

Bankers and Regulators

The Foundation for Economic Education, Inc.
Irvington-on-Hudson, New York

Published November 1993
ISBN 0-910614-91-1
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Irvington-on-Hudson, NY 10533

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Introduction

Many banks and thrifts are tottering on the brink of bankruptcy. The deficit in the fund that insures deposits in savings institutions more than doubled last year, and continues to rise. Government action may well be needed again to sustain the structure. Even the future of mighty city banks is in doubt: billion-dollar loans have been made to Third World countries that have neither the ability nor the intention to repay.

To explain such ominous happenings in American finance is to search for the ideas that are guiding Americans in their financial matters. Ideas and images in men's minds are the invisible powers that govern them. The financial structure, in disrepair and disrepute, is the logical outcome of financial thought that places legislators and regulators in the center of things. It rests on their wisdom and discretion, and relies primarily on political force rather than individual freedom. It is a precarious system that builds on government insurance and government guarantees and, in final analysis, depends on monopoly money and legal tender force. It is a discredited system that is inflicting immeasurable harm on many people.

To rebuild the financial structure is to identify and discard the features that discredit it, and to lay a new foundation. It is to explode the erroneous thought that permeates it, and to dispel old myths that guide it. It is to refute the fictions and fallacies that have created a number of myths.

Myth 1: Banking is inherently unstable when left free and unhampered.

Although economists disagree on many things, most see eye to eye on their acceptance of political control over money and banking. Being accustomed to banking legislation and regulation, and addicted to a money monopoly and legal tender force, they rarely spare a thought for individual freedom in such matters. Most economists pin their

hope on legislators and put their trust in regulators who are to safeguard the system.

The deep-seated aversion to individual freedom does not spring from any explicit theory that pinpoints the shortcomings of freedom, nor does it rest on any consistent school of banking thought that elaborates specific faults. It springs from intellectual lethargy and a long tradition of political control over money and banking. "We've had it so long. It's the American way." This is the most convenient, although rarely enunciated, justification for government control. These economists invariably point at American money and banking before the Civil War which, in their judgment, confirms their belief. In particular, they cite the "Free Banking Era" of 1838–1860 as a frightening example of turbulent banking and, therefore, applaud the legislation that strengthened the role of government.¹

In reality, the instability experienced during the Free Banking Era was not caused by anything inherent in banking, but resulted from extensive political intervention. At no time in American history has banking been free of onerous legislation and regulation. The "free banking" law, which New York State adopted in 1838 and many other states emulated thereafter, did not establish free banking; it merely ended the creation of banks by special charter. "Free banking" acts were little more than "incorporation acts" that invited applicants to seek charters from the administration rather than the legislature. They did not repeal burdensome statutory provisions and regulatory directives. In fact, they added a few, especially for note issues by these "free" banks.

"Free" bank notes were printed by the offices of the state comptrollers. To obtain these notes, a New York bank had to deposit with the comptroller an equivalent value of (1) U.S. Treasury obligations, state bonds, or bonds of other states approved by the comptroller, or (2) mortgages on approved real estate with a 50 percent or better equity. Severe restrictions curtailed the issue of mortgage notes, which limited their volume rather significantly. State bonds became the primary collateral for note issue. Most states and, eventually, the federal government (in the National Banking Act of 1863) emulated the system.²

Many banks that failed during the "Free Banking Era" went to ruin when the states defaulted on their debts. Florida, Mississippi, Arkansas, and Indiana defaulted in 1841, followed by Illinois, Mary-

land, Michigan, Pennsylvania, and Louisiana in 1842.³ Mississippi, Arkansas, and Florida even repudiated their debt. The state governments continued their operations in debt default; the banks that were built on the obligations of those states lacked such a privilege.

State bonds were the major component of free bank portfolios, which exposed the banks to the ever-present risk of rising interest rates and declining state bond prices. When state governments suffered budgetary deficits, interest rates on state obligations tended to rise, which immediately cast doubt on the banks that carried the debt. State politics obviously played a major role in the life and death of a bank.

In several states with free-banking laws, the stated value of eligible government bonds exceeded their market value, which not only invited multiple credit expansion but also bred fraud and corruption. With government bonds selling at a discount, bankers could use them at face value, issue notes, then buy more discount bonds, and issue even more notes. For example, with government bonds selling at 80 percent of par, an unscrupulous operator could purchase a \$1,000 bond for just \$800, issue \$1,000 worth of notes, purchase \$1,250 in face-value bonds, issue another \$1,250 worth of notes, buy more bonds and issue more notes, and finally acquire valuable assets, and abscond with them, in "wildcat banking" fashion. Obviously, law and regulation bred the scheme and led to instability.

When compared with many other countries, the total number of local banks in the U.S. became rather large, which points to yet another important source of bank disorder: the restriction of banks to unit size. Many states prohibited intrastate branch banking as well as banking across state lines, which prevented much diversification, and limited lending and borrowing to one location. Unit banking tied the solvency of a bank to the fortunes of the town in which it happened to locate, and to the commerce and industry that sustained the town. As a town prospered or decayed, so did the bank that served it.

Legislators and regulators further circumscribed banking with onerous charter requirements. To obtain a bank charter, an individual had to petition the state banking authority and, among other requirements, bring proof of a minimum capital of \$10,000 or \$20,000, or even \$50,000, as was later required for national banks in communities with populations under 6,000, or \$100,000 for national banks in larger cities. Most Americans with low incomes and little material wealth were barred from entering the banking business. The restric-

tions obviously kept the industry smaller than it otherwise would have been, and bred countless local banking monopolies, especially in rural communities. In most of their money and credit transactions the American people became dependent upon a local bank. In many a town in territories just opened up they depended on a single bank if there was one at all.⁴

During the "Free Banking Era" the banks obviously were not free; they were curious combinations of public enterprise and special interest. No matter how free other industries may have been throughout this period, the principles of the market order never took hold in the fields of money and banking. Motivated by the popular hostility against moneylenders and the age-old belief in the desirability of ever more money, politicians and officials carefully regulated all important aspects of money and banking and protected their charges from the full severity of commercial and civil law. In periods of financial crisis many states permitted banks to flout their contractual obligations, to suspend payment of specie, or resort to makeshift devices in order to avoid payment on demand. Such practices did not make for a sound and reliable banking system.⁵

Myth 2: Banks tend to charge usurious rates of interest, contrary to the commands of charity, justice, and natural law.

The myth of banking instability receives strong support from the ancient usury doctrine, which led authorities to outlaw interest-taking altogether or at least to set maximum rates. In their zeal for preventing usurious interest-taking, many regulators set their maxima at levels far below free market rates, thereby curtailing lending or preventing it altogether. Banks, which seek to bring lenders and borrowers together, cannot serve them properly with government stipulating the rates. Usury laws are price-control laws; they disrupt markets, mislead production, cause shortages, and waste economic resources. Yet, they have been popular throughout the ages because money lending was believed to have evil effects on the community. Even Adam Smith endorsed legislation that put a ceiling on interest rates.⁶ His contemporary, Jeremy Bentham, promptly took him to task in a famous essay, *Defense of Usury*,⁷ that made a strong plea for individual freedom in determining the terms of a loan.

Throughout U.S. history the states set usury ceilings to interest-

taking. In many cases, especially at the frontier, they set maxima far below the rates that would have prevailed if there had been freedom. Consequently, capital markets were crippled and sound banking was hampered. The institutions that emerged kept their interest charges at or below the legal limit and, to remain profitable under given conditions, issued money substitutes in the form of unbacked notes. Circumscribed by usury legislation, they printed bank notes against which they maintained fractional reserves in legal money—silver or gold. Unfortunately, fractional reserves always are an invitation for disaster as soon as the note holders lose confidence in the solvency of the issuer.

Especially in the West, where the need for capital was enormous and the credit risk very great, the maximum rates of 6 to 10 percent as set by state laws constituted a severe impediment to the banking business. At the frontier the debtor's risk component alone often amounted to a multiple of the ceiling rates, which made most lending clearly illogical. When market conditions call for rates of 10 to 20 percent while the usury rates are set at 6, 7, or 8 percent, most lending comes to a halt. As the courts endeavored to enforce the laws with fervor and severity, the banks were forced to choose between closing their doors or issuing unbacked notes at permissible rates of interest. Many chose to issue notes and face the risk inherent in unbacked issue and fractional reserves.

The precarious situation of American banking today springs from similar causes. The 1970s were years of accelerating inflation and soaring interest rates. Commercial banks welcomed the abundance of credit, which meant more bank loans and higher profits. Yet, in some states, lending ground to a halt as the market rates of interest reached usury levels and were barred from going higher. Under such conditions financial institutions readily placed their funds in other states and other countries without usury restrictions. A bank in Pennsylvania could freely place its funds in Mexico at market rates, but could not legally do so in Pennsylvania.⁸

Many savings and loan associations are sharing the fate of the big city banks. Some can be charged with making poor loans; yet, most lived faithfully by the strictures of legislation and regulation, financing the construction and purchase of homes through mortgage loans. They, nevertheless, are in dire straits because inflation together with regulation is inflicting painful losses. Until 1981, legislation narrowly circumscribed the rates of interest they were permitted to pay their

passbook depositors while inflation raised the market rates far above the permissible rates, which lifted them right out of the competition for funds. They lost many billions of dollars of deposits, which sought higher interest rates in money-market funds and other instruments. To survive the painful drain of savings and safeguard their liquidity, the thrifts then had to "purchase" funds through the sale of certificates at interest rates far above those earned on old mortgage loans. Compounding the difficulties, the market value of old loans fell precipitously as interest rates rose to new highs.

In turmoil and change the Depository Institutions Deregulation and Monetary Control Act of 1980 sought to give relief to the ailing industry. It relaxed some controls over banking and tightened others. It repealed old interest-rate legislation, which was playing havoc with banks and thrifts. It made monetary control more comprehensive and effective, and sought to solve the problem of declining membership in the Federal Reserve System. In particular, the law authorized banks and thrift institutions to offer interest on checking accounts starting at the beginning of 1981. It introduced so-called NOW accounts (negotiable order of withdrawal accounts), which were to make banks and thrifts more competitive with money market funds. Moreover, the law phased out Regulation Q, the ceiling on interest rates payable on time deposits, and set aside the usury ceilings that many states had imposed on mortgage loans as well as business and agricultural loans. The new freedom to pay market rates of interest was to give relief to a suffering industry. Unfortunately, it came too late for many institutions that had suffered so long in the vice of inflation and usury legislation.

Myth 3: Effective economic policy requires government control over banks.

In recent years the old doctrines of banking instability and usurious interest rates have found a new ally in the doctrine of government responsibility for full employment and economic growth. The old and the new have joined forces to deny freedom to banking and confirm government as a money monopolist and banking regulator. Government is held responsible for economic prosperity and full employment, and, therefore, is expected to direct, control, and manage the national economy through the Treasury, the central bank, and numerous other agencies. Yet, it is prevented from doing so effectively, we are told, if

it lacks control over all issuers of money, in particular all banking institutions. Money balances must be concentrated in narrowly defined banks so that the total stock of money can be properly guarded and managed.

Most economists readily accept this dogma; they are convinced that legislators and officials must manage the people's money. In the footsteps of John Maynard Keynes, mainstream economists hold government solely responsible for prosperity and full employment and, therefore, expect it to manipulate and fine-tune money and banking. Monetarists contend that government must increase the stock of money at a steady rate, in order to achieve economic stability and steady growth. And supply-siders call on monetary authorities to manage the people's money, keeping an eye on gold. Only economists in the Austrian tradition reject all such notions as myths or fictions that contribute so much to the sorry state of banking today. They reject not only the popular acclaim of government control over the stock of money, but also the very foundation of the Keynesian structure, the "full-employment policy."⁹

More Regulation Ahead?

It is unlikely that the Austrian explanations and recommendations will prevail in the coming years of savings and loan disasters and banking crises. The doctrines of political power and wisdom in all matters of money and finance are deeply imbedded in the American frame of reference and discourse. This is why we must brace for more efforts at regulation. Surely, some controls may be relaxed as others are tightened, reacting continuously to an unsatisfactory state of affairs.

Politicians and regulators can be expected to lay the blame on the remaining margin of individual freedom however small it may be. They will seek to tighten the controls as the losses mount and the U.S. government is called upon to honor its guarantees. Surely, he who pays the bill will want to have a say on how it may be incurred. This is why the federal government can be expected to tighten its grip on American banking and finance. And, once again, it may confirm the old observation that one government intervention tends to breed another and ultimately leads to all-round regimentation.

Yet, no matter how dark our financial future may look, individual freedom is alive and well in many other parts of the world. It bestows

its largess to any country with the wisdom and courage to pursue it. Its light is shining brightly all over the world, visible to all who can see. Having suffered staggering losses and economic stagnation, and having tried every conceivable highway and byway of the political command system, we do not doubt that, in the end, we, too, will see the light again and make it our guiding beacon.

