What To Do About the Dollar

By Robert de Fremery | September 23, 1965 | *The Commercial and Financial Chronicle*

On June 1, 1965, Wm. McChesney Martin jolted the financial world by pointing to "disturbing similarities between our present prosperity and the fabulous '20s." But he didn't go far enough. He didn't pinpoint the underlying cause of the disaster of 1929-1933. And obviously we can't avoid another severe depression if we don't understand--or refuse to admit--the cause of preceding depressions.

The worst possible mistake we can make is to assume--as Mr. Martin and many others do--that we can avoid another collapse without making institutional changes. We can't. Cycles of inflation and deflation are inherent in our system of fractional reserve banking. The very basis of this system is the unsound and unprincipled practice of borrowing short to lend long.

Bankers "borrow" the money you deposit in checking accounts withdrawable on demand and lend it for as long as 90 days and even six months. They borrow the money you put into savings accounts withdrawable on 30 days' notice and lend it for as long as 20 years.

The money thus loaned by banks is immediately deposited or credited to the account of the borrower--thus resulting in an expansion of bank deposits. As checks are drawn against these new deposits to pay for goods and services and redeposited in a checking or savings account with the same or another banker, the receiving banker repeats the process. He borrows short and lends long--increasing deposits still further.

Fraudulent Deposits

This essentially fraudulent practice multiplies bank deposits that exist only as book entries. Bankers become obligated to pay out on demand, or on 30 days' notice, money that doesn't exist. They place themselves in substantially the same position as a de Angelis or a Sol Estes. Both authorized the creation of titles to nonexistent goods.

The only difference is that we have legalized the banker's operation. But making this unsound practice legal doesn't prevent the public from periodically losing confidence and asking for its money. The result is panic and depression. Neither a banker nor a de Angelis can perform the magic of delivering something that doesn't exist.

When a panic occurs because of a suspected shortage of actual money, the small amount that does exist is naturally hoarded. Gresham's Law!

Debtors then go through the wringer. Bankruptcies multiply. Foreclosures rise. Prices fall. Unemployment mounts.

The cause-and-effect relationship between bank panics and depressions was obvious in the early days of the system. But as the wiser members of the business and financial world finally learned the inevitable consequences of steadily increasing the amount of bank deposits that had no

existence except as book entries, they began anticipating these panics by curtailing capital expenditures, reducing inventories, and getting out of the stock market.

These very actions, of course, serve as storm warnings to others. They, in turn, take protective measures that become storm warnings to still others. Finally a general loss of confidence occurs as a wholesale liquidation of stocks takes place in anticipation of a depression.

Many hold that if the banking system were based on an essentially fraudulent practice, it would have died a natural death long ago. Yes, that's what would have happened if the bankruptcy laws that apply to most businesses were applied to banks. But they aren't. When panics occur, the bankers (who have borrowed short from their depositors) are favored as compared with those who borrowed from the bankers. [Author's hand-written notation: This, of course, is a violation of Article 1, Section 8 of the Constitution, which gives Congress the power to pass "uniform laws on the subject of bankruptcies throughout the United States."]

Those who can't pay the banks are declared to be insolvent and forced into bankruptcy. But the banker who cannot pay his depositors on demand is not forced into bankruptcy. He is merely "technically insolvent." He is given the opportunity to foreclose on those who can't make their payments to him. Those who are really responsible for the panic--the bankers who borrowed short to lend long--can foreclose on others in an effort to obtain the money they (bankers) owe their depositors! The frightful injustice of this should be obvious.

Another explanation for the system's survival is the ingenuity we have shown in devising schemes that enable banks to help each other out of temporary jams. The Federal Reserve System is a good example of this. The panic of 1907 was so severe bankers decided to form a new system in which their reserves would be in one large pool. Then if any one of them--or even several of them in an area--were under pressure from depositors, massive help could be obtained from the pool. Thus the Federal Reserve System was formed. (de Angelis could no doubt have lasted longer had there been a Federal Salad Oil Reserve System set up to serve men in his kind of business.)

