	10	22	12	12	12	12	9	8
- Harriman Bthrs	NYC	n.a.	n.a.	n.a.	-	29	31	29	-	-	x	x	x	x
Kid. Peab. Ac. Corp	Bost.	x	n.a.	n.a.	10	10	11	12	38	x	x	x	x	x
Schroder Bkg Corp	NYC	n.a.	n.a.	n.a.	15	17	16	11	14	13	23	24	19	19
Goldman Sachs	NYC	n.a.	n.a.	n.a.	16	16	17	23	30	26	33	31	29	34
Lee Higginson	Bost.	n.a.	n.a.	n.a.	18	24	24	20	21	22	22	x	x	x
Huth & Cy	NYC	n.a.	n.a.	n.a.	22	26	28	31	35	38	51	44	38	35
Lazard	NYC	n.a.	n.a.	n.a.	-	-	-	-	39	33	42	-	-	-
Heidelbach, Ickel.	NYC	n.a.	n.a.	n.a.	33	-	[40]	-	-	54	45	53	55	56
US foreign banks' international partnerships														
Warburg														
- IAB	NYC	x	3	3	2	5	4	4	6	x	x	x	x	x
- Bk of Manh. Cy ³	NYC	-	-	-	19	13	18	-	-	4	4	4	6	6
Fr. Am. Bkg Corp.	NYC	x	24	25	24	25	21	19	27	20	13	16	16	16
Bque Belge P. l'Etr.	NYC	-	-	-	-	-	-	-	40	28	31	32	31	32
B. Com. Ital.	NYC	-	-	-	36	36	33	38	-	47	41	85	49	38
Royal Bk of Canada	NYC	-	-	-	21	17	23	26	29	18	20	19	18	11
Asia Bkg Corp.	NYC	n.a.	28	29	x	x	x	x	x	x	x	x	x	x
Equ. East. B. Crp ⁴	NYC	n.a.	n.a.	-	-	30	20	x	x	x	x	x	x	x

¹ After merger with American Exchange, becomes Irving Trust Cy. ² Becomes Brown Brothers Harriman after merger with Harriman in 1933. ³ Later, Bank of Manhattan Trust. ⁴ Subsidiary of Equitable Trust, merged with Chase at same date as Equitable Trust.

Sources: Kniffin 1920. New York commercial 1922 and 1923 from *Acceptance Bulletin*. 1928 onwards from *Acceptance Bulletin's* own league tables. Mergers from *Acceptance Bulletin* and various sources. 1917: May; 1922 and 1923: December; 1927: January 1928; 1928, 1929, 1930, 1931, 1933, 1934 and 1935: December; 1932: January 1933; 1936: June (last issue of *Acceptance Bulletin*).

Table 4

Determinants of banks' acceptances

Dependent variable: Ln (acceptances outstanding, bank i, t)
 OLS. All variables in logs, except Branching

Without clustering

	I	II	III	IV	V	VI	VII
- Total assets/liabilities	0.90 (12.19)	0.72 (13.53)	0.73 (13.21)	-	-	-	0.59 (3.91)
- Capital, surplus and undivided profits	-	-	-	0.94 (13.45)	0.67 (12.43)	0.72 (12.36)	0.15 (0.99)
- US total trade (exports + imports)	0.68 (4.70)	-	0.08 (0.68)	0.83 (5.86)	-	0.25 (2.10)	0.12 (1.01)
- Total US acceptances outstanding	-	1.05 (12.72)	1.03 (11.61)	-	0.96 (11.10)	0.88 (9.37)	0.99 (10.34)
- Branching	0.30 (2.41)	0.57 (6.09)	0.55 (5.71)	0.32 (2.66)	0.64 (6.79)	0.58 (5.79)	0.54 (5.53)
- Intercept	-8.92 (-6.25)	-8.77 (-14.27)	-9.36 (-8.77)	-8.35 (-6.23)	-6.37 (-11.01)	-8.25 (-7.74)	-9.27 (-8.65)
N	262	249	249	263	250	250	249
Adjusted R ²	0.51	0.72	0.72	0.55	0.70	0.71	0.72