—HANS F. SENNHOLZ

1. Paul Studenski and Herman E. Krooss, *Financial History of the United States* (New York: McGraw-Hill Book Co., 1952), p. 114; Bray Hammond, *Banks and Politics in America* (Princeton, N.J.: Princeton University Press, 1957), pp. 572–604; Major B. Foster Raymond Rodgers, Jules I. Bogen, Marcus Nadler, *Money and Banking*, Fourth Edition (New York: Prentice-Hall, 1955), pp. 97–98; Gerald C. Fisher, *American Banking Structure* (New York: Columbia University Press, 1968), p. 181; Charles L. Prather, *Money and Banking*, Sixth Edition (Homewood, Ill.: Richard D. Irwin, 1957), p. 163 *et seq.*

2. Hugh Rockoff, *The Free Banking Era: A Re-examination* (New York: Arno Press, 1975), pp. 125–130; also Robert G. King "On the Economics of Private Money," *Journal of Monetary Economics*, July 1983, pp. 127–158.

3. Arthur J. Rolnick and Warren E. Weber, "The Causes of Free Bank Failures: A Detailed Examination," *Journal of Monetary Economics*, October 1984, pp. 267–291; also "New Evidence on the Free Banking Era," *American Economic Review*, December 1983, pp. 1080–91.

4. Comptroller of the Currency, *Annual Report*, 1895, Vol. 1, p. 20.

5. Lawrence White points at the Scottish free banking system (1727–1844) as an example of a sounder system. Individual freedom and unlimited banker liability gave rise to a banking system that did not suffer from panic-induced runs. Cf. *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845* (Cambridge: Cambridge University Press, 1984).

6. Adam Smith, *The Wealth of Nations* (New York: The Modern Library, Random House, 1937), p. 339.

7. W. Stark, ed., *Jeremy Bentham's Economic Writings* (New York: Burt Franklin, 1952), Vol. 1, pp. 121–207.

8. It was also more profitable and convenient to place a few big loans with a few borrowers than to make many small loans to numerous borrowers. The big city banks in the money centers showered their favors on foreign governments all over the world. Eager to make friends and win allies, the U.S. government encouraged and guided them every step of the way.

9. Hans F. Sennholz, *Debts and Deficits* (Spring Mills, Pa.: Libertarian Press, 1987), p. 159 *et seq.*; also *Money and Freedom* (Spring Mills, Pa.: Libertarian Press, 1985).

I. THE FAILURE OF REGULATION

The Impossible Task of the Fed

Ernie Ross

The Federal Reserve *has* an impossible task? Of course it does. But it is seldom mentioned. Most everyone just assumes that this autonomous government agency “on line” since 1914 has a job to do and should, well, simply *do* it. It’s not that easy. The Fed does indeed have a job which it is *expected* to do. In fact, given modern politics, it has several. However, there is a profound difference between being expected to do a job and being *able* to.

On the surface, to the layman, the Fed’s job might appear unequivocal: take care of the nation’s money supply in such a way as to help America. As the fiftieth anniversary edition (1967 revised version) of *The Federal Reserve System: Purposes and Functions*, issued by the system’s Board of Governors, succinctly put it, “The principal function of the Federal Reserve is to regulate the flow of bank credit and money.”¹ While this seems straightforward enough, the Fed’s monetary manipulation to serve the national interest is a means to a number of ends. In the modern U.S.A., the Fed is expected to prevent banking crises, facilitate commerce (“at high levels of employment,” as the Board put it), cover government deficits and fight inflation. The trouble is, manipulation toward one or more of these ends almost always contradicts another. They don’t mesh!

There is perhaps no better example of this than the Fed’s issuance of credit to cover the deficits of Congress. As monetary experts know, unless Congress raises taxes, the Fed is virtually forced to expand the money supply to pay for deficits. This is regarded as essential in order to protect the credit rating of the nation. Monetary expansion means more dollars will chase fewer goods; the dollar’s value is lowered.

While the initial surge of new money may benefit some, often high-profile, politically well-connected industries (most recently, synthetic fuels, solar energy, automobiles, housing, and aerospace), the eventual effect of devalued currency on the economy cannot rationally

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be regarded as a factor which facilitates commerce; it slows commerce (and lowers employment). Inflation takes purchasing power away from businesses as it takes it away from everyone. Persistent inflation, such as we have had since the late 1960s, makes it more expensive to run government, too, thereby increasing chances Congress will deficit spend even more.

So, while attempting to help the nation meet its debts in the short run, the Fed has in the long run actually damaged business and private employment and increased the operating costs of government (especially state and local governments, which cannot fall back on the power to issue their own credit). As this happens, the Fed quite obviously must abrogate its responsibility to fight inflation! Conversely, if the Fed cuts the money supply, it abrogates short-run responsibilities to cover Congressional deficits and stimulate depressed businesses (and employment) through lowered interest rates on borrowing.

After years of overlooking it, the newly more economically aware national press is noticing this dilemma. As *Newsweek's* Harry Anderson remarked just prior to the November 1980 general elections, "Regardless of who is the next President, the pressure on the Fed seems to intensify as the budget deficit swells. . . . Any Federal deficit must be financed through borrowing, and unless the Fed meets the new demand by creating more money, interest rates could be pushed to ruinous levels as private and public borrowing compete for funds. . . . In fact, the battle between the nation's fiscal and monetary authorities is a no-win situation for the economy. If the Fed caves in and finances immense budget deficits, the inflationary implications would be vast. If the Fed does not, a fragile recovery—if in fact it has arrived—will be slower than almost all the forecasts predict."²

Bailing Out Banks Subsidizes Bad Investments

Another example of the failure of Fed purposes to mesh is apparent in bank bailouts. What, in the name of preventing banking crises, does bailing out banks accomplish long term? Whether by means of credit subsidies, loan guarantees or perhaps forced mergers with other stronger banks (the method makes almost no economic difference), banks require bailing out primarily because they have made bad investments. The policy of bailing out banks subsidizes bad investments.

True, the Fed may frown upon and chastise the makers of bad

investments, but that is not the message that sticks with the banking community—it is not the economic message. The economic message comes through loud and clear from the Fed's action: the rewarding of malinvestments. A reward is exactly what it is. The more the Fed does it, the worse it will get. It's the old incentive principle at work—rewards encourage more of the action that is rewarded. Put another way, subsidizing poor investments makes them appear profitable. Could that seriously be regarded as a method of facilitating the nation's commerce? Hardly. Commerce on a national scale gains and retains health only through wise investments.

Nor can the Fed bailout obligation be regarded as a sound banking practice or even a method of preventing banking crises. Admittedly, in the short run it may well appear sound, especially to those banks "pulled out of the fire," to the investors of the banks, and to a Fed determined to polish its image as a financial savior. (One must always remember that the Fed is subject to the bureaucratic survival principle: act to serve those who perpetuate your existence, or die.) But one could quite cogently argue that repeatedly making malinvestment remunerative must ultimately lead to banking crises—perhaps on a massive, unmanageable scale.

As banks, including some of the nation's giants, continue operating in this insulated atmosphere of guaranteed bailouts, they become progressively involved in larger and larger unwise, often downright speculative loans. Loans to Third World countries—whose political instability makes their solvency highly questionable—are frequently in this category.

As the unwise investments accumulate, the danger increases that a bailout, or series of them, will be required that is so large the American government will not be able to generate the funds. Not only will we see losses to millions of American investors in banks, we could also see a severe monetary crisis. If the Fed hyperinflates in order to "save" the banks and the savings of American citizens and businesses, respect for the dollar will nose dive along with its value. It's crucial to constantly bear in mind that the dollar is the reserve currency of most of the free world. Therefore, a rapid dollar depreciation could precipitate a world depression.

Consider the depth of the economic contradictions involved in the Fed's various tasks. Manipulating the money supply must serve the masters of Combatting Banking Crises, Covering Government Defi-

cits, Inflation Fighting, and Facilitating Commerce. But different manipulations are required to accomplish these ends—depending on the range of one’s vision. This means the monetary caretaker function of the Fed is necessarily eroded. Being a caretaker requires that one should ensure no harm comes to that for which one cares. If the Fed’s service to multiple masters creates a currency of wild fluctuations, a currency neither business nor consumers can count on, it cannot fulfill what an AP business writer aptly termed the Fed’s obligation as the “appointive guardian of the nation’s money supply.”³

In addition, one must take note of what I call “the confusion factor” existent at the Fed. The guardian of the nation’s money supply must know clearly what it is to guard; a doubting guardian, a confused guardian, cannot function efficiently and cannot be counted on in times of crisis when his efficiency is critical. With the conflicting functions the Fed is expected to pursue these days, frequently at the expense of the health of the nation’s currency, its purpose as a money supply guardian cannot be clear to the agency.

After all, Fed members are human and therefore subject to human pressures and frustrations. Human beings subjected to contradictory orders and aims exhibit lowered efficiency and confusion. While this state of turmoil over objectives makes the Fed’s job tougher, it is not what makes it impossible. Rather, the turmoil occurs because the Fed’s job is impossible. Nevertheless, the doubts and confusion over purpose do act as a feedback loop, amplifying the difficulties.

Catering to Expediency

There are people in respectable economic circles who argue that the basic purpose of the Fed is not to act “purely” as a money supply caretaker, or, for that matter, as a caretaker of any single function. They argue, and have argued for over 60 years, that the Fed must also act as a servant of “political necessity,” as a caterer to the political “facts of life” in a modern democracy. But what is increasingly apparent even to the man in the street is that the primary fact of life in modern politics is the equivalency of “political necessity” and rampant expediency.

Catering to expediency makes the Fed a neurotic, nervous servant of favor and fancy—no matter how much it likes to regard itself as above all that. If the Fed is not above it all, why bother having a Fed? Surely, elected politicians, bickering and empire-building, could suc-

cessfully provide a proper Congressional psychology of neurosis in which to manipulate the money supply in a most honorable tribute to frenzied expediency!

Of course, it was precisely such a madhouse political free-for-all Congress intended to avoid when it passed the Federal Reserve Act of 1913 (augmented, eventually, by the Banking Act of 1935). It intended to avoid that kind of mess and what was then seen as the “frenzied” actions of the free market. Congress has not succeeded. It could be no other way. The nature of the task it set for the Fed decades ago and the additional duties demanded of the Fed in more modern times are permeated with contradictions. What seems generally unrealized in modern economic forums is that the creation of the Fed involved not just problems but a fundamental flaw common to all economic tyrannies.

A Legally Empowered Tyranny

The Fed is an economic tyranny—a democratically created, legally empowered tyranny over the nation’s money supply. Whether an economic tyranny takes the broader forms of socialism, fascism, and Communism or this narrower form of federal monetarism, it holds an error in common: *it seeks to subjugate private, individual, or business decision-making to state authority*. In fact, private monetary decision-making was precisely the economic “frenzy”—i.e., free human action—so unacceptable to the politicians and fellow supporters of federal monetary centralization.

Politicians have long understood that maintaining and expanding state power is incompatible with freedom. The Fed has been used for just such maintenance and expansion—perhaps more than any other government institution created by man. Given that this nation’s money supply is crucial to the U.S. economy and to the world economy, that it underlies and affects all transactions of the free world (and much of the unfree world), the creation and perpetuation of the Federal Reserve System is the most gripping, insidious economic tyranny yet accepted. The domains and edicts of such agencies as the Federal Trade Commission, departments of Energy, Education, or Health and Human Services and most other agencies of this government are small potatoes indeed when compared to the realm and power of the Fed.

Yet, most of today’s established market economists tacitly support

this tyranny. Even the most influential of them, Milton Friedman, in his bestseller, *Free to Choose*, while documenting a damning case against government economic intervention in general and the Fed's specific malfeasance in the 1930s depression, nevertheless insists that the Fed could have "used wisely the powers that had been granted to it (in order to) perform the task for which its founders had established it."⁴ Unfortunately, it is instances of this sort of wishful thinking which divert attention from a proper contextual focus on the subject.

The issue is not that a government agency could have made a right decision in any particular instance, but rather that the *propensity* of government agencies is to make wrong economic decisions. Friedman and his admirers (and even more so the statist economists) forget that the Fed's task is to perform as monetary dictator. The evidence is overwhelming that no government has succeeded for long in productively dictating the actions of any segment of the economy; monetary policy is no exception. Governments have succeeded—notoriously so—in destructively dictating economic actions; monetary policy is no exception.

Abolish the Fed and Privatize Monetary Functions

The case record of the Fed—most notably, its recession-causing sharp monetary contractions after World War I; its inflation in 1927 which created the dangerous speculative market boom; its effort to counter that boom with a panicky, severe contraction which led to the Great Depression; its hand in causing the severe 1937 recession; and its ever-widening post-World War II swings have finally merged into "stagflation," plunging the business morale and hopes of American citizens for their future to new lows—is enough by itself to warrant a case for abolishing the Fed. But the fact that the Fed is *by its nature* bound to serve impossible ends must surely add philosophical ammunition to the case.

There is in the long run only one answer to the problem of managing the monetary economy: It should be privatized, with privately coined and printed currency, privately controlled credit systems and private insurance of monetary deposits. Because of the scope of such a revision we would also be forced to consider more seriously privatizing many other government services. For without its own monetary ma-

chinery, the government will find the financing of redistributive and vote-buying schemes considerably more difficult.