Nobody bothered to ask what would happen if confidence in banks were lost in several areas at the same time. And to make matters still worse, the Federal Reserve System also was allowed to pyramid credit on the reserves it held. The result, as might be expected, was the creation of more fictitious deposits than ever before--followed by the worst deflation we ever had.

Still not willing to face facts, and with confidence in the banking system badly shattered by the many statewide moratoria that had led to the National Bank Holiday, Congress created the Federal Deposit Insurance Corporation. The object was to restore confidence in the banks. The public was told that the U.S. Government was protecting its deposits.

FDIC's Vulnerable Position
A recent FDIC report states: "The Corporation protects approximately 150 million deposit accounts which, on Dec. 31, 1963, totaled $313 billion in 13,621 insured banks." (Foreword, "Your Insured Deposit," *FDIC*, September, 1964).

How can the government insure the safety of deposits in a banking system that borrows short to lend long--thus creating fictitious deposits? Obviously it can't. Nobody knows this better than those who manage the FDIC.

In 1957 the FDIC acknowledged: "There is no question that the present deposit insurance would be entirely inadequate should, for example, a situation similar to that of 1930-33 recur." (*Annual Report, FDIC*, 1956, pp. 62-63). No basic change in the FDIC has been made since then.

Some idea of just how inadequate the FDIC would be in the event of another loss of confidence can be obtained by looking at their last annual report (Annual Report, FDIC, 1963, p. 15). It showed total assets of less than $3 billion, of which less than $2 million was in cash. The rest was in government bonds. They also have the right to borrow an additional $3 billion from the U.S. Treasury (a privilege not accorded to De Angelis). A failure of just one of our largest banks would topple the entire FDIC.

Many frown on such blunt talk. They say it may provoke a loss of confidence and lead to a collapse. Yes, it may. But a loss of confidence is bound to occur anyhow if we keep this system. Gresham's Law makes it inevitable.

Others will ask, "Isn't the system OK as long as confidence is not lost?" This is like asking, "Wouldn't de Angelis still be operating if his clients hadn't lost confidence in him?" We must face the fact that confidence never would have been lost --we never would have had bank panics--if the system were sound.

The banking structure and our whole economic system is built on confidence. To say that our system is sound if confidence is not lost is the same thing as saying that your new house will be sound if the foundation is sound.

If a builder made such a statement he would naturally be told not to build the house without a sound foundation. But we don't take that precaution with our economic system. We allow our bankers to engage in a practice (borrowing short to lend long) that inevitably leads to a loss of confidence.

International Extension
After the second world war, the world's central bankers decided to do what the United States did when it formed the Federal Reserve System. They decided to pool some of their reserves. The International Monetary Fund was formed to help any central bank in difficulty with the rest of the world. But after massive aid was given to Britain during the Suez crisis, members of the IMF

realized the pool of reserves wasn't big enough, so they each put in still more. Even this was later felt to be inadequate, so the Paris Club was formed--a group of ten countries that agreed on a plan whereby the IMF could borrow from one or more of them in an emergency.

Soon the United States was making swap agreements with central banks of other countries (you come to my aid in a pinch and I'll come to your aid in a pinch). And the latest development is another proposed increase of each member's quota in the IMF--yet to be ratified by the legislative bodies of each member country.

Despite these frantic efforts to shore up this tottering edifice, a worldwide "confidence crisis" becomes more and more likely. Every central banker and all large financial interests know this. That is why various proposals to reform the international monetary system are being made today. But not one of the plans being discussed would solve the problem.

The Triffin plan, the Bernstein plan, CRU, the suggestions made by Pierre-Paul Sweitzer, and the Rueff proposal all have the same weakness that the Federal Reserve System of 1913 had. All assume the soundness of borrowing short to lend long. All would make it possible for this unsound practice to be continued a little longer.

When will we come to our senses?

