Monetary Requirements of a Free Society

By Robert de Fremery | *Paper delivered at the 1979 Joint Georgist Conference, San Francisco, CA*

Most Georgists explain bank panics and liquidity crises in terms of our unsound tax system. Although I agree 100% that our tax system unquestionably magnifies the economic dislocations resulting from these monetary disturbances, I wish to suggest the possibility that the fundamental cause of such panics lies in our banking system rather than in our tax system. In other words, we need both tax and banking reforms to assure the survival of a market economy.

What's wrong with banking? Plenty. Bankers are engaged in the unsound practice of borrowing short and lending long. What does that mean? Think of it in personal terms. If you borrowed $1,000 from me for thirty days and loaned that money to another person for one year, you would be borrowing short and lending long. You wouldn't do it, of course, because it's obvious you would be inviting trouble by so doing. Yet that is precisely what a banker does every day. For example, he borrows funds by issuing certificates of deposit (CDs) that mature in one year and lends those funds for five years; he borrows the money left in savings accounts -- money legally withdrawable on 30 days notice and customarily withdrawable on demand -- and lends it for a year or more; he borrows the money we deposit in our checking accounts -- money legally withdrawable on demand and lends it for 60-90 days.

When banks borrow short and lend long, they credit the account of the borrower by the amount of the loan -- thus increasing their total deposits and obligating themselves to pay on demand more money than is in their vaults. Hence the term 'fractional reserve banking'. This unsound, panic-prone system -sanctioned and protected by the government since its origin-has expanded to such an extent that well over 90% of what we use as money is nothing but these book entries created by our banks as a result of borrowing short and lending long. And it is our desperate effort to prevent another panic that makes inflation so difficult to control.

Please note that this defect in our banking system has nothing to do with our tax system. We could have a thorough-going system of land value taxation and still suffer greatly from this unsound banking system if we failed to correct it.

The monetary reform we need is called 100% reserve banking. Under that system bankers would be prohibited from borrowing short and lending long. To make five-year loans they would first issue five-year CDs. To make one-year loans or ninety-day loans, they would issue one-year or ninety-day CDs respectively. They would then have a back-to-back relation between the maturity of their loans and their outstanding CDs. And they would no longer be allowed to make loans on the basis of deposits that are withdrawable on demand. They would be completely solvent at all times. Their daily operations would no longer make them vulnerable to a panic.

One method of converting to a 100% reserve system without causing inflation or deflation is as follows:

1. The government should lend to each commercial bank sufficient new currency printed for that purpose to give it a 100% cash reserve behind all its demand deposits, and prohibit them from lending or investing such deposits.

2. Each bank's debt (incurred in Step 1) could be immediately reduced by cancelling U.S. Obligations held by that bank.

3. A similar loan should be made -- and cancelled the same way -- to each Federal Reserve Bank so that the Federal Reserve System would have a 1007o cash reserve behind member bank reserves deposited with it. The remaining U.S. Obligations held by the Federal should be cancelled. The Federal Reserve Banks would henceforth be 'money warehouses' and would continue facilitating the nation-wide clearing of checks. They would no longer be lenders-of-last-resort. And they would no longer have any control of the supply of money or of interest rates.

4. On the day of conversion to 100% reserves, each bank would have a large amount of loans outstanding. As these loans are repaid, the banks should be required to pay off their time and savings depositors and offer them, as an alternative, negotiable CDs with whatever interest rates and maturities were necessary to meet the needs of borrowers and savers. Banks would no longer be allowed to borrow short and lend long.

5. After every time and savings depositor has been paid off, banks would still have a huge amount of old loans carried over from the past in addition to the new loans being made on a back-to-back basis. As the remaining old loans are repaid, each bank would use these funds to further reduce its debt incurred in Step 1. The government should then use these funds to reduce the National Debt. And banks would then compete for the use of these funds by offering negotiable CDs.

6. The banks could pay off any remaining debt incurred in Step 1 by selling a small portion of other securities they hold (such as municipal bonds). The government would again reduce the National Debt with these funds and the banks would again compete for them.

7. The supply of money would now consist of the total coin and currency in existence - clearly definable and measurable at last. It would no longer be altered by the lending activities of banks. The government should not be allowed to change the supply of money except as provided by a constitutional amendment. Whenever the money supply needed to be changed according to whatever rule of law is adopted (a population standard would have great merit), the change could be made with absolute precision by reducing that much of the National Debt.

The net effect of the above would be to stabilize our monetary system where it is today. Henceforth all checks that are written would be backed dollar for dollar by actual cash in the banks. Our price level would therefore be in terms of a stable supply of legal tender that actually exists in our banks. Banks would be fully liquid at all times and therefore panic-proof. Interest rates and the value of the dollar in foreign exchange markets would no longer be manipulated by the Federal Reserve System. We would at last have provided ourselves with the monetary requirements of a free society.

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