Privatized monetary functions *do* act as a natural check on the power of government. But the alternative to privatizing the U.S. monetary system, tinkering and fiddling with the derelict government system we have, means keeping a form of tyranny intact. There is only one way to prevent the damages to human liberty which a tyranny inflicts—take away the tyranny. The Fed is such a tyranny. There is no place for it in the future of a free America.

1. *The Federal Reserve System: Purposes and Functions* (Board of Governors, 1967), p. 4.

2. Harry Anderson, *Newsweek*, October 13, 1980, p. 88.

3. AP Wire, October 7, 1980.

4. Milton Friedman, *Free to Choose* (New York: Harcourt Brace Jovanovich, 1980), p.

On Usury Laws

William Cullen Bryant

The fact that the usury laws, arbitrary, unjust, and oppressive as they are, and unsupported by a single substantial reason, should have been suffered to exist to the present time can only be accounted for on the ground of the general and singular ignorance which has prevailed as to the true nature and character of money. If men would but learn to look upon the medium of exchange, not as a mere sign of value, but as value itself, as a commodity governed by precisely the same laws which affect other kinds of property, the absurdity and tyranny of legislative interference to regulate the extent of profit which, under any circumstances, may be charged for it would at once become apparent.

The laws do not pretend to dictate to a landlord how much rent he may charge for his house; or to a merchant what price he shall put upon his cloth; or to a mechanic at what rate he shall sell the products of his skill; or to a farmer the maximum he shall demand for his hay or grain. Yet money is but another form into which all these commodities are transmuted, and there is no reason why the owner of it shall be forbidden to ask exactly that rate of profit for the use of it which its abundance or scarcity makes it worth—no reason why the laws of supply and demand, which regulate the value of all other articles, should be suspended by legislative enactment in relation to this, and their place supplied by the clumsy substitute of feudal ignorance and worse than feudal tyranny

Such attempts have always been, and always will be, worse than fruitless. They not only do not answer the ostensible object, but they accomplish the reverse. They operate, like all restrictions on trade, to the injury of the very class they are framed to protect; they oppress the

William Cullen Bryant (1794–1879) was born at Cummington, Massachusetts. He was the young Republic's first distinguished poet, best known, perhaps, for his youthful composition "Thanatopsis." Bryant was also a journalist, editor, and reformer—nineteenth-century liberal variety. He was editor of the *New York Evening Post* from 1829 until his death. This excerpt, taken from an item in the September 26, 1836, *Evening Post*, was reprinted in the January 1981 issue of *The Freeman*.

borrower for the advantage of the lender; they take from the poor to give to the rich. How is this result produced? Simply by diminishing the amount of capital, which, in the shape of money, would be lent to the community at its fair value, did no restriction exist, and placing what is left in the most extortionate hands.

But usury laws operate most hardly in many cases, even when the general rate of money is below their arbitrary standard. There is an intrinsic and obvious difference between borrowers, which not only justifies but absolutely demands, on the part of a prudent man disposed to relieve the wants of applicants, a very different rate of interest. Two persons can hardly present themselves in precisely equal circumstances to solicit a loan. One man is cautious; another is rash. One is a close calculation, sober in his views, and unexcitable in his temperament; another is visionary and enthusiastic. One has tangible security to offer; another nothing but airy one of a promise. Who shall say that to lend money to these several persons is worth in each case an equal premium?

Should a person come to us with a project which, if successful, will yield an immense return, but, if unsuccessful, leave him wholly destitute, shall we not charge him for the risk we run in accepting his views? The advocates of usury laws may answer that we have it at our option either to take seven percent or wholly refuse to grant the required aid. True; but suppose the project one which is calculated, if successful, to confer a vast benefit on mankind. Is it wise in the legislature in such a case to bar the door against ingenuity, except the money lender turns philanthropist and jeopard his property, not for a fair equivalent, but out of mere love to his fellow man?

The community begin to answer these questions aright, and there is ground for hope that they will ere long insist upon their legislative agents repealing the entire code of barbarous laws by which the trade in money has hitherto been fettered.

The International Monetary Fund

Ken S. Ewert

It was on July 1, 1944, just three weeks after the Allies had landed in Normandy, that the most significant intergovernmental conference of the century began. The conference took place at Bretton Woods, New Hampshire, and it represented, in the main, the thinking of two individuals, Harry Dexter White and John Maynard Keynes. Both of these men had grave doubts about the beneficence of market processes and preferred to put their faith in the ability of national and international “managers” to coordinate the world’s economic affairs. And in 1944 White and Keynes were not alone in their views. As some 45 countries met to plan out the “new economic order,” there was consensus on the necessity for increased economic coordination and a general view that the international gold standard was undesirable because of the restraints it placed on a nation’s ability to pursue the “full employment” policies prescribed by the nouveau Keynesian wisdom.¹

Two of the organizations formed at Bretton Woods have become increasingly more important in the world’s economic affairs. These are the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). Of these two institutions, the World Bank has evoked considerable criticism over the years for its policy of lending primarily to governments instead of to private, profit-seeking organizations. A strong case can be made that the policies of the World Bank have supported worldwide statist economic policies, and discouraged the expansion of the free market. The IMF, however, has generally been more acceptable to defenders of the market, since its operations do not so clearly subsidize anti-free market policies. However, as a closer look shows, the IMF has also been a major influence for statist economic policies.

The IMF was established “to promote international monetary co-operation” by maintaining fixed exchange rates among the currencies of different nations.² To accomplish this, the Fund was to make short-

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term loans to nations which had temporary balance of payments deficits (i.e., the net imports of the country exceeded its net exports). The short-term loans (usually three to five years) would presumably allow a nation to recover from its imbalance without having to resort to devaluing its currency.

IMF loans were, and are today, made according to the "quota" of each member nation. The quotas consist of the capital each country has paid in, usually 25 percent in gold and the rest in the member nation's currency. A member nation can exchange a portion of its quota to buy another nation's currency (usually dollars, German marks, or Japanese yen). These funds in turn can be used to support the borrowing country's currency on exchange markets or to pay off creditors while it (supposedly) gets its economic house in order.

While the capital for these loans is officially provided by all member nations, in reality it is the industrialized "hard currency" countries who provide the lion's share. At Bretton Woods, nearly every weak currency nation sought to increase its "quota" so that it could "buy" more currencies of real value. The same is true today as many debtor governments favor large increases in quotas while industrialized nations seek more moderate increases. The quota system amounts to an agreement of hard-currency countries to lend funds to the soft-currency countries, and it ultimately represents a net transfer of funds from citizens of industrialized countries to the debtor-nation governments (since the loaned funds are continuously rolled over or reloaned, and not repaid to the donor country).³

Subject to special Fund approval, a member nation can also borrow amounts well beyond its quota. The size and number of these loans (called "standby agreements") have increased over the years, and they usually include specific economic conditions which the debtor nation must observe. The standby agreements usually are repaid over a period of three to five years. In addition to this regular financing, the IMF has greatly expanded its role by establishing several "special facilities" which give the Fund more discretion in lending and allow longer-term loans and larger subsidies for less developed countries (LDCs) which are the principal users of Fund resources.⁴

The Fund's credit-dispensing ability was further expanded in 1970 with the creation of "Special Drawing Rights" (SDRs). While dubbed "paper gold," the SDRs are actually fiat money, i.e., only bookkeeping entries in the Fund's books. They are allocated to countries according

to their quotas, and they are used by member nations in their transactions with each other and as reserve assets. The SDR is the fulfillment of what John Maynard Keynes had envisioned in the early 1940s. Keynes proposed a world reserve currency called the “bancor” which supposedly would free all governments from the disciplines of gold. Like the proposed bancor, the SDRs are designed to replace gold in world monetary transactions and to further free member governments to inflate their currencies.

Initially the IMF’s primary role was to foster the fixed exchange system.⁵ But the Fund had little success at this, since the inflation⁶ in many countries made devaluation of their currencies inevitable.⁷ Even the widespread use of IMF credits couldn’t sustain the value of debased currencies for long. By the time the fixed exchange system collapsed on August 15, 1971, the IMF had sanctioned more than 200 devaluations.⁸

Not only was the IMF powerless to stop the devaluations, its funding may well have been a net negative force since it restrained and slowed what would have been the normal market corrections of international exchange rates.⁹

When the fixed rate system finally collapsed (as the U.S. abandoned the gold-exchange standard) there were many people who speculated that the IMF would slowly fade into oblivion, since its primary role—maintenance of fixed rates—was eliminated. Such was not to be the case however, and the IMF has survived and even substantially expanded its role in the subsequent years.

When the IMF no longer had fixed exchange rates to justify its existence, it turned to lending for “temporary” balance of payments deficits as its primary function in the 1970s.¹⁰ Between 1970 and 1975 the volume of the Fund’s lending more than doubled in real terms, and from 1975 to 1982 it increased by a further 58 percent.¹¹

Balance of Payments Deficits

For the most part, the balance-of-payment lending by the IMF seems to assume that a country’s imbalance of payments is caused by factors other than its own economic policies. Examples of externally caused temporary trade imbalances (supposedly proving the necessity of the Fund’s role) might be a poor year for a country’s major export crop, or a sharp rise in the price of a principal import (such as oil).

While national trade imbalances are sometimes caused by such factors, most often the culprit is not some twist of fate but rather the economic policies of the debtor nation's government.

Governments the world over find it expedient to spend more than their citizens are willing to provide in tax revenues. The additional spending is often financed by increasing the quantity of money and credit, which results in rising domestic prices. Faced with rising prices at home, the country's citizens will tend to buy more goods and services from abroad, since they have become relatively cheaper. At the same time, exports from the inflating country will tend to become less attractive to foreign buyers because of their increased cost. The end result is a balance of payments deficit.

This deficit would tend to correct itself if exchange rates were left unmanipulated by the inflating country's central bank. The value of the inflated currency would tend to drop in relation to foreign currencies, and this in turn would discourage imports and encourage exports. But what often happens is that the inflating country's central bank intervenes in foreign exchange markets to prevent the value of its currency from falling to (or closer to) its market level. It can do so, however, only as long as it has access to foreign currency reserves with which it can intervene to purchase its own currency.

The Results of IMF Rescues

Often when a country has depleted its reserves, the IMF enters and offers loans which enable the inflating government to continue its folly by providing it with the funds to negate (temporarily) some of the consequences of the inflation. According to Henry Hazlitt: "If nations with 'balance-of-payments' problems did not have a quasi-charitable world government institution to fall back on and were obliged to resort to prudently managed private banks, domestic or foreign, to bail them out, they would be forced to make drastic reforms in their policies to obtain such loans. As it is, the IMF, in effect, encourages them to continue their socialist and inflationist course."¹² The IMF thus facilitates inflationary policies (euphemistically called "full-employment policies") in member nations by being a "safety net"—it is always there to bail out its profligate members with fresh funds.

There is no doubt that by rescuing LDC governments, the IMF has helped make possible the massive monetary inflation which has

occurred and is still occurring in many of these countries. Even more important, it has allowed governments the world over to expropriate the wealth of their citizens more efficiently (through the hidden tax of inflation) while at the same time aggrandizing their own power. There is little doubt that the IMF is an influence for worldwide socialism.

Although IMF loans have been primarily short term and for the stated purpose of rectifying temporary balance of payments deficits, the Fund has been a *de facto* supplier of long-term financing to many LDCs.¹³ A long-term loan is no different from a number of short-term loans strung together, and many of the IMF's member nations have a long record of back-to-back loans.¹⁴ Between 1954 and 1984, 24 member nations used Fund credit for 11 continuous years or longer; it seems that the majority of countries which begin using IMF funds continue to do so.¹⁵

Without question, IMF lending has had a sizable impact on the long-term economic policies of some LDC governments, and it thus deserves some of the blame for the triple-digit inflation, price controls, oppressive taxation, stifling regulations, and general disregard for private property rights which are common to many of these countries. There is, of course, no way to know what political and economic changes for the better would have occurred in the absence of IMF bailouts, but as *The Economist* notes, the Fund often "stands as the last defense between a mismanaged economy and outright financial collapse."¹⁶ Such a collapse, if it brings an end to statist policies, might well usher in increased economic freedom for millions of people.

Subsidizing LDC Governments

It might be objected that Fund lending merely takes the place of what otherwise would be private lending to LDC governments. And if this were the case, the IMF could not be held responsible for the policies that these loans made possible. However, the IMF often lends to financial "basket-case" countries which have little hope of obtaining private loans without IMF help. More important, almost all IMF loans are not market-rate loans, but are subsidized, sometimes heavily.¹⁷ Given the basic economic axiom that more of an economic good will be consumed if its cost is lowered, the subsidized loans made by the IMF have encouraged LDC indebtedness and, since such loans are

made to governments and not private individuals, increased the politicization of these societies.