Stubborn adherence to an essentially unsound monetary system has been forcing us to adopt many unsound measures such as deficit financing, the Full Employment Act, price supports, etc. The further we depart from sound economic principles, the more trouble we get into. This leads to demands for still more government controls.

Public Education

Our high schools and colleges are turning out graduates who have no faith in the operation of free market forces. Their teachers believe the so-called "business cycle" is inherent in a free enterprise system. It is not. Free markets cannot be expected to function smoothly without a sound and reliable money in terms of which prices can be expressed. Indeed it is a tribute to the inherent strength of a free enterprise system that it has survived as long as it has. But it can't survive much longer if we fail to put our banks on a sound basis.

Once we admit the unsoundness of borrowing short to lend long, we will see the wisdom of converting our banks into lending institutions that borrow long to lend short. Government alone would then exercise its constitutional prerogative "to coin money and regulate the value thereof." And once government performs its legitimate function of providing our country with an adequate supply of money, banks could perform their proper function of safeguarding that money, facilitating the exchange of titles to money by means of checking accounts, and lending the savings of the community by borrowing long to lend short.

Instead of the U.S. Government issuing 90-day bills and 1- to 20-year bonds, the banks would be doing this. Money so obtained could safely be loaned by the banks for a shorter term without causing any alteration of the supply of money or any multiplication of bank deposits.

100% Reserves

All money in checking accounts should, of course, be backed dollar for dollar by actual cash that is awaiting the depositors who have the right to withdraw their funds on demand. Banks operating in this system would always be 100% liquid. There would be no excuse for any government interference with such banks except to see that their outstanding loans would mature before their bonds mature.

During the 1930s there was widespread interest in the idea of 100% reserve banking. In 1937 over 1,100 members of the American Economic Association--many of them well-known economists and heads of their departments at their respective universities--approved this reform as a means of alleviating the business cycle. But because it was not considered "politically feasible," interest waned.

For over 200 years we have been doing what is politically feasible rather than what is economically sound. That's why the world is in such a mess. And we can expect things to get worse if we continue letting expediency determine our actions.

The Solution

There is a quick and easy way to convert our existing banks into sound institutions. The Federal Reserve Bulletin gives the following figures for Commercial Banks and Mutual Savings Banks as of May 26, 1965 (*Federal Reserve Bulletin*, June, 1965, p. 842):

$349.8b Deposits (Demand and Time)
52.2b Cash, balances with other banks, and cash items in process of collection
63.1b U.S. Government Obligations
226.7b Outstanding Loans

(The combined total for demand and time deposits is being used because--as observed by Wm. McChesney Martin, quoted by *Morgan Guaranty Survey*, February, 1964, p. 5--"Time and savings deposits are in practice convertible without penalty into demand deposits or currency." He concluded, "For purposes of policy determination these deposits should be counted as part of the money supply.")

(1) By subtracting $52.2 b. from $348.9 b. we get $297.6 b.--the amount of additional currency needed to make total bank deposits actually convertible into currency as Mr. Martin says they are in practice supposed to be. (This shows why the FDIC--with total assets of less than $3 billion--would be entirely inadequate in the event of a panic in today's system.) The $297.6 b. of new currency should be printed by the government and loaned to the banks. (NOTE: This $297.6 b. is

not new money. That amount of money is already in the system in the form of bank deposits that exist only as book entries. The new currency is needed in order to prevent a possible contraction of those bank deposits.)

(2) Since the banks have $63.1 b. in government obligations, a mutual cancellation of debt can occur, leaving a balance of $234.5 b. that the banks will owe the government.

(3) The banks would then have a 100% reserve behind their demand deposits and sufficient cash to pay off all time depositors in full. There will no longer be any time deposits. Former time depositors will be asked to buy bank bonds. Banks will henceforth be borrowing long to lend short.

(4) As the outstanding loans of $226.7 b. are paid back to the banks, this money will be used to retire most of the banks' indebtedness to the government--leaving a balance due the government by the banks of $7.8 b. (234.5 - 226.7 = 7.8).