With clustering

	I	II	III	IV	V	VI	VII
- Total assets/liabilities	0.90 (11.64)	0.72 (8.46)	0.73 (8.49)	-	-	-	0.59 (2.48)
- Capital, surplus and undivided profits	-	-	-	0.94 (13.15)	0.67 (8.43)	0.72 (8.70)	0.15 (0.73)
- US total trade (exports + imports)	0.68 (4.66)	-	0.08 (0.42)	0.83 (5.68)	-	0.25 (1.32)	0.12 (0.65)
- Total US acceptances outstanding	-	1.05 (10.88)	1.03 (9.44)	-	0.96 (8.42)	0.88 (7.08)	0.99 (9.91)
- Branching	0.30 (1.47)	0.57 (3.55)	0.55 (3.26)	0.32 (1.55)	0.64 (3.58)	0.58 (2.94)	0.54 (3.15)
- Intercept	-8.92 (-6.96)	-8.77 (-16.28)	-9.36 (-6.39)	-8.35 (-6.20)	-6.37 (-9.36)	-8.25 (-4.98)	-9.27 (-6.35)
N	262	249	249	263	250	250	249
R ²	0.52	0.73	0.73	0.56	0.71	0.71	0.73

Table 5

**Determinants of banks' acceptances: including
Federal Reserve's own market-making activities**

Dependent variable: Ln (acceptances outstanding, bank i, t)
All variables in logs, except Branching

With clustering

	I	II	III	IV	V	VI	VII
- Total assets/liabilities	1.00 (10.36)	0.94 (9.26)	0.94 (9.30)	-	-	-	0.72 (2.77)
- Capital, surplus and undivided profits	-	-	-	0.97 (15.72)	0.92 (11.60)	0.93 (11.83)	0.24 (1.05)
- US total trade (exports + imports)	-0.09 (-0.69)	-	-0.10 (-0.68)	0.10 (0.70)	-	0.08 (0.56)	-0.04 (-0.25)
- Total US acceptances outstanding	-	0.42 (2.65)	0.42 (2.65)	-	0.21 (1.27)	0.21 (1.22)	0.34 (2.26)
- Fed acceptances/"own account"	0.27 (3.17)	0.15 (1.64)	0.18 (2.12)	0.27 (3.03)	0.27 (2.86)	0.24 (2.67)	0.20 (2.18)
- Branching	0.22 (1.44)	0.30 (1.96)	0.31 (2.09)	0.32 (2.07)	0.39 (2.38)	0.37 (2.27)	0.30 (2.02)
- Intercept	-3.80 (-3.31)	-6.48 (-8.99)	-5.80 (-5.64)	-3.28 (-2.83)	-3.59 (-3.72)	-4.18 (-3.63)	-5.52 (-5.37)
N	205	205	205	206	206	206	205
R ²	0.72	0.74	0.74	0.71	0.72	0.72	0.74

Table 6

**Determinants of banks' acceptances: including
Federal Reserve's own market-making activities
and holdings on foreign account**

Dependent variable: Ln (acceptances outstanding, bank i, t)
All variables in logs, except Branching

With clustering

	I	II	III	IV	V	VI	VII
- Total assets/liabilities	0.90 (10.00)	0.83 (8.84)	0.83 (8.76)	-	-	-	0.66 (2.80)
- Capital, surplus and undivided profits	-	-	-	0.88 (13.92)	0.80 (11.43)	0.81 (11.01)	0.19 (0.94)
- US total trade (exports + imports)	-0.12 (-0.77)	-	-0.13 (-0.83)	0.12 (0.72)	-	0.08 (0.50)	-0.07 (-0.45)
- Total US acceptances outstanding	-	0.53 (3.66)	0.54 (3.66)	-	0.41 (2.71)	0.40 (2.59)	0.49 (3.67)
- Fed acceptances/"own account"	0.22 (12.71)	0.14 (4.35)	0.14 (5.14)	0.19 (9.00)	0.14 (4.33)	0.14 (4.59)	0.15 (5.19)
- Branching	0.31 (1.95)	0.40 (2.51)	0.42 (2.57)	0.36 (2.15)	0.47 (2.76)	0.45 (2.49)	0.40 (2.48)
- Intercept	-2.76 (-1.96)	-6.59 (-9.13)	-5.45 (-4.14)	-2.62 (-1.79)	-3.77 (-4.54)	-4.48 (-2.91)	-5.31 (-3.98)
N	249	249	249	250	250	250	249
R ²	0.74	0.76	0.76	0.73	0.74	0.74	0.76