Member nations can borrow from ordinary (non-facility) Fund resources at well below market rates. For example, from May 1982 through April 1984, the annual charge for use of these Fund resources was 6.6 percent. During this same period, interest rates paid by LDCs to commercial lenders were between 11 and 13 percent (often plus additional charges).¹⁸

The bulk of member borrowing, however, is done through Fund "facilities." As of 1984, more than one-third of these loans were financed by Fund borrowings from industrialized governments (rather than from quota contributions). Since the Fund can borrow at substantially lower interest rates than those available to the poor-risk LDC, it implicitly subsidized the borrowing country by passing on this lower rate. Moreover, some of the facilities are even more explicitly subsidized. The oil facility, for example, includes a "grant" factor of some 30 percent.¹⁹

With the increasing debt burden of many LDCs and the ensuing "international debt crisis," the IMF has garnered even more power and resources. In 1983 the Fund's resources were increased from 61 billion SDRs to 90 billion SDRs, and a number of new lending programs subsequently have been initiated.²⁰

In addition to expanding its role as a lender, since the early 1980s the Fund has become the central player in "managing" the debt restructuring packages among debtor nations and their creditors. The IMF coordinates rescheduling packages in which commercial banks, governments of industrialized nations, and international agencies agree to supply new loans and reschedule old loans on the basis that the debtor nation promises to abide by IMF conditions.

The fact that the IMF loans are "conditionality agreements," which require the debtor nations to adhere to (or at least work toward) specific IMF-mandated policies, is pointed to by some Fund supporters as a crucial function served by the Fund, and one which justifies its existence. The Fund is supposedly needed to impose some sort of economic discipline on nations which seem unable to impose it on themselves.

However, the conditions imposed by the Fund are seldom free-market oriented. The Fund concentrates on "macro-policies," such as

fiscal and monetary policies or exchange rates, and pays little attention to fundamental issues like private property rights and freedom of enterprise.²¹ Implicit in the Fund's stated policy of "neutrality" with regard to national political decisions is a belief that with proper "macro-management" any economic system is viable, whether it be socialist or capitalist. Because the Fund does not advocate the true prerequisite for economic prosperity—a lawfully constrained government which respects private property—its record as an economic manager is rather poor. There is every reason to believe that in the absence of the IMF, private lenders would require conditions (in return for further loans) which would be at least as effective in promoting economic health for the LDC.²²

Until recently the IMF conditions routinely required "austerity measures" in the debtor nation. These measures often included reduced budget deficits, slower money creation, and more realistic exchange rates. These conditions have evoked widespread protests both from within the "Third World" and from the universities, think tanks, and charities of the industrialized countries. Austerity measures are attacked by liberal critics as being overly harsh, politically unfeasible, and particularly harmful for the poor who depend upon government programs in the affected LDCs.

In response to this criticism, the IMF's newest director, Michel Camdessus, has indicated that the IMF in the future will be less stringent with the debtor nations and place more emphasis on "growth." According to Camdessus, the IMF must take care to "respect a member government's judgment of priorities and of domestic political constraints." Reflecting the same tone, at the annual meeting in September 1987, the IMF interim committee proposed that the "conditionality" of Fund loans should be reviewed in light of the "increased emphasis being placed on growth-oriented adjustment."

In addition to more lenient conditions, Camdessus, with the support of U.S. Treasury Secretary James Baker, advocated more funding (from industrialized countries) for the IMF over the next few years to enable the debtors to "grow" their way out of debt.²³

The IMF role in the current crisis has not necessarily been beneficial and might well prove, in hindsight, to have worsened the debt situation. As IMF historian Margaret Garritsen de Vries notes, IMF involvement has prompted "net new lending from commercial banks on a much larger scale than had been thought possible in mid-1982."²⁴

Presumably the commercial lenders have been willing to extend new funds for one of two reasons: either they believe the IMF will "straighten out" the debtor nation's economy, or they believe that the IMF's involvement in the rescheduling process is an implicit guarantee of these loans. Congressman Henry B. Gonzalez, among others, believes the latter is true, and has called the IMF an "international FDIC for banks."²⁵

Whatever reason for increased lending, if, as seems likely, the LDC debtor nations fail to "grow" out of their present predicament, the IMF deserves much of the blame for the future losses and financial havoc which will result.

There are indications that the Fund may be currently evolving beyond its debt management role. It is clear from recent statements by Fund Director Camdessus that the IMF desires a more central role in international economic policy co-ordination and management of exchange rates. In fact, in recent years the IMF's annual meeting has increasingly come to serve as a focal point for the major industrialized countries' finance ministers and heads of central banks to meet and discuss economic coordination.

However, until now the U.S. has sat "in the driver's seat" so to speak, because of the premier position enjoyed by the dollar among world currencies. The IMF, supported by several industrialized countries, advocates replacing the current American pre-eminence in the global economic management process with the international oversight provided by the Fund. In order to achieve this, Director Camdessus advocates that the dollar be replaced as the world's reserve currency by the IMF-issued SDRs.

Conclusion

The IMF is seen by many within government (as well as banking and academic) circles as "the world's master economic trouble-shooter," and there is a growing call for an increased role for the Fund in world monetary and economic affairs.²⁶ More than 40 years after the Bretton Woods Conference, the same call continues to be echoed: "We need more international economic coordination."

Yet the faith that governments around the world are ever willing to place in a supranational organization like the IMF seems ill-founded. After all, the IMF has failed to achieve its original goal of

maintaining fixed exchange rates, it has failed to attain its subsequent goal of improving the balance of payments problems of LDCs, and it is currently failing to solve the world debt crisis. Moreover, its "successes" also are open to serious question. It has financed statist policies in LDCs, it has transferred billions of dollars from citizens of industrialized nations to Third World regimes—some of them despotic—and it has facilitated worldwide inflation.

Why, then, the widespread support for the IMF?²⁷ The reason is more straightforward than many of us would like to believe. When governments speak of the need for "increased economic coordination," what they mean is that governments around the world want to better synchronize their inflationary monetary policies. Inflation is politically expedient for every government in our age. It temporarily stimulates economic activity and in so doing buys considerable political favor. Only later when the unpleasant effects appear—rising prices, economic dis-coordination, consumed capital, and unemployment—does the inflation become a political liability. The illusive goal pursued by governments around the world is to reap the political benefits of inflation without paying its subsequent costs.

The IMF is seen as a means to achieve this goal of simultaneous world monetary expansion. As Hans F. Sennholz observes, the IMF represents the "spurious notion that the policy of inflation can be made to last indefinitely through cooperation of all member governments. It acts like a governmental cooperative with 146 members that tries to coordinate the inflationary policies of its members."²⁸ It is this vain pursuit that has sustained and nurtured the IMF throughout its history.

1. The Treasury Secretary at the time, Henry Morgenthau, declared: "It has been proved . . . that people in the international banking business cannot run successfully foreign exchange markets. It is up to the Governments to do it. We propose to do this if and when the legislative bodies approve Bretton Woods." Cited in Henry Hazlitt, *From Bretton Woods to World Inflation: A Study of Causes and Consequences* (Chicago: Regnery Gateway, 1984), p. 88.

2. Article I of the original "Articles of Agreement," cited in Margaret Garritsen de Vries, *The IMF in a Changing World: 1945–1985* (Washington, D.C.: The International Monetary Fund, 1986), p. 14.

3. According to Henry Hazlitt: "The guiding idea of the conference, even at its opening, was that the value of the weak currencies should be maintained by the countries with strong currencies agreeing to buy them at a fixed rate, regardless of their market value." See Hazlitt, p. 46.

4. These "special facilities" include: (1) The General Arrangements to Borrow which

coordinates the lending of ten major industrial countries to wayward debtor countries in order "to forestall or cope with an impairment of the international monetary system." (2) The Compensatory Financing Facility which allows short-term, non-conditional loans to countries suffering from a temporary major decline in primary exports. (3) The Oil Facility and Subsidy which was established in response to the sharp increase in oil prices and allows minimal-condition loans beyond normal drawing rights. (4) The Extended Fund Facility which was established in 1974 to allow longer-term financing (over 8 to 10 years instead of the previous 3 to 5 year terms for repayment). With this special facility, the Fund has officially moved into the medium-to-long-term financing traditionally done by the World Bank. (5) The Supplementary Financing Facility, which was financed by Fund borrowing from industrialized country governments, further aided countries which had large payments deficits and did not qualify for regular IMF financing. See Richard Goode, *Economic Assistance to Developing Countries Through the IMF* (Washington: The Brookings Institution, 1985), pp. 5–10.

5. More accurately, a system of "adjustable peg" rates. It was recognized that occasionally "fundamental disequilibria" would occur in a nation's balance of payments which would necessitate adjustments in the value of the currency.

6. The word "inflation" is used here to denote the expansion of the money and credit supply of a nation, not the most noticeable result of that monetary expansion, which is rising prices.

7. "Currency depreciation can always be avoided through a sufficiently restrictive, usually disinflationary, monetary policy. Exchange crises are from a technical point of view—always the fault of the country's own monetary authorities." Roland Vaubel, "The Moral Hazard of IMF Lending," in Allan H. Meltzer, ed., *International Lending and the IMF: A Conference in Memory of Wilson E. Schmidt* (Washington, D.C.: The Heritage Foundation, 1983), p. 69.

8. Hans F. Sennholz, *Age of Inflation* (Belmont, Mass.: Western Islands, 1979), p. 138.

9. Without IMF assistance, "the countries with the most inflation would have suffered the consequences of their currency debasements much earlier and would have had to retrench much sooner." Sennholz, p. 138.

10. As *The Economist* wrote on January 17, 1976, "the IMF did its best to resist the change to floating. Now that it has had to be accepted, why is the IMF still bent on credit creation?" (cited in Vaubel, p. 70).

11. Vaubel, p. 66.

12. Hazlitt, p. 14. Even if the balance of payments problem were due to a "temporary" shock such as a sharp increase in the cost of oil imports, there is no reason to believe that postponing the necessary adjustment by borrowing will be beneficial to the country. Even if such "adjustment smoothing" was advantageous, the country hit by the disturbance could borrow in the international capital markets. This would lead to a better utilization of resources because the borrower would pay the full cost, instead of using subsidized IMF funds. The borrower "would have to borrow at the opportunity cost of lending in the rest of the world" (Vaubel, p. 71).

13. In recent years, the IMF has been increasingly lending for longer periods, often ten years.

14. "The IMF appears to have created a class of permanent bad-credit nations that have grown accustomed to its emergency assistance." Fred L. Smith, Jr., "The Politics of IMF Lending," *Cato Journal*, Vol. 4, No. 1 (Spring/Summer 1984), p. 222.

15. Goode, pp. 19–20.

16. "Poor Man's Fund," *The Economist*, February 13, 1988, p. 14.

17. Vaubel, p. 66.

18. Goode, pp. 15–16.

19. Goode, p. 18.

20. The Structural Adjustment Facility (SAF) was established in 1986 in order to aid the poorest African, Asian, and Pacific countries. It allows the borrower a five-year grace period after which repayments begin and continue for another five-year period. IMF Director Camdessus is seeing an expansion of SAF from its current three billion SDR to 1.1 billion SDR. In the fall of 1987, Treasury Secretary James Baker proposed yet another IMF facility called the External Contingency Facility which would provide further aid to help sovereign debtor and creditor countries. (Anthony Rowley, "All Friends Again: IMF-World Bank Meeting Produces Harmony If No Answers," *Far Eastern Economic Review*, October 15, 1987, pp. 67–70).

21. "Does it make any difference whether budgets are balanced by cutting spending or raising taxes?" I [Tom Bethell] asked the IMF information officer.

"That's a national political decision," he said. "How the government does it is its own affair."

I raised the problem of very high tax rates in many Third World countries.

"What is too high?" he asked.

"What about property rights?" I further inquired. "Do you insist that they be respected?"

"No," he said. (Tom Bethell, "Loony Lending," *National Review*, October 14, 1983, p. 1260).

22. The lenders could, in the absence of the IMF, form a type of consortium arrangement for dealing with their problem debtors. Moreover, IMF programs have not been very successful in curing these sick debtors. A former executive director of the Fund, Jahangir Amuzegar, admits "... it is disturbing that, despite its valiant rescue efforts across the Third World, the IMF is hard pressed to show more than a few clearly viable programs out of the roughly three dozen under its wing" (Jahangir Amuzegar, "The IMF Under Fire," *Foreign Policy*, Fall 1986, p. 114). Another author notes that "According to an analysis performed by T. R. Reichman, an economist in the Fund's powerful Trade and Exchange Relations Department, 21 stabilization programs initiated after Oil Shock I had only about a 33 percent success rate." Michael Moffit, *The World's Money: International Banking from Bretton Woods to the Brink of Insolvency* (New York: Simon and Schuster, 1983), p. 130.

23. Rowley, p. 70. IMF Director Camdessus is presently calling for a further doubling of the Fund's capital.

24. de Vries, p. 189.

25. Smith, p. 218.

26. Amuzegar, p. 98.

27. There is also, happily, growing opposition to the IMF. The debate over increased funding in 1983 prompted a powerful coalition of Left/Right IMF opponents including Ralph Nader and Howard Phillips. It was only the about-face switch of the Reagan administration, which had been very critical of the IMF until the fall of 1982, that assured passage of the funding increase. Treasury Secretary Donald Regan was quoted in the *Financial Times* as saying, "I lobbied 400 out of 435 congressmen before that vote" (Smith, p. 238).

28. Hans F. Sennholz, "The World Debt Crisis," *The Freeman*, February 1983, p. 79.

The Savings and Loan Bailout: Valiant Rescue or Hysterical Reaction?