(5) As the banks commence retiring their debt to the government, the government will be required to use the first $26.3 b. to retire $26.3 b. of the $38.3 b. government obligations held by the Federal Reserve System. (Federal Reserve Bulletin, June, 1965, p. 836. "Cash items in process of collection" and "Deferred availability cash items" offset each other--the difference between them being "float.") The remaining $12 b. government obligations should be canceled. The Federal Reserve then will have a 100% reserve in currency behind the 18.5 b. deposits of member banks and should turn over the remaining $7.8 b. cash to the member banks (which own the Federal Reserve System) to enable them to retire the last of their debt to the government. (See step 4 above.)

(6) All debt repaid to the government by the banks in excess of the first $26.3 b. will be used to retire $208.2 b. (234.5 - 26.3 = 208.2) government obligations held outside the banking system. This will leave only $9.6 b. of government debt held outside the banks.

(7) The Federal Reserve System would no longer have the power to alter the supply of money or bank deposits in any way. It would serve primarily as a clearing house for checks and as fiscal agent for the government.

New Standard of Value

(8) The number of dollars per capita existing immediately after our banks have been put on a sound basis will be our new standard of value. We would henceforth be on a population standard instead of a gold standard. Our Constitution should be amended to indicate what our new standard is so that it will be maintained in the future.

The net result of the above steps is that over a period of 20 years we would have eliminated $309.6 billion of a government debt that totaled $319.2 billion without altering the supply of money and without increasing taxes. We would merely have given an actual existence to bank

deposits that have been multiplied during the years by the unsound practice of borrowing short to lend long. We would have put dollars where we have a right to expect them to be.

This plan for monetary reform may not be perfect in all details. All that is intended is to give a general idea of how the reform could be made.

Remove Threat of Inflation and Deflation

Were we to adopt such a system at this time, we would remove the threat of inflation and deflation while at the same time removing the necessity for any government controls of the lending operations of banks. We could henceforth cease to worry about the amount of consumer debt. All savings should be loaned so as to keep money in circulation. Debts that arise when a bank borrows long and lends short are perfectly sound so long as ordinary caution is used by the bank. It is debts that arise when a bank borrows short and lends long that cause our price level to become inflated. And the deflation that threatens us today is due to the fact that our price level is in terms of mere book deposits in our banks--a type of money that has no actual existence. By converting those book deposits into actual dollars we will have removed the threat of deflation.

Perhaps the most important result of such a change would be that our bankers and businessmen could now rely on the stability of the per capita supply of money. Neither our banking system nor our government would have the power to expand or contract the per capita supply of money.

Keep in mind that no new purchasing power would be given to nor taken away from anybody. We would merely be putting actual dollars where they ought to be but aren't. Bankers would be free to make the savings of the country readily available for loans without the fear of a possible collapse of the money market. That's not true today. At present, bankers are fully aware of the weakness of their position. Therefore, a conservative banker--anxious to protect his depositors--is reluctant to lend on long-term, because his deposits are withdrawable on demand or at most on 30 days' notice. The Government--also aware of how unstable the banking system is--has surrounded bankers with a mass of red tape, rules, and regulations in a vain effort to protect the public from this essentially unsound operation.

Under this new system, the bankers and the government would know that the money market had a solid, noncollapsible base. They would know that the basic cause of bank panics had been removed. The only restriction on the banks now would be that they would not be allowed to borrow short to lend long as they did formerly. They could only lend money obtained by sale of their bonds. But they would be free to lend for any purpose they pleased, for any length of time they pleased (provided their loans mature before the bonds mature), and charge whatever interest rate they pleased, and pay whatever interest rate was necessary to sell their bonds. In short, free market forces would be allowed to regulate the money market.

This plan has been discussed at length with several bankers. A few, who see the threat of a nationalized banking system unless a reform of this sort is made, are strongly in favor of this change.