Table 7

Robustness: with Fed-commercial spread in place of Fed holdings

Dependent variable: Ln (acceptances outstanding, bank i, t)
 OLS. All variables in logs, except Branching and Spread (Fed-commercial)

With clustering

	I	II	III	IV	V	VI	VII
- Total assets/liabilities	0.82 (9.66)	0.75 (8.79)	0.74 (8.60)	-	-	-	0.64 (2.67)
- Capital, surplus and undivided profits	-	-	-	0.84 (12.08)	0.73 (9.44)	0.73 (8.85)	0.12 (0.57)
- US total trade (exports + imports)	-0.71 (-2.57)	-	-0.35 (-1.62)	-0.27 (-1.05)	-	-0.04 (-0.18)	-0.30 (-1.34)
- Total US acceptances outstanding	-	0.92 (7.47)	0.89 (8.20)	-	0.75 (6.00)	0.75 (6.41)	0.86 (8.54)
- Spread (Fed-commercial)	-0.92 (-5.52)	-0.15 (-1.26)	-0.36 (-2.75)	-0.71 (-4.22)	-0.24 (-1.89)	-0.26 (-1.93)	-0.35 (-2.69)
- Branching	0.42 (2.63)	0.52 (3.14)	0.54 (3.22)	0.42 (2.47)	0.56 (2.95)	0.57 (2.90)	0.53 (3.13)
- Intercept	4.72 (1.70)	-7.97 (-10.26)	-4.46 (-2.44)	2.44 (0.97)	-5.02 (-6.25)	-4.61 (-2.38)	-4.56 (-2.51)
N	245	245	245	246	246	246	245
R ²	0.63	0.72	0.72	0.64	0.70	0.70	0.72

Table 8

Robustness: using log (market share) as dependent variable

Dependent variable: Ln (market share, bank i, t)
 OLS. All variables in logs, except Branching

With clustering

	I	II	III
- Total assets/liabilities	0.72 (8.67)	-	0.62 (2.58)
- Capital, surplus and undivided profits	-	0.67 (8.80)	0.11 (0.53)
- Branching	0.57 (3.52)	0.65 (3.60)	0.57 (3.50)
- Intercept	-8.45 (-8.21)	-6.64 (-24.37)	-8.24 (-11.39)
N	249	250	249
R ²	0.66	0.63	0.66

	I	II	III
- Total assets/liabilities	0.77 (9.47)	-	0.73 (3.03)
- Capital, surplus and undivided profits	-	0.69 (10.20)	0.04 (0.20)
- Branching	0.50 (3.20)	0.61 (3.41)	0.50 (3.19)
- Federal Reserve share	0.07 (3.23)	0.06 (2.19)	0.07 (3.15)
- Intercept	-8.58 (-18.35)	-6.62 (-25.41)	-8.50 (-11.77)
N	249	250	249
R ²	0.68	0.65	0.68

Data sources for regression analysis

US banks data

Extracted from 31 December balance sheet (or closest available date). Balance sheets were collected from Baker Library (Harvard), Columbia University Library, British Library (London) and Graduate Institute Library (Geneva). The banks in the sample are as follows (periods for which we have data are indicated):