Hans F. Sennholz

Introduction

This is the story of monumental failure of financial legislation and regulation, of federal deposit insurance that penalizes good managers and bails out the incompetent and reckless, of cartel management that is to assure stability, but instead brings uncertainty and loss. More than 500 commercial banks have failed during the 1980s, and more than 3,000 thrift institutions have suffered insolvencies. Yet, depositors whose funds were lost may rest assured—their deposits are covered by federal insurance, which, in the final analysis, is underwritten by none other than American taxpayers.

The causes of the disaster are hidden in much controversy and misconstruction. Guided by popular notions and doctrines, most observers exonerate the legislators who built the system and the regulators who guided it every step of the way. They deplore the partial deregulation that took place in recent years. Deregulation, they are convinced, together with management greed and folly have given rise to the dilemma. Lax supervision permitted S&L managers to squander customers' funds while S&L depositors stood idly by, relying on federal deposit insurance. The obvious solution, we are told, is thorough supervision and control.

Actually, the real cause of the financial disaster is clear to all who care to see. The American financial system was fashioned by legislators and is regulated by regulators who together created a cartel that is crumbling under the weight of its own contradictions. The system rests on government force, rather than voluntary cooperation. Enmeshed in countless laws and regulations, it was unable to cope with the rampant inflation of the 1970s, and the globalization of capital

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markets during the 1980s. In desperation about their sinking ship, the legislators and regulators finally consented to "deregulate," that is, relax their rules a little. Unfortunately, the deregulation proved to be too little and too late.

President Bush's rescue proposals, which in their essentials were made law on August 9, 1989, contain no significant changes. They call for noisy restructuring of the regulatory system, without any change whatever in the basic structure. The same Federal Home Loan Bank (FHLB) regulators who guided the system in the past will continue to direct it in the future. They will do so under a new label, the Office of Thrift Supervision. FSLIC will join FDIC, and be called the Savings Association Insurance Fund (SAIF). Under the new label, the same people will continue to insure S&L deposits at the risk and expense of American taxpayers.

The Reform and Rescue Act has merely rearranged the chairs on the deck of the regulation liner. The heading has not changed one degree; the speed has accelerated a little. A new captain, the Secretary of the U.S. Treasury, who serves at the pleasure of the President of the United States, has replaced the old captain, the chairman of the Federal Home Loan Bank Board.

The Reform and Rescue Act created a new federal agency, the Resolution Trust Corporation (RTC), which will be a giant government corporation, the biggest ever of its kind. It will take possession of, and then dispose of some \$300 to \$500 billion in real assets formerly held by defunct S&L institutions. It thereby will create the potential and temptation for politics at its worst, for fraud and abuse that may permeate the entire system. It also will open the floodgates for countless lawsuits and other legal proceedings that are likely to grow out of the RTC liquidation of defunct property. When FDIC liquidated some \$9 billion in assets of failed commercial banks, it triggered an estimated 21,000 claims and lawsuits. If FDIC experience is an indication of things to come, RTC may engender one million or more claims and lawsuits. Indeed, RTC is likely to keep judges busy and lawyers in income and wealth for many years to come.

Unfortunately, many men cannot learn the truth because it is too complicated, or they may reject it because it is too simple. Government officials may deny it because it would deprive them of their positions and livelihood. The Reform Act prefers to give employment and promotion to many more civil servants and endow them with new powers

over their fellow men. While the act calls for prosecution and punishment of S&L managers, it is utterly silent about the blunders of legislators who created the system, and the regulators and auditors who guided it throughout the years.

Most policymakers are resisting the only rational conclusion that can be drawn: the time has come to dismantle the financial cartel of which the S&Ls are an integral part. It is an aberration and abomination. If a cartel structure, which restricts competition and divides the market, does not function satisfactorily, and inflicts painful losses on the underwriter, it is reasonable and just that it should be abolished. When all expedients of the cartel system have failed, we may try freedom.

Structure and Superstructure

Savings and loan associations have a long and honorable history. Throughout the ages, relatives, friends, and neighbors pooled their savings to pursue high aims and lofty objectives. Some pooled their resources to realize the ultimate objective of all their ambition: to own a home and to be happy at home. During the early nineteenth century, many associations were organized by English immigrants along lines of building societies they had known in old England: the "Friendly Societies."

In the early years, savings and loan associations were not incorporated, and not subject to special legislation. They were partnerships in the widest sense, associations for a common purpose: to purchase a home. Individual rights and duties were generally arranged by contract among the partners, sometimes in written form, sometimes merely orally. They were not permanent institutions, but were organized for a period necessary to enable each of the members to realize his objective.¹

After the Civil War, permanent institutions began to replace the small neighborhood associations; membership grew into many thousands, and many members had no intention of building or buying a home. In time, the growing importance of S&Ls attracted the attention of politicians and officials, who began to regulate the associations; Pennsylvania passed the first building association act as early as 1850.

In the footsteps of Pennsylvania, other states gradually erected a regulatory structure. Political authorities assumed control of S&L op-

erations on four or more levels. First, no one individual or group of individuals was permitted to organize an association unless it was properly licensed or chartered by a political authority. To obtain a charter, applicants had to show proof of a minimum capitalization and other qualifications. In New York, state legislation required certain associations to put up a cash deposit of \$100,000 with a state office before they could transact business. Second, the lending activities of S&Ls were narrowly limited as to size, purpose, location, and repayment conditions of a loan. Early state supervision took the form of reports to state officials, then occasional examination by officers representing the state and, finally, periodic examination by state officials.² Third, political authorities imposed reserve requirements and issued other regulations that were to assure prompt repayment of deposits. S&L reserves had to be kept in the form of government obligations, preferably in debt instruments of the government that issued the charter and regulated the S&L. The reserve requirement did not release S&Ls from the redemption requirement that all payments be made in gold or silver. Fourth, all states passed and vigorously enforced "usury laws" that limited the interest rates S&Ls and other lenders could charge. Failure to live by these laws and regulations invited heavy fines, imprisonment, and loss of license or charter. Yet, whenever the whole system teetered on the brink of collapse and disintegration, the regulatory authorities were quick to declare "banking holidays." They suspended legal and contractual obligations so that their regulatory structure would stand.

During the 1930s, when the world sank into a deep depression, the federal government joined the states in their regulatory endeavor, and further restricted the scope of S&L activity. It created a financial superstructure, and organized a supercartel in which savings and loan associations were severely limited as to rates and prices, services to be rendered, and territories to be served.

During the depth of the Great Depression, when the Smoot-Hawley Tariff Act had cut off most trade relations, and the Revenue Act of 1932 was about to order the sharpest increase in federal tax burden in American history, the Hoover Administration sought economic revival by creating a special housing finance system. It established the *Federal Home Loan Bank System*, which was to provide a regulatory and support structure for the suffering S&Ls. The Federal Home Loan Bank Board (FHLBB) was authorized to charter and

regulate S&Ls which theretofore had been state chartered only. Twelve regional Federal Home Loan Banks, owned by the member S&Ls in their district, with parallels to the Federal Reserve System, were to borrow in the capital markets and lend to S&Ls against mortgages as collateral. The loans were to provide liquidity to S&Ls, especially at times of crisis, when individual S&Ls have difficulty keeping and attracting deposits.³

In return for such favors, the S&Ls were ordered to observe strict asset and liability limitations, make long-term home mortgage loans in local markets, and generally attract the savings of workers and middle-income families. They were charged with the most dubious function in all of finance: to make long-term home mortgage loans from short-term deposits.

When President Roosevelt came to power, he sought to build on the Hoover approach. Instead of merely removing the obstacles to economic activity and prosperity which the Hoover Administration had erected, President Roosevelt sought to stimulate economic activity through more legislation and regulation, through deficit spending and dollar devaluation. To offset the inherent flaw and danger in borrowing short and lending long, a deposit insurance system was instituted. In 1933, the Roosevelt Administration organized the *Federal Deposit Insurance Corporation (FDIC)* to provide deposit insurance for commercial banks;⁴ in 1934, it created the *Federal Savings and Loan Insurance Corporation (FSLIC)* to insure deposits in savings and loan associations and mutual savings banks.⁵

In the same year, the New Deal Congress added the *Federal Housing Administration (FHA)*, to provide government insurance against mortgage default. This insurance sought to broaden the capital base of housing finance, and stimulate the development of mortgage banking in general. Federal Housing Authority was to encourage commercial banks to serve the housing market by making mortgage loans, preferably fixed-rate, self-amortizing, long-term loans, and permit other institutional lenders, such as life insurance companies and mutual savings banks, to originate mortgages and then sell them, fully insured, to other investors.

The National Housing Act of 1934, finally, offered charters to new private *secondary* market institutions that were to issue bonds and buy mortgages from primary lenders. As none were started, in 1938, Congress created a government-owned agency, the *Federal National Mort-*

gage Association, (FNMA or Fannie Mae) with the primary purpose of purchasing FHA-insured mortgages from banks and other lenders.

The new government agencies adopted detailed regulatory codes, and began to conduct frequent, thorough examinations of their charges. The FHLBB, FDIC, FSLIC, FHA, and FNMA diligently supervised and audited the industry, according to their particular regulatory codes. In addition, the regulatory authorities of the states busily conducted their examinations of state-chartered institutions, according to the regulatory codes mandated by their legislatures. The purpose of all such supervision was to make certain that an association was complying with its charter and that its investments were sound. There cannot be any doubt that *banks and savings and loan associations were and continue to be among the most regulated and audited private enterprises in the United States. Legislators and regulators guard and guide them every step of the way.*

The Hoover-Roosevelt system prospered at first. The ready access to capital markets together with the FHA insurance caused mortgage rates to decline, which in time generated a feverish postwar housing boom. The new Veterans Administration (VA) added its fuel to the fire by guaranteeing mortgages for veterans. It cannot be surprising that home ownership rose significantly during the 1940s, from 43 to 55 percent of all households.⁶

These were the golden years of S&Ls. Mortgage insurance was keeping interest rates artificially low, regional home loan banks were tapping the capital market, Fannie Mae was lending a hand, and the U.S. Congress was granting special tax breaks. Savings and Loan Associations were prospering, and growing by leaps and bounds. In a 1947 film, *It's a Wonderful Life*, Jimmy Stewart reflected public sentiment by playing a sympathetic S&L manager who confronted a ruthless banker.

The builders of the new order had not radically altered the old; they had merely tightened the political reins, and erected a superstructure of political authority on top of the old. They had not dismantled the command posts from which their predecessors had designed and guided the system, nor had they rescinded any previous laws and regulations; they merely added a few of their own.

In 1970, when some flaws inherent in the system became visible at last, Congress added yet another agency; it gave S&Ls a secondary market agency of their own, the *Federal Home Loan Mortgage Corpora-*

tion, commonly called *Freddie Mac*. As an agency within the Federal Home Loan Bank System, it was designed to deal primarily in conventional mortgages, and assist ailing S&Ls.⁷

Freddie Mac was just another structure in the financial cartel system that comprises nearly every phase of the financial industry. Its members are thousands of privately owned institutions rendering financial services under conditions and in locations assigned by the cartel authorities. Its regulators are thousands of agents of numerous government agencies, from FHLBB, FDIC, FSLIC, FHA, FNMA, to Freddie Mac, and their counterparts in state governments.

At the uppermost point of the regulatory structure stand the U.S. Treasury, and the board of governors of the Federal Reserve System. The former is forever using its great influence and power for the purpose of raising funds to cover budgetary deficits. The latter is facilitating the spending through currency and credit creation, and orchestration of credit expansion by financial institutions.

At the helm of it all stand the legislators, both federal and state, who patch the system whenever it is in need of repair, and set it to work again where it breaks down. As the ultimate authorities in all matters of American finance, it is not unreasonable to expect that they bear the ultimate responsibility for its defects and shortcomings.

SEEDS OF DISASTER

Built on legislation and regulation, on command and constraint, the Hoover-Roosevelt system, unfortunately, contained the seeds for disaster. It was a political structure, designed in the halls of politics, regulated by civil servants, adjudicated by judges, and enforced by policemen; it differed greatly from a system unhampered economic principles would have built.

No one can possibly know what form an unhampered financial structure would take, and how it would actually function. Yet, we do know that human cooperation and division of labor, practiced freely in a private property order, bring forth maximum individual energy and productivity, which tend to raise the levels of living of all to astonishing heights. The private property order works wonders in every other industry in the most unlikely places all around the globe. Why should American finance be an exception?

The advocates of a political command order are quick to point at

a long history of banking calamity and failure. Unfortunately, they misread American history, and misinterpreted financial phenomena. What they call the “free banking period” actually was a period of increasing government intervention in banking activity. “Free banking laws” merely abolished the practice of granting bank charters by special legislative act, and replaced regulation by legislators with regulation by government officials. State governments, and after 1863, also the federal government, imposed onerous conditions and requirements, such as minimum reserve requirements against notes and deposits, minimum purchases of government obligations, and compliance with interest rate ceilings that severely limited access to the capital markets. To call this system “free banking” is to call a truancy system that threatens imprisonment “an invitation to free education.”⁸

Cartel Regulation and Insulation

The Hoover-Roosevelt system actually was a governmentally regulated banking cartel, complete with segmented markets, price fixing, and entry restrictions. Specific types of depository institutions were allowed to provide specific types of financial services. Commercial banks were permitted to accept demand deposits, upon which checks could be drawn; savings and loan associations and mutual savings banks were denied this privilege. Commercial banks were expected to specialize in business and consumer loans, thrift institutions in housing loans, preferably local loans.