Reaction By Some Bankers

Those who react against it do so for a variety of reasons. Some don't like the prospect of losing the income on all the government bonds they are now holding. But a large part of the income the banks have received from government securities has been passed on to their depositors in the form of lower service charges on checking accounts. These charges should be raised. The full cost of safeguarding money and facilitating the transfer of titles to that money (by means of checking accounts) should be borne by each person or company for whom that service is rendered.

Some bankers will call the plan inflationary and some will call it deflationary. But it should be clear that neither accusation is valid. No additional purchasing power would be added to the system nor would any be taken out of the system. We would merely be converting bank deposits (which are now being used as money) into actual money. This money ought to be in the banks today--but isn't. It is money that belongs to those who have checking and savings deposits. At present those deposits have no existence except on the books of the banks. And because that situation prevails with all our banks, our price structure is not on a firm basis. By putting a 100% reserve behind all checking accounts and converting time deposits into bonded indebtedness, we will be putting our price structure on a sound basis.

Bankers may say that it would not be fair to force them to rely on sales of their bonds in order to obtain money for lending, when other lending institutions such as Savings and Loan Associations are not required to operate that way. They are right. At the time this reform is made all Savings and Loans and similar lending institutions should be required to gradually convert their liabilities to their depositors into bonded indebtedness. People should recognize that it is not proper or sound for them to have the right to withdraw their savings on demand, or on 30 days' notice, when those savings have, in fact, been borrowed by others from the lending institutions for a much longer period than 30 days. The banker may then ask: What happen if everybody wants to sell these new savings bonds at the same time?

Gresham's Law

Buried in the answer to this question is one of the most powerful arguments against our present system, as well as one of the most powerful arguments for reform. Variations on the volume of money-hoarding are inherent in our present monetary system. Gresham's Law makes this inevitable. Prime examples of this are the many bank panics which have rocked the system ever since it started. By reforming our system as outlined above and stabilizing the per-capita supply of dollars, we will have removed the basic cause of variations in the volume of money-hoarding.

If, for the sake of argument, we assume that the public suddenly did wish to hoard money (by selling their bank bonds), there would be a natural and healthful counteracting force to prevent such actions from reaching excessive proportions: the price of bank bonds would fall.

Contrast the two systems. Under the present system, there is a justifiable reason for a periodic increase in the desire to hoard money and there is no deterrent to the withdrawal of money from the banking system for hoarding purposes. Indeed, the desire to hoard--as well as the hoarding itself--is encouraged by the fact that hoarding is likely to cause a contraction of bank deposits and therefore an appreciation in the value of money.

Under the new system there is no justifiable reason for any increase in the desire to hoard money. However, if we should assume that an increase in the desire to hoard money should occur, there would be a natural deterrent operating to prevent this from becoming excessive; i.e., the price of bank bonds would fall.

Bank Bonds

This does not mean, however, that a bank bond would be a poor investment. It should be obvious that any commodity or security will fall in price if everyone holding decides to sell it. Bank bonds--under the new system--would be one of the safest investments that a person could make. The security behind these bank bonds would certainly be all that could be asked for--loans secured by collateral, the dollar value of which is not subject to collapse. Contrast this with the present system in which the dollar value of a bank's collateral collapses whenever bank deposits contract.

When it is realized that the conversion of our present banking system into a sound banking system will wipe out most of our national debt, some persons might think that a sleight-of-hand trick is being played. But there is nothing tricky about it. The only tricky thing took place when the debt was created in the first place.

Our banking system--by borrowing short and lending long--either bought the government obligations themselves or loaned the money to large corporations to buy them. And the resulting multiplication of book deposits has put our price structure on an unsound basis. By putting actual dollars where they ought to be, we're merely accepting the inflated situation the bankers have put us into and stabilizing it so that it can't collapse.

It might appear that if we stop allowing banks to borrow short to lend long, there will be a great reduction in the liquidity and transferablility of wealth. That would be true if we did not monetize the existing volume of bank deposits. Today bank deposits are nothing but a substitute for money--and a very poor substitute at that. One of the functions of money is to make wealth liquid and facilitate the exchange of wealth.