American Exchange Irving Trust 1927–28
Bank of New York and Trust Company 1922–38
Bank of the Manhattan Company 1924–35 (missing years)
Bankers Trust Company 1915–35
Central Hanover Bank and Trust Company 1930–35
Chase Bank 1915–38 (missing years)
Chemical Bank and Trust Company 1929–35
Commercial National Bank and Trust Cy of NY 1929–39
Continental Illinois National Bank and Trust Company 1932–35
First National Bank of Boston 1915–35
First National Bank of Chicago 1915–35
Guaranty Trust 1914–37
International Acceptance Bank 1929
Irving Bank-Columbia Trust Company 1920–26
Manufacturers Trust Company 1924–35
Marine Midland 1929–35
National City Bank of new York 1915–35
National Bank of Commerce in New York 1923–28
Old Colony Trust Company 1919–29 (missing years)
New York Trust Company 1920–35
Philadelphia National Bank 1926–35 (missing years)
Wells Fargo 1921–35

Heavy branching dummies

Dummy equals 1 for Chase, First National Bank of Boston, Guaranty Trust, National City Bank

Total acceptances outstanding

December totals from *Acceptance Bulletin* and Federal Reserve, as described in text.

Federal Reserve holdings of acceptances (own and foreign accounts)

December observation from Federal Reserve publications.

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Comments on Barry Eichengreen and Marc Flandreau's paper "Central banks as architects"

Robert O Keohane⁵⁹

Unfortunately, family health issues prevent me from attending this meeting and presenting this commentary in person. But my task is also complicated by a lack of fit between my areas of expertise and the topic of the paper. I am a student of contemporary world politics, with interests in large political-economic issues, such as those raised by the 2008–10 financial crisis, and in the political processes that generate economic policy.

Of the papers for this conference, Charles Goodhart's tackles these issues most directly. He discusses the "procyclicality" of Basel II and says that as late as the summer of 2007, "neither bankers nor regulators, nor virtually all commentators, had any appreciation of the (systemic) risks that were being run". Indeed, regulation led to a "poor outcome, in that the banks held a stock of required capital that could not be treasured upon without signalling a crisis occasion, while the usable buffer was too small". Clearly, regulation by central banks failed.

Perceived failure by central banks invites politicians to take charge. In his paper for this conference, Harold James states that "the increasing politicisation of central banks" (at the present time) "looks like a dramatic repeat of the interwar story". Indeed, Professor James detects signs of increased financial nationalism in attacks on the US Fed interventions for helping foreign interests. When the clear rule followed by central banks becomes muddled, central bank discretion seems more problematic, and politicians deploy financial nationalism to take over. So in Professor James's view, "the pendulum is swinging back, toward a nationalised Bank of England, a more accountable Federal Reserve, and an ECB that answers to the people of Europe".

I wish that at least one of the papers at this conference would have explored, in depth, the political reasons for the policies and policy changes discussed by Professors Goodhart and James: the policies actually adopted in Basel II, other central bank policies prior to the 2008 financial crisis and the shifts towards politicisation of central banks. Such a discussion should also have examined the still formidable abilities of central banks to resist such politicisation and to maintain, or even expand, the domain of their activities. Perhaps the previous two sessions have explored these questions, and if so, I very much regret not being able to be here for this discussion.

The Eichengreen-Flandreau paper does not take up these issues of how politics generates a failure to regulate systemic risk, or how it shapes reactions to such failure. Instead, it is about banking in the interwar period, and politics does not play a significant role in the authors' argument. The focus is instead on the importance of network effects and increasing returns on international currency issues. The authors are eminent economic historians and their argument is interesting, but it does not connect closely with the previous two sessions or with international politics, which is my own area of expertise. I am therefore not an ideal discussant for this paper, and arguably not an appropriate one. My comments will therefore range a little more broadly than the focus of this paper, referring to broader issues raised in the first two sessions.

⁵⁹ Princeton University.

There are some references to politics in the paper. For instance, war plays a role: Britain took advantage of World War I to expand its banking position in Latin America at the expense of Germany. It is well known that World War I facilitated the rise of the United States to a strong international economic position, and it is not surprising, given British control of the seas, that the war strengthened Britain's economic position relative to Germany in Latin America, while weakening it relative to the United States. The effects of war in advantaging states – especially maritime powers – that can maintain access to neutral areas for trade and investment are well known. However, we can hope that the contemporary relevance of this insight is limited: that understanding future patterns of global finance will not turn on understanding the effects of war.