The cartel arrangement protected the territorial prerogatives of every institution. To enter the financial institution business required a state or federal license, which was issued only upon demonstration of “public need.” If and when issued, it was limited to one geographic location. Interstate banking was prohibited. The inevitable consequence was growing inefficiency, which always occurs when competition is hampered. Financial innovations were stifled, and banking services were overpriced. The cartel arrangement, which meant to bolster profitability and security, actually bred uncertainty and instability.⁹

Like all other cartels, the financial cartel was destined to disintegrate as soon as the cartel members were no longer prepared to live by the “stabilization” arrangements and found ever new ways of competing with each other. Even a thick blanket of cartel regulation cannot suppress competition for long. It springs to life in countless forms

because man is ever eager to improve his lot. In an economic order based on private property in the means of production, he can do so best by rendering better services to his fellow men; that is, he competes with other producers in serving consumers. He does so even within a cartel.

When newcomers are permitted to join the organization, they are likely to add competitive fervor. Foreign bankers are very anxious to enter the U.S. market for obvious reasons: to join the cartel and enjoy its advantages, to outstrip the older members through greater effort and efficiency, and to place their funds at exceptionally high interest rates.

The spirit of competition is always gnawing at the foundation of a cartel. It is weakening the structure from within and from the outside. Throughout the world, massive capital formation in private-property economies has given rise to new financial centers that compete vigorously with New York. Tokyo, Hong Kong, Singapore, London, and Frankfurt are financial centers that "globalize" the capital markets, and erode competitive barriers. Observing rapid capital formation abroad, many U.S. banks eagerly went offshore to compete in foreign financial centers. In consideration of American freedom to go abroad, U.S. cartel authorities had to grant foreign institutions the right to operate in the United States. Foreign banks came to compete vigorously in American markets through branches, agencies, subsidiaries, Edge corporations (which cannot accept deposits from U.S. residents unless the deposits are linked to international trade), and representative offices. In short, the new world of international competition is seriously threatening the old world of protection and insulation.

The spirit of competition is clearly visible in the frantic search for new ways to diversify. It is visible in the rise of "nonbank banks," that render financial services formerly reserved to commercial banks. Brokerage houses, money market mutual funds, finance and insurance companies, and retail establishments compete effectively, offering cash management accounts, other liquid accounts, credit card services, and loan services. Merrill Lynch, American Express, and Sears Roebuck are pointing the way. Financial competition is alive, although the regulatory apparatus is fighting it every step of the way.

Technological innovations are forcing their way through the thicket of regulations. The computerization of many financial operations has greatly reduced transactions costs, which is enabling non-

depository institutions to offer many bank-like services. The use of automated teller machines (ATMs) has grown dramatically since the late 1970s. Individual ATM systems may soon link up with national and international networks. Thousands of point-of-sale terminals may serve millions of customers using a great variety of credit cards. On the financial horizon, in-home banking promises to offer all the essential banking services, including bill-payment services, electronic purchases, sales of securities, etc. Telephone or cable hookups, satellite linkages, and home computers are destined to play important roles in the financial system of the future.

Keen competition is bound to separate the successful enterprises from the laggards. The former succeed by best serving consumers; the latter fail because they fail to serve consumers satisfactorily. They may misjudge or ignore consumer choices and preferences, mismanage their resources, or allow themselves to be misled by political machinations. To rely on cartel regulation and insulation is to invite financial disappointment in the end.

Maladjustment and Overinvestment

Born from politics, and guided by swarms of officials, the system distorts the employment of capital and labor, subsidizes some people at the expense of others, and causes maladjustments on a massive scale. It springs from a public attitude that housing is special, deserving social preference because it is believed to promote social cohesion and democratic stability. Moreover, it makes housing the central object of countercyclical policies, which tends to aggravate, rather than alleviate, the business cycles. It creates feverish housing booms that are followed by painful stagnations and declines.

Throughout the 1970s, the housing market was one of the most volatile markets of all. Construction of new housing units rose sharply from 1970 to 1972, soaring from some 1.4 million units to more than 2.3 million, then plummeted to barely 1.1 million units in 1975, rose again to some 2 million in 1978, and fell again to 1.29 million in 1980. During the 1980s, the volatility of housing construction continued to disrupt and destabilize economic activity. In 1982, new-home production plunged to 1.06 million units, the lowest since World War II. It surged strongly in 1983, to 1.7 million units, the highest since 1979. The strongest markets were in areas with concentrations in oil produc-

tion, in particular Texas, Louisiana, Oklahoma, Arkansas, and Alaska. Construction continued to rise until 1986, when housing starts reached the 1.85 million level; they fell to 1.49 million units in 1988, and have been in a relatively weak condition ever since. In the "oil patch" states, which fell in a deep recession as a result of plummeting oil prices, the volume of housing starts fell to depression levels.¹⁰

While housing construction fluctuated wildly, the costs of construction moved upward continually. In 1970, the median price for a new single-family home was \$23,400. By 1975, inflation had increased the price to \$39,300; by 1980, it was \$64,600; by 1985, more than \$84,300; in the second quarter of 1987, \$104,000; and it is likely to exceed \$130,000 by the end of the decade. While median family income also increased during this period, it did not keep up with the inflation in housing costs. Many families found it increasingly difficult to realize their dream of purchasing their own home.¹¹

While FHLBB, FDIC, FSLIC, FHA, FNMA, and Freddie Mac are laboring to make available below-market-rate financing, numerous federal, state, and local government housing programs are attempting to foster housing construction. The federal government's Community Development Block Grant (CDBG) program is financing rehabilitation and other housing activities; the Housing Development Action Grant (HDAG) is subsidizing new construction and substantial rehabilitation of rental housing; the Rental Rehabilitation Grant program is subsidizing the renovation of rental properties; and the Joint Venture for Affordable Housing is financing a search for construction cost reductions.

Many state governments are issuing tax-exempt bonds in order to offer below-market rate financing; others are offering direct subsidies. New York State, for example, is seeking to foster the construction of housing for low- and middle-income families by offering "seed money grants" and other assistance. Not to be left behind, many local governments are attempting to provide housing for less advantaged people by offering direct subsidies. Some even introduced a novel device: inclusionary zoning, that forces builders to offer a portion of the total number of units in a development at below-market prices. Yet, many families are finding it increasingly difficult to find affordable housing.

An industry that, for several decades, has labored under the heavy hand of politicians and officials cannot help but be badly maladjusted and in need of readjustment. After all, the very purpose of government

intervention is to bring about differences and deviations from unhampered economic activity. The differences may result from subsidies, tax advantages, government guarantees, and countless other devices. They last as long as the intervention continues, but quickly erode as soon as government decides to withdraw. The manufacturers of steel may prosper as long as they are protected by a high wall of import restrictions; they are likely to suffer grievously when the wall is dismantled and they, once again, must face international competition. Financial institutions may prosper as long as government protects them; they are likely to suffer when competition, foreign or domestic, breaches the protective walls, or when government lowers them. Political force may prevail temporarily over economic principle, but cannot succeed in the long run.

Some housing analysts indeed are concerned about overinvestment in housing. They point at mortgage rates, which the combined efforts of FHLBB, FDIC, FSLIC, FHA, FNMA, and Freddie Mac have kept, and continue to keep, lower than market rates; they call attention to deposit-rate legislation and regulation, which for many years forced S&L depositors to subsidize home builders and buyers. Such favors promote and induce special activity by the beneficiaries, and lead to maladjustments that necessitate painful readjustments as soon as the favors are spent. Even when they continue, the maladjustment may become so severe that painful readjustment can no longer be avoided. Public awareness of this fact may explain why, in the 1981–1982 recession, which was the most painful since the Great Depression, no new countercyclical housing program was enacted although herebefore housing had stood in the center of countercyclical plans and policies.

Even if government had managed to keep housing construction booming, the consequences would have been even more disruptive and painful in the end. Government intervention that negates the directions of consumer choices and preferences is destined to fail and bear evil fruit in the end.

Federal Deposit Insurance

The Hoover Administration created the regulatory structure; the Roosevelt Administration expanded it by adding government insurance. Without political regulation, economic relationships are governed by contract, voluntarily entered upon by both parties. Voluntary

deposit insurance would depend on a contract between insurers and insured. The premiums would vary according to the risk involved; insurance would be terminated quickly whenever, in the eyes of the insurer, the risk became excessive.

The S&L industry, unfortunately, is a component part of a financial cartel that builds on legislation and regulation rather than contract. Federal deposit insurance violates many principles of insurance, suffers staggering losses, and then covers the deficits with funds forcibly taken from taxpayers and from the thrifts themselves. FSLIC levies heavy "special assessments" on profitable S&Ls so that mismanaged S&Ls may stay in business. In 1988, thrifts paid some \$1.2 billion in extra premiums—or half of their earnings—in order to keep insolvent members going.¹²

Federal deposit insurance subsidizes risk in direct proportion to the degree of risk taken. Because the rates are the same for all institutions, regardless of their policies, the most incompetent management, conducting the most reckless investment policy, obviously enjoys the greatest insurance bargain. Confident that federal deposit insurance will cover all losses, both the institutions and their depositors can play the game, "heads I win, tails you lose."

Federal Savings and Loan Insurance Corporation subsidies create perverse incentives, not only for institutions, but also for their depositors. They create a kind of "reverse run" of deposits from prudent and healthy thrifts paying market rates of return to sick institutions typically paying above-market rates. Funds may be withdrawn from uses that readily attract funds, and be allocated to projects that would not have been funded otherwise. In fact, they may be wasted in ill-fated commodity speculation, or other misallocation. By prompting malinvestments of savings, federal deposit insurance tends to benefit some borrowers at the expense of others. It misuses and loses productive capital, keeping society poorer than it otherwise would be. Indeed, the American people are paying a high price for federal deposit insurance.

The perverse incentives extend to the regulators themselves. Federal deposit insurance obviously creates incentives for regulators on both the federal and state level to adopt popular regulations, no matter how harmful they may be. Regulators may take credit for popular commands and arrangements, especially if they benefit some people at the expense of others, but suffer no personal harm from the problems they cause. In every case, federal deposit insurance is standing by to

make restitution when harmful regulation plays havoc with an institution; it sustains the regulation by offering compensation to some of its victims. In this sense, federal deposit insurance serves as a complement to regulation; it extends the sphere of regulation far beyond the natural boundaries drawn by visible harm and early failure.

Federal deposit insurance also extends the scope of government spending that evades taxpayer constraint and control. There are no legislative constraints on FSLIC making commitments which, in final analysis, are the responsibility of American taxpayers. "Other than the Treasury Department," Senator Lawton Chiles of Florida once observed, "FSLIC seems to be the only federal agency which prints money."¹³

The senator unfortunately overlooked the grand conductor and impresario of all money printing: the Federal Reserve System; but he recognized correctly that FSLIC is spending billions of dollars with absolutely no taxpayer control. To bail out defunct savings institutions, FSLIC is issuing promissory notes and making costly credit arrangements that increase FSLIC costs. The Congressional Budget Office and the Office of Management and Budget estimate that FSLIC will issue some \$16.2 billion to \$17.2 billion of FSLIC notes, and run a cash flow deficit of \$11.4 billion (CBO) to \$13.7 billion (OMB) through fiscal year 1993.¹⁴ Whatever the deficit figures and taxpayer liabilities ultimately may be, there cannot be any doubt that federal deposit insurance is open-ended and unaccountable.

IN THE VISE OF REGULATION AND INFLATION

For a while, regulation and cartelization created a golden age; the inherent faults of the cartel, federal insurance and guarantees, the housing distortion and maladjustment, together with rampant inflation brought it to an end. Inflation tends to boost the gross market rate of interest by giving rise to an inflation premium. During the 1970s, this premium lifted interest rates far above the rates S&Ls were permitted to pay, which immediately brought forth two painful effects: (1) S&Ls lost deposits as depositors began to withdraw their funds and turn to new higher-yielding money market mutual funds; (2) S&L investments consisting primarily of long-term mortgages yielding only ceiling-rate interest fell precipitously in value. The withdrawal of funds threatened S&L liquidity; the decline in value inflicted staggering

losses. Caught in the vise of inflation and regulation, many S&Ls were squeezed to death.

The federal government could have dismantled the vise either by halting the inflation and credit expansion, which would have lowered the market rates of interest, or by demolishing its controls, which would have permitted S&Ls to adjust, or better yet, by doing both. Unfortunately, it was not about to relinquish its inflation power, which is the very source of its spending power; but it could be persuaded reluctantly to relax a few of its regulatory powers.

Federal legislators and regulators responded to the growing crisis by raising the interest ceilings and permitting S&Ls to render some banking services. In 1975, they granted permission for Negotiable Order of Withdrawal (NOW) accounts, which allow savings depositors to make check-like payments to third parties. In 1980, in one stroke, they increased FSLIC insurance coverage from \$40,000 per account to \$100,000, which increased the federal risk and potential taxpayer liability by 2½ times. The insurance boost undoubtedly attracted some deposits and, therefore, alleviated the growing liquidity crisis; but it did not remove the seeds of disaster that continued to sprout in the fertile soil of the financial cartel, onerous regulation, federal deposit insurance, and chronic maladjustment. Moreover, the higher insurance coverage actually raised S&L costs through higher premium charges.