Depression Cause

The curse of using bank deposits-that-exist-only-as-book-entries as money is that when confidence in the banks is lost, the liquidity of wealth is destroyed. That's why we have depressions. If we furnish ourselves with an adequate supply of money--and stabilize that money

by making it unlawful for banks to borrow short to lend long--we will then be assured of continuous liquidity.

Would there be an adequate supply of savings channeled into bank bonds so that banks could lend as freely as they do today? Some banks lend too freely. But there will certainly be an adequate supply of savings to take care of all justifiable requests for loans. In addition to the current supply of savings being loaned by banks there will be all the savings now frozen in government bonds. For example, outside the banking system there are $17.2 billion in government obligations that mature in over 20 years, $5.6 billion 10- to 20-year bonds, $22.2 billion 5- to 10-year bonds, $25.2 billion 1- to 5-year bonds, and $49.4 billion less than one year (*Federal Reserve Bulletin*, June, 1965, p. 859). As these are paid off, the recipients can be expected to buy bank bonds.

Cut Gold Tie

The question arises: Would it be wise to have such a currency convertible into gold. Certainly not. The time has come to cut ourselves loose from the gold standard altogether. The stability of international trade depends primarily upon the stability of all national currencies.

By putting our banking system on a sound basis--thereby stabilizing the dollar--we will be doing the most that can be expected of us toward the establishment of conditions that would make possible an expansion of world trade on a sound basis. (This subject has been thoroughly dealt with in the excellent book *International Monetary Issues* by Charles R. Whittlesey.)

Some people look with distrust upon "printing press" or "fiat" money. But they overlook one of the basic facts about money. It is true that we need a "hard" money. But we should not make the mistake of associating "hardness" with convertibility into gold. The essence of a hard money is that its supply is stable and there are precise limits to it. In other words, gold can be a comparatively hard money if it is not debased with alloys or with false titles to gold. Bank credit convertible into gold is a very soft money, because it is elastic and there are no precise limits to its supply; i.e., it expands and contracts. And a purely paper or "fiat" money can be a hard money if we set precise limits to its supply, or it can be a soft money if we set no precise limits to its supply. A population standard would give us a much harder money than the orthodox gold-credit system gave us prior to 1933--and certainly a much harder currency than the money-managers have given us since.

Gold's Acceptance

The reason gold has more acceptability than the dollar in the world today--as evidenced by the increasing desire of central banks to convert their dollars into gold--is the foolish attempt of the United States to maintain convertibility of the dollar into gold at the rate of $35 per ounce. There isn't enough gold to do that. Our banking system, by borrowing short to lend long, has brought about the creation of too many claims against our gold. Confidence in our ability to liquidate is

rapidly disappearing. And we will therefore be forced to devalue the dollar in terms of gold if we wish to continue this absurd system.

It is because of the expectation that gold will soon be worth more dollars that central bankers prefer gold to dollars.

There is every reason to believe the price of gold would go down if the United States completely abandoned the gold standard. Even Jacques Rueff concedes this (*Essays in International Finance*, No. 47, June 1965, p. 15). In other words, it is not gold that gives value to the dollar today. It is the other way around: It is the dollar that gives value to gold. It is about time Uncle Sam abandoned his price support program for gold. The entire world would be much better off.

The time is ripe for a thorough study of the principles upon which our monetary system ought to operate. To do that, we must first clear our minds of the erroneous theories that have been devised to defend the gold standard and the practice of borrowing short to lend long. (See "Arguments Are Fallacious For World Central Bank," *Commercial and Financial Chronicle*, Sept. 26, 1963, p. 13.) We must think solely in terms of sound economic principles.

It's a challenge--a very great challenge. If we face it and solve the problem, we will be taking the first constructive step back toward sanity in national and international relations. If we fail to accept the challenge, we will continue sinking into the mire of Collectivism--hopelessly weighted down by the ever-increasing problems arising from an economic system that can't regulate itself because it lacks a stable and reliable standard of value.

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