The paper indirectly raises another set of political issues when it tells us that the Federal Reserve was the “architect” of a policy that promoted the international role of the dollar. The Fed did so, the authors argue, by becoming a “secondary-market-maker of last resort” in an effort to help to build a liquid secondary market for bankers' acceptances in New York. The authors say there is a message here for China, and elsewhere in the paper refer to the international role of China's currency. But these issues are only referred to obliquely.

From a political scientist's perspective, some of the most interesting political issues raised by this paper's narrative are *not discussed*. As in the valuable papers by Professors Goodhart and James, the effects of political activity are more evident than its causes. In the Eichengreen-Flandreau paper, the Fed is a shadowy institution: we see the effects of its actions but not their real source. That is, the reasons for Fed actions, and the interests behind them, are never analysed. In particular, the whole narrative depends on a provision of the Federal Reserve Act of 1913, which “removed the prohibition on foreign branching and authorised banks to deal in trade acceptances”. The only explanation for this crucial action is in a footnote, which states that one motive for the act was to create a market in trade acceptances in New York, in the belief that this would be a stabilising move.

For a political scientist this account is unsatisfying. Other questions come to mind. What *interests* were behind this change in the law? Was the justification that a market in trade acceptances would enhance financial stability a genuine reason for its enactment, or only a public-spirited justification for an action that had more parochial motives? Did major New York banks lobby for the change in the law? Were the non-New York banks supportive – which might support the stabilisation argument – or opposed to the change – which might suggest more self-interested motives on the part of its sponsors? Did the President take a position, focused on US economic or strategic interests? In other words, the sources of the key *political* move that created the process discussed by Eichengreen and Flandreau remain obscure.

We are now either still in the largest financial crisis of the last 70 years or just emerging from it. In this context, many scholars and commentators, from different disciplinary and doctrinal perspectives, have been engaging in soul-searching about how international economic institutions, and more deeply the economic theory on which their practices are based, failed. We find such reflection in the recent book by Carmen Reinhart and Kenneth Rogoff, *This time is different*. So in the interest of helping to focus a discussion on these larger issues, I now use the Reinhart-Rogoff analysis to pose some broad questions, from the standpoint of a political scientist.

Reinhart and Rogoff document an increase of 86%, on average, in public debt during the three years after major postwar banking crises. They sketch out a prototype for the “sequencing of crises” in which default on external and/or domestic debt follows banking crises. They declare that “capital flow and default crises have been around since at least 1800... Why they would end anytime soon is not obvious”. And in the last paragraph of their book, they state that “highly leveraged economies, particularly those in which continual rollover of short-term debt is sustained only by confidence in relatively illiquid underlying assets, seldom survive forever”. I would like to know whether, in view of their deep

knowledge of economic history, Professors Eichengreen and Flandreau agree with the implication: that sovereign debt crises are likely to follow the banking crisis of 2008 and the subsequent explosion of public debt in rich democracies. *Should we now expect a wave of sovereign defaults?*

In response, one might point to the fact that the major democracies are on friendly terms with one another and that institutions such as the BIS and the IMF exist. Indeed, Reinhart and Rogoff document that financial crises were much less frequent, and less intense, during the second half of the 20th century than in the preceding 50 years (Figure 16.3). Until the crisis of 2008, it would have been easy to argue that the combination of US hegemony and institutionalisation was benign. But the 2008 crisis originated in the US subprime mortgage market, emanating from a classic bubble aggravated, rather than controlled, by Fed policy. As Professor Goodhart's paper recognises, international efforts under the Basel I and Basel II processes were ineffective.