The year 1980 was momentous for American finance. It brought a short period of *comprehensive credit control that was a major cause of extreme financial volatility*. In an effort to restrain the use of consumer credit, monetary authorities placed mandatory reserve requirements, not just on banks and thrift institutions, but also on all other lenders, such as retailers and auto dealers. Then, in order to expand credit, the Depository Institutions Deregulation and Monetary Control Act reduced aggregate reserve requirements for Federal Reserve member banks by about 43 percent. As could be expected, interest rates skyrocketed to a 20 percent prime rate, plummeted to 10 percent, and then moved up again. The rate of price inflation reached a staggering 18 percent level, which struck hard at the thrift industry.

The goal of the Depository Institutions Deregulation and Monetary Control Act was to ease credit, tighten Federal Reserve control over financial institutions, and simultaneously promote competition in financial markets.¹⁵ Unfortunately, to ease *credit and tighten control*

is highly inflationary and detrimental to competition—unless competition is viewed as a contest that is planned, commanded, and regulated by the authorities.

The Act authorized banks and thrift institutions to pay interest on checking accounts, starting in 1981. Although every such authorization may widen the margin of financial freedom, it also amplifies the cartel system. In an unhampered capital market, interest is paid only to savers who forgo present funds for use in production for the future. To safeguard cash and demand deposits, depository institutions could not possibly pay an interest on such holdings, but actually would charge a fee for services rendered. The situation is quite different in a cartel structure. The federal deposit insurance and government guarantee tend to convert, in the eyes of depositors and bankers alike, the cash holdings to actual savings that command an interest. *What would be an absurdity in a free system becomes a logical addendum in a cartel system.*

The Act also phased out, over six years, the interest rate ceilings that limited what financial institutions could pay savers for their funds. It removed the usury ceilings that many states had imposed on mortgage loans, business loans, and agricultural loans of more than \$25,000. The new authorization was to make banks and savings institutions more competitive with unregulated institutions such as money market funds.

Removal of usury ceilings is salutary and laudable in all situations and at all times. After all, they distort the use and allocation of capital, reduce economic output, and keep people poorer than they otherwise would be. *To phase out interest ceilings over six years is to continue the malefaction and mayhem for six more years.* It is hardly surprising that between 1980 and 1986, 664 FSLIC-insured institutions failed. More would have failed if FSLIC could have afforded to close them; its reserves were insufficient to do so.

When they were free, at last, to compete for funds, S&Ls labored diligently to restore their liquidity and avert certain insolvency. Yet their aggressive bidding for funds at rising interest rates meant rising losses from the discrepancy between the interest paid and interest received. To bolster their earnings potential, the Garn-St.Germain Act of 1982, finally, permitted thrifts to diversify into commercial loans, the financing of office buildings, and even such businesses as fast-food restaurants.¹⁶ It gave the thrifts lending power which even the biggest

commercial banks did not have. They now could finance acquisition, development, and construction, form development subsidiaries, and make direct investments.

This new authority to invest in potentially profitable ventures unfortunately did not compensate the S&Ls for the losses suffered on old investments. The income from old mortgage loans did not cover the interest payable on new deposits. Moreover, the deposit liabilities were short-term while the mortgage loans were long-term, falling due in the distant future. *Throughout most of the 1980s, the S&L crisis grew worse as a result of the laws passed by Congress and the regulations imposed by the authorities.* The system suffered staggering losses which soon exceeded the ability of the FSLIC to compensate the losers. American taxpayers, who are the underwriters of all government policies and blunders, had to be called upon. Yet, there was always hope that the crisis would pass without taxpayer rescue. Profitable ventures might rescue the suffering S&Ls, and interest rates might fall significantly, raising the market value of S&L assets.

Hoping and waiting for the crisis to pass, the authorities understandably sought to hide the sad state of affairs from the public eye. After all, legislators and regulators derive their authority from the public, which at any time may curtail or even rescind the authority. *Intentionally or unintentionally, the Garn-St. Germain Act invited crooked appraisals and dubious accounting.* While state regulators allowed state chartered S&Ls to lend up to the purchase price or the appraised value of any project, whichever was less, the Act authorized federal regulators to override this requirement. It encouraged S&Ls to lend 100 percent of appraised value, even if the actual purchase price was lower. Savings and Loans now could lend whatever an appraiser would recommend, even if the amount exceeded the market value. In short, S&Ls could lend \$2 million on a \$1 million project, as long as an accommodating appraiser could be found.

To lend more than 100 percent of market value need not cause failure, as long as the borrower is honest and able to repay his loan. Many projects are overfinanced and, yet, do not lead to disaster; but the Garn-St. Germain Act clearly created opportunities for aggressive developers who would deal, wheel, party, and embark upon dubious projects. Their guiding motto may have been "Heads I win, tails FSLIC loses."

Rather than close hundreds of ailing S&Ls, the regulators used

dubious accounting gimmicks to hide the dismal situation, and give thrifts time to rebuild their capital. They issued "special certificates" and other illusory assets that would meet capital requirements. Regulators, auditors, and legislators stood idly by, or even encouraged and promoted the high flyers, many of whom were to be brought down by the Oil Belt depression. By 1986, the FSLIC insurance fund had plunged into the red, and was looking for government funding. In August 1987, Congress authorized the Bank Board to issue \$10.8 billion in bonds to cover S&L losses and protect insolvent institutions. In August 1989, finally, the S&L Reform and Rescue Act projected a loss of \$166 billion.

Dubious accounting and destructive tax policies played a major role in the S&L debacle, especially in the Southwest. The Economic Recovery Tax Act of 1981 (ERTA) offered generous incentives for the creation of limited partnerships to build income-producing property, such as office buildings, shopping centers and rental apartments. The tax incentives, in particular the accelerated cost recovery, led to a feverish boom of tax-driven projects, especially in the oil-producing regions of the country, which suffered least from the deep recession of 1981–1982. While the rest of the country lingered in economic stagnation, construction of housing continued at lively rates in Texas, Colorado, and Oklahoma. In fact, ERTA, together with the 1979 OPEC oil price increase, set the Oil Patch real estate markets on fire.

What Congress giveth, it may take away. The Tax Reform Act of 1986 virtually repealed all incentives for income-producing property. Consequently, many projects fostered by ERTA were rendered unprofitable. Combined with the 1986 price collapse of oil, resulting from the disintegration of the OPEC cartel, the tax reform led to a wave of defaults by developers cutting their losses and leaving lenders holding half-empty bags.

Tax policy—both ERTA and tax reform—contributed its fair share to the sinking of many savings institutions and debilitating the FSLIC. James W. Christian, the U.S. League's chief economist, demonstrates convincingly that the tax reform necessitated a loan writedown on the order of 35 percent, even for fully occupied, well-underwritten projects, once in default. To restore the original value of these underwater projects, nothing but full restoration of ERTA's incentive system would do—which the tax reformers are rejecting offhand.¹⁷

Responsibility walks hand in hand with power. If it can be measured by the amount of injury resulting from wrong action, the responsibility of legislators who created the cartel structure and enacted the tax laws is huge. It is great and truly personal, even though the injury is inflicted by a multitude of legislators in Congress assembled.

THE BAILOUT ACT

When, on August 9, 1989, President Bush signed the Savings and Loan Reform and Rescue Act, he set into motion the largest remaking of the American financial system. The law not merely changes a great many labels and shuffles a large number of chairs in the cartel structure, but also visibly tightens the regulatory reins. It imposes new burdens on taxpayers and reconfirms their responsibility for all present and future financial blunders. It reiterates the political commitment to economic transfer favoring some classes of people at the expense of others, and thereby promises to create new political and social conflict. The law mandates hysterical fines and imprisonment, which in the past undoubtedly would have clashed with Article VIII of the Bill of Rights: "Excessive bail shall not be required nor excessive fines imposed, nor cruel and unusual punishments inflicted." While the law allocates an extra \$75 million annually for the prosecution of institutional crimes and civil violations, it blithely ignores any and all thought of the culpability of the legislators and regulators who created and guided the system.

The Most Contentious Issue

The law calls for outlays of some \$166 billion over 10 years, and for many more billions thereafter, to close and merge insolvent institutions. It represents the largest federal rescue on record, eclipsing the combined bailouts of Lockheed, Chrysler, Penn Central, and New York City. It raises momentous and agonizing questions as to the causes of the financial debacle, which hopefully would lead to judicious answers and lasting solutions. Yet, our legislators, in Congress assembled, barely touched on such questions; their most contentious issue, which was debated until the wee hours of August 4, was over how to account for the \$50 billion that need to be borrowed. Should the

bailout costs be clearly visible in the budget, or should they be relegated to an obscure off-budget agency using special off-budget accounting?

The Administration would have the entire amount borrowed by an off-budget agency, and the spending not be shown as an increase in federal spending and federal deficit. While the Senate was willing to support this maneuver, the House insisted upon on-budget accounting, counting the spending as part of the deficit, but exempting it from automatic spending-cut calculation under the Gramm-Rudman deficit reduction act. After lengthy debates and last-minute veto threats by President Bush, the legislators reached a compromise that put \$20 billion on budget in fiscal 1989, which, at the time of enactment, was no longer subject to automatic spending cuts; the remainder was placed off-budget in fiscal 1990 and 1991.¹⁸

The difference between the Administration's method of accounting and that of the House may be important in political quarters; it is quite irrelevant in financial matters. To show the full magnitude of the disaster, pointing at the Administration in power, is a favorite ploy of the political opposition, which in this case is represented by the House. To minimize the political embarrassment, the Administration tends to favor the camouflage.

The crucial issue of the bailout is not the method of accounting, but the causes of the disaster and its portentous effects. The losses suffered are a national disaster. They consume a large share of American savings, deplete and exhaust the capital market, keep interest rates higher than they otherwise would be, prevent productive investments, and reduce labor productivity and labor income. If economic life should sink into stagnation and decline, the monetary authorities would come under pressure to create money and expand credit—as if money and newly created credit could take the place of savings consumed. In the end, the consumption of capital and the inflation that is bound to follow will raise goods prices and reduce the standards of living of all.

Changing the Labels

Changes may be fundamental, or only cosmetic; they may alter the direction, or merely vary the pace in an old direction; alter the content

of a package, or merely change the label; replace the furnishings, or merely shuffle the chairs.

The S&L Reform and Rescue Act merely changes some labels and shuffles some chairs. The industry's primary regulatory agency, the FHLBB, President Hoover's hope and joy, will be dismembered. Its regulatory arm, with all its assets and personnel will be transferred to a new Treasury Department agency, called the Office of Thrift Supervision.¹⁹ In the footsteps of the old, the same agents will continue to supervise and audit the thrifts, perhaps more frequently. The plaques on the door and the stationery will change, but the system will not. It is revealing, however, that the law moved the supervision of the thrift industry, which plays a prominent role in the capital markets, from a separate agency, the FHLBB, directly to the U.S. Treasury. The people's savings henceforth will be guarded by the archenemy of thrift—the U.S. Treasury.

The fund insuring savings and loan deposits, the FSLIC, moves to the FDIC, and will be called the Savings Association Insurance Fund (SAIF). Under the new label, federal authorities will continue to levy heavy assessments on profitable S&Ls so that mismanaged institutions may stay in business. They will continue to subsidize risk in direct proportion to the degree of risk taken. They will continue to create perverse incentives, not only for the institutions, but also for their depositors. By making restitution when harmful regulation plays havoc with an institution, they will continue to sustain the regulation, and thus serve as a complement to political intervention. As a division of FDIC, SAIF will continue to force the responsibility for legislative and regulatory blunders upon American taxpayers.

The Reform Act will move control over Freddie Mac from the FHLBB to a new, 18-member board that will be similar to the board that governs the Fannie Mae. Both Freddie Mac and Fannie Mae will be subject to oversight by the secretaries of the Treasury, and Housing and Urban Development (HUD). The General Accounting Office, which already audits Freddie Mac, will also audit Fannie Mae.

Such are the changes mandated by the Reform Act. Do they fundamentally alter the substance and direction of the system, or merely noisily reshuffle the chairs on the deck of the old regulation liner? They also raise the gnawing question: why was the President of the United States not added to the ranks of inspectors and overseers? Should he not be the "Inspector General"?

Tightening the Reins

Prior to the Reform Act, the financial institutions that formed the cartel could choose their positions in the cartel—provided they met certain charter and regulation conditions. Banks could choose to turn into S&Ls, and S&Ls could become banks. To escape the heavy assessments, many S&Ls indeed chose to convert to commercial banks. The Reform Act puts a halt to such escapes. It prohibits S&Ls, for five years, from seeking to change their charters to those of banks; and it prohibits them from moving their deposit-insurance coverage from SAIF to BIF, the new Bank Insurance Fund under FDIC that will handle existing bank insurance operations; however, the law allows thrifts to sell up to 35 percent of their deposits, over five years, to banks. In every case, S&Ls will be forced to pay exit fees for deposits sold, and conversions that may be allowed after the moratorium.²⁰

The exit fees raise an interesting regulatory question: how high should they be to prevent even the most desperate S&L from leaving the fold? Surely, there is a level of no escape, where it is more preferable to bear S&L regulation and suffer S&L assessments than to pay the exit fee. From the regulators' points of view, the optimum fee obviously will extract a maximum amount from solvent S&Ls, perpetuate the S&L system, and reinforce the regulatory structure. What would regulators do without the regulated?