In this context, we need to ask some difficult political questions about institutions such as the BIS and IMF. Has control – or at least influence – over these public institutions perhaps passed largely to private actors, as a result of pluralist political processes with which political scientists are all too familiar? In pluralist democracies, those who pay attention have the most influence, even if there is no corruption of any kind. Almost everyone else ignores almost every policy issue almost all of the time. If only bankers pay attention to banking issues, it should not surprise us that policy favours bankers and that self-serving banking practices that generate systemic risk will not be well controlled.

In domestic politics, there is at least some recourse: Congress or Parliament can hold hearings and pass legislation, and voters can “throw the rascals out”. No such clear recourse is possible for international institutions such as the BIS or IMF. We need to think more deeply about the accountability and legitimacy of international financial institutions. I was pleased to see the discussions in Ross Levine's paper about transparency and in Peter Stella's about the trade-off between central bank independence and political legitimacy. Accountability, which is a fundamental principle of democratic governance, has three key components: that some actors have the right to (i) hold other actors to a set of standards, (ii) judge whether they have fulfilled their responsibilities in the light of these standards, and (iii) impose sanctions if they determine that these responsibilities have not been met. One result of the financial crisis of 2008 is a new debate about what the proper standards of accountability for central banks are. How can central banks be held accountable for their actions without generating dangerous and dysfunctional political interference?

I return at the end to the question, raised a minute ago, about whether US hegemony has been benign. Despite the crisis of 2008, a good case can be made that it was benign over the first 60 years since World War II. But we are now quite clearly in the twilight of that hegemony. As the developing countries outpace the rich countries in rates of economic growth, US dominance will fall. China will become increasingly important and assertive. But China and the United States are emphatically not strategic partners: they are rivals, which at best display wary and limited cooperation. So historical analogies from the period before 1914, when the United Kingdom, France and Germany were strategic rivals, may become more relevant.

To summarise, let me indicate seven questions to which I would like to have answers.

1. Is the banking crisis of 2008–09 likely to lead to a series of sovereign default crises?
2. Could any concerted cooperation among governments or central banks prevent such crises?
3. What is the political likelihood of such cooperation?
4. Should we understand contemporary international financial institutions such as the IMF and BIS primarily as providing real public goods, or as acting at the behest of, and in the interests of, organised private actors?

5. Are there feasible ways of enhancing the political accountability, and therefore legitimacy, of these institutions?
6. As US hegemony declines, will destabilising pressures increase in the area of global finance?
7. If so, are there institutional reforms that could mitigate these pressures and help to maintain financial stability?

These are questions that I hope this conference has either addressed in earlier sessions, or will confront at this or another session before it adjourns.

Comments on Barry Eichengreen and Marc Flandreau’s paper “The Federal Reserve, the Bank of England and the rise of the dollar as an international currency, 1914–39”

Leszek Balcerowicz⁶⁰

Not being an economic historian I can only raise several questions with respect to some wider implications of this interesting paper and not to the historical facts it discusses.

Architects seem to enjoy a high reputation, as witnessed by the fact that to be called “an architect” (of something) sounds very good, it is a flattering metaphor. However, it is only a metaphor. What exactly does it mean that the Federal Reserve was “the architect” with respect to the dollar as an international currency? A designer, a creator, a facilitator? Would the dollar have remained the domestic currency only if not for some special interventions of the Fed?

There are some intriguing passages in the paper regarding this issue:

We show (...) that not just market forces (the actions of American commercial banks and trust companies) but also public support – the Fed’s role as architect – played a role in the dollar’s rapid catch-up and brief overtaking of sterling as the leading international currency. This occurred before a liquid secondary market of private and institutional investors to which the acceptances originated by US banks and trust companies could be resold was built. The mechanism that enabled this stage to be skipped was the Fed, which stepped in as secondary market-maker of last resort. Our estimates suggest that the US market in trade acceptances grew significantly faster than it would have in the absence of this official support. There is a message here for governments like China’s seeking to promote the international use of their currency.

We show (...) that when central banks stepped out of the market for acceptances in the 1930s, the market in dollar acceptances collapsed all but completely whereas the market in sterling acceptances did not. Evidently the task of building a new secondary market of individual and institutional investors, analogous to what London had already done in the 19th century, was more difficult than supposed. Indeed, the Fed’s aggressive intervention as buyer of last resort may have stifled rather than fostered the development of that market.

I am not quite sure what is the normative message of the paper on the role of central banks as “architects” of some financial markets. Should they intervene in order to accelerate the emergence of a certain market or – in a more radical version – to enable the emergence of such a market which otherwise would not have originated at all (a “big push” theory of central banks as “architects”), or should they refrain from attempting to be architects of certain financial markets as their interventions would “stifle rather than foster the development of that market”? The authors stress that the network effects giving rise to increasing effects in the financial markets and, thus, strengthening the position of the first mover into certain markets “have limits”. This may imply that the “natural” forces of the market are sufficient to ensure the successful entry into the market for international currencies.

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This and the stifling effects of Fed's interventions as an "architect" may be taken to suggest that such interventions are not recommended. However, the authors are not clear on this point. And it is a part of a more general and important problem: what is the rationale for public bodies to initiate (or sustain) private markets (except for the market in public debt)? Unless we believe in the "free lunch" we must consider the costs and compare them with potential effects of such interventions. The costs would include some resource costs, the opportunity costs and the crowding-out of the private transactions via reduced incentives and reduced expertise with regard to private participants.

The authors not only discuss the emergence of the dollar as an international currency but also try to draw some conclusions from that with respect to how quickly we should expect China's currency to gain a consequential influential role. They write:

As we show, the United States went in only 10 years from a position where the dollar had no place as an international currency and New York was a negligible source of finance for international trade to one where the dollar was at least sterling's coequal and New York rivalled London as a source of trade credit. This is not to assert that the renminbi will necessarily rival the dollar and the euro in 2020. But it does suggest that, if network effects are less powerful than commonly asserted, the renminbi's emergence may be quicker than widely presumed.

One is tempted to ask: what is "widely presumed" regarding the rise of the renminbi as an international currency, and what is the authors' educated guess on the dynamics of that process? In pondering the second question one should consider, I think, at least two issues.

First, as the authors rightly stress, a country with an international currency must play an important role in international trade. China's accelerated economic growth since the late 1970s has been accompanied by an even faster expansion of its foreign trade. As a result, China's economy has an amazingly high foreign trade/GDP ratio for such a large country – much higher than the ratio for India. Therefore, China's foreign trade/GDP ratio is not likely to grow in the future; it will rather decline as China gradually moves away from export-oriented growth to growth more geared to its domestic market. The implication is that China's foreign trade is likely to grow more slowly than in the past and will grow not faster than its GDP, which, in turn, will slow down in the longer run.

Second, I wonder whether the role of international currency is related not only to a country's economic potential and its role in international trade but also to some characteristics of its political regime, or – to be more specific – to the possession of some minimal features of the rule of law or a limited government. If this is the case, then in thinking about the renminbi's international role one should not only look at China's economic evolution but at its political evolution, too.

Finally, the authors have raised a host of important questions regarding the present situation:

Finally, there is concern that central banks' extraordinary actions in 2007–09, taken to provide liquidity to distressed financial markets by purchasing commercial paper, mortgage-backed securities and other financial assets outright, created a reservoir of inflationary pressure that will burst when bank lending picks up (in clear, central banks' market-making and market-supporting actions would have created a conflict with their price stability mandate). There are fears that central bank action created a new credit babble destined to burst, and that their interventions merely disguise problems that will become acute once they exit. There is concern about crowding out: central banks' readiness to step in as market-makers of last resort may have discouraged other buyers from re-entering the market. There is concern that the indiscriminate purchase of securities by central banks will encourage the renewed issuance of financial instruments of dubious quality, setting the stage for another round of financial excesses and problems. We note that the same criticisms were levied against

central banks' market-making activities in the 1920s. While we do not have definite answers to all these questions, we offer some food for thought.

I must confess that the authors have raised my appetite enormously, but I wish they had given me more food. They should link more strongly their story of the emergence of the dollar as an international currency to the important contemporary problems they mention.