The Reform Act raises the capital requirements for all thrift institutions. Those that fail to meet the new requirements will be put under supervisory mandates by the Office of Thrift Supervision that may limit the payment of dividends or compensation. Thrifts that operate in an approved manner may seek an exemption from such mandates.

The Office of Thrift Supervision not only may forbid the payment of dividends or compensation, but also restrict the ability of thrifts that fail to meet regulatory standards to make new loans. In fact, after 1990, such thrifts will not be allowed to make new loans, unless the Office of Thrift Supervision grants certain exceptions. The permission to make new loans to home buyers, to pay dividends to owners, and compensation to managers henceforth will depend on proper compliance with reform edicts and regulations, and the regulators' approval of such compliance. Surely, the Reform Act does tighten the reins another notch. How much further can they be pulled without turning S&Ls into a "socialized industry" in a "command economy"?

Saddling the Taxpayer

When President Bush first announced his 32-year rescue plan, total bailout costs were estimated at \$126.1 billion, of which \$59.8 billion were to be contributed by taxpayers. When, half a year later, Congress passed the Reform and Rescue Act, the Treasury Department estimated a loss of \$166 billion, of which some \$80 billion were projected to come from taxpayers.²¹ The General Accounting Office, the auditing arm of Congress, estimates the costs will exceed \$285 billion, of which some 70 percent may ultimately be borne by taxpayers. House Banking Committee Chairman Henry Gonzalez put the cost at \$335 billion. All these estimates have undergone several upward revisions and, in the end, the true figures are likely to exceed these amounts.

The actual losses can be calculated only after the last bill has been paid, and the last chapter of the S&L disaster has been written. Future generations of historians and accountants will have to render the final verdict on this incredible phase in American financial history. We only may surmise the magnitude of the burden which the apparatus of politics is putting on the shoulders of the American people. If the total bailout costs should exceed \$300 billion, the per capita share of the loss would amount to some \$1,200. When placed on the backs of taxpayers, who are the primary victims of political bungling, some 80–85 million Americans will be forced to contribute some \$3,000 to \$4,000 each. Highly productive taxpayers in high income tax brackets will pay more.

Taxpayers are the innocent bystanders who will be forced to bear the losses. The culpable actors in the drama will go free without even a reprimand: the legislators who created the system, the regulators who guided and supervised it, the owners who sought to benefit, the managers who accepted the deposits and made the loans, and the depositors who blithely entrusted their deposits to the institutions. In their special ways, they all contributed to the debacle. Yet, taxpayers will be held responsible because they are the ultimate guarantors and underwriters of all political ventures and blunders. When politics enters business, taxpayers are forced to stand by.

Seizing Insolvent Thrifts and Disposing of Their Assets

The law created a new on-budget agency, the Resolution Trust Corporation (RTC), that took possession of all insolvent thrifts, and

will take possession of all thrifts that will become insolvent within three years of the date of enactment. Resolution Trust Corporation will manage and dispose of the seized property, and terminate its operations no later than December 31, 1996.²²

On the day of enactment, the RTC took control of 262 insolvent S&Ls, with \$107 billion in total assets. It is likely that another 125 to 300 of the 2,959 S&Ls now in operation will fall under RTC control by 1991. Altogether, RTC may end up with some \$300 billion or more in S&L assets, of which some \$250 billion may consist of real estate, and the balance of other assets such as government securities and mortgage based securities.

When RTC closes or sells an S&L, it may transfer the deposits to another S&L or commercial bank. The transfer immediately enables the recipient to embark upon a round of lending and investing; mortgage rates may fall temporarily, and real estate prices may rise. The transfer funds which RTC disburses are new government funds either drained from the capital market, or created outright. The former depress economic activity, the latter inflate and distort it.

Savings and Loan assets, consisting of loans and real estate financed by the loans, are more difficult to dispose. Surely, not all the loans held by insolvent S&Ls are problem loans. Many homeowners will continue to make regular payments on their mortgages, regardless of the owner of the loan; they are not in default and, therefore, need not fear a change in ownership. Similarly, many commercial debtors will continue to pay on time. All such loans, properly discounted to the market rate of interest, can be sold easily to other financial institutions. Resolution Trust Corporation losses will be limited to the difference between the amount of the loan and the present value.

Even some foreclosed property may be liquidated readily and placed in private hands. Most single-family homes should find willing buyers at prices that cover the delinquent loans. Apartment houses that are enjoying 80 to 100 percent occupancy rates should attract buyers at prices that cover RTC costs.

Yet, the losses suffered by insolvent S&Ls will cost RTC many billions of dollars; the harm inflicted by the vise of regulation and inflation is visible in the difference between the par value of a loan and its present market value. Old mortgage loans continue to yield returns far below the market rate of interest, and sell at substantial discounts from market prices, while depositors need to be paid in full. Moreover,

the cartel regulation has become more restrictive and confining than ever; federal deposit insurance and federal mortgage guarantees continue to obscure the housing market, and becloud responsibility and sound judgment. In short, the heavy hand of government in housing causes visible distortions and maladjustments.

Resolution Trust Corporation is expected to suffer billion dollar losses from the sale of assets the defunct S&Ls took back from borrowers who went bankrupt. A great deal of this real estate is in the Southwest, where prices collapsed in the wake of the tax reform and decline in oil prices. The law requires RTC to consider the effects of its sales on the local real estate market. In "distressed" markets, RTC must demand a "minimum disposition price" no lower than 95 percent of fair market value as appraised by RTC. To benefit lower-income families, RTC is expected to sell single-family residences at or below their "net realizable market value."

Much of the property which the defunct S&Ls sought unsuccessfully to sell for years is unlikely to bring a full price soon. Resolution Trust Corporation may have to settle for 50 cents on the dollar or less. Some property may not attract any bids at any price. Many of the worst properties—unfinished, poorly constructed apartment houses, malls, and office buildings—may have to be torn down. It may take many years to return the building lots to private hands.

Resolution Trust Corporation has taken possession of a tremendous amount of undeveloped land, located throughout the country. To minimize its losses, RTC may be tempted to put it on the shelf for several years until inflation lifts real estate prices to RTC cost levels. Given the natural propensity of monetary authorities to inflate and depreciate the currency, the time it takes for real estate prices to rise to RTC cost levels should not be long. Unless more political intervention and bureaucratic delays prevent the prompt liquidation of seized property, RTC need not hold a large part of America for the rest of our lives.

Aiding Lower-Income Families

The Bailout Act expands the Home Mortgage Disclosure Act of 1975 that requires all mortgage lenders to collect and report to the authorities information on the race, gender, and income level of loan applicants and recipients. Both laws aim to prevent the practice of

“redlining,” denying loans to certain racial or income groups, often by neighborhood.

While private lenders, under threat of penalty, are prohibited from discriminating on the basis of race, gender, and income levels, the Bailout Act instructs financial authorities actually to discriminate. It requires each FHLB to set aside a portion of its annual earnings to subsidize low-income mortgagors. The total amount from all twelve Home Loan Banks must be 5 percent of earnings, or at least \$50 million a year; after 1994 the amount is to rise to 10 percent of earnings, or at least \$100 million a year.²³

These subsidies to low-income mortgagors build on the subsidies granted by the FHLBs to S&Ls borrowing against mortgages as collateral, and ultimately on the subsidies by taxpayers who underwrite FHLB borrowing in the capital markets. They complete a triple-level subsidy system that openly discriminates in favor of certain economic classes at the expense of others.

The mortgage subsidies are to go to families with incomes of 80 percent or less of the median in a given area, or to buyers of multifamily dwellings in which 20 percent of the units are permanently set aside for families with incomes at 50 percent or less of a given area's median. The former will channel residential property from owners who were dispossessed because of mortgage loan default to new owners with less than 80 percent of area median income. Of course, the new owners, who may earn lower incomes than the old owners, will enjoy the advantage of the triple subsidy, while the defaulting owners may have had only a double benefit. It is doubtful that this addition will afford greater stability in home ownership.

The subsidies to multifamily dwellings in which 20 percent of the units must be reserved for families with incomes of 50 percent or less of a given area's income would have to be very high to make an apartment house a viable property. Tenants who pay the full market rental and public-assistance tenants do not mix readily. It is much easier to lease apartments to low-income families only, and collect the mortgage subsidies, provided they cover all costs.

The law also instructs FHLBs to make direct mortgage loans to families with incomes equal to 115 percent or less of a given area's median, and to finance commercial and economic development property that will benefit low- and moderate-income persons. To make such direct mortgage loans, and to finance commercial and economic devel-

opment projects obviously puts FHLBs in the retail business of housing finance. It will pit FHLBs in competition against S&Ls and other lenders, which will not enhance the stability of S&Ls. To compete with the vast resources of the FHLB, and indirectly with the federal government, is a hopeless undertaking; however, there will be many more employment opportunities for S&L employees in the retail offices of FHLB.

The law gives state and local governments, non-profit housing agencies, and families whose incomes are less than 115 percent of the area median income a 90-day right to purchase certain low-cost, single-family residential properties seized from failed thrifts. State and local governments and non-profit housing agencies also will have a 45-day right to purchase certain low-cost, multifamily residential properties, provided some units are offered to low-income persons at very low rents. Single-family residences, finally, may be sold below their "net realizable market value" to aid lower-income families.

Granting state and local governments and non-profit housing agencies the right of first refusal to purchase low-cost, single-family residences is to expand public housing wherever S&L housing defaulted. It is doubtful, however, that the quality of such housing will improve in the hands of state and local politicians, and officials of non-profit organizations. Such ownership usually breeds much favoritism and corruption, which may occupy many more attorneys and judges for years to come. The same may be true in the case of single-family units that will be sold below their "net realizable market value." The difference between the market value and the discount value is also the margin of corruption.

The 45-day right of first refusal to purchase multifamily properties would be an open invitation to state and local governments and non-profit organizations to rush into the housing business, if it were not for the condition that some units are to be offered to low-income persons at very low rents. The ambiguity of the clause, together with the inherent difficulties of mixing different-income families who are charged different rentals for the same facilities, may discourage many a state and local official from making use of the right of first refusal. Resolution Trust Corporation may have to keep and manage such properties for many years to come.

These provisions of the Reform Act, designed to increase the available supply of low-income housing, are unlikely to improve housing

conditions for many Americans; but they surely will benefit some people at the expense of others, and enhance the realm of officialdom and regulation. They are likely to create much conflict between the regulators and the regulated, and the beneficiaries and the victims, and keep judges busy and attorneys in income and wealth.

Fighting Mismanagement and Fraud

There is plenty of blame to go around. Savings and Loan legislators, regulators, auditors, owners, managers, and even depositors, all contributed to the debacle. It would be rather erroneous and grossly misleading, however, to ascribe equal shares of blame to all the parties involved. After all, some individuals created the system, others guided and regulated it, adjudicated it, managed it, audited it, exploited it, or merely used it in good faith. Obviously, the creators of the system, who gave it life by law, and designed every one of its features, and regulators who guided it every step of the way, bear primary responsibility. Yet, they are quick to point at all others and noisily charge them with dereliction and fraud.

At a field hearing in San Francisco, Frederick Wolf of the GAO, the investigating and auditing arm of Congress, even proclaimed that "fraud and/or insider abuse were the main failure of all of the sample of twenty-six savings institutions studied. Economic conditions compounded the problems, but did not cause them." Bank Board Chairman Danny Wall subsequently disputed the testimony, but charged that fraud was a significant factor "in perhaps one-quarter of the failures."²⁴

Such charges are not only self-serving, but also highly deceptive. They do not explain why the thrift institutions should harbor such concentrations of fraudulent managers, and why the supervisory authorities should be so virtuous as to become their accusers. Surely, it is readily apparent that the particular relationship between S&L regulators and regulatees is conducive to fraud and abuse because it is based on authority and coercion, rather than voluntary contract, just like the economic command systems that invariably breed corruption and give rise to black markets. Even if their relationships were entered into freely and contractually, the very existence of thousands of regulations by several regulatory authorities invites violations for additional reasons: individual limitations of knowledge and comprehension, and the multiplicity of possible interpretations of the regulations. Regula-

tory law, which may be designed to serve special interests, is not known for simplicity and lucidity.

It is probably true that a large percentage of all S&L insolvencies involve "wrongdoing" on the part of managers. In desperation about their sinking enterprises, many probably violated a regulation or two in order to save the sinking ship. Many undoubtedly succeeded, which some 2,000 solvent and profitable thrifts readily affirm. Unfortunately, others failed in their desperate rescue attempts, engaging in unorthodox and unapproved trading practices, such as index trading, program trading, hedging in commodities, etc. Unfamiliar with such strategies, they failed, and now face indictments by their regulators.

Some old-fashioned managers just gave way to a new breed of S&L administrators who were willing and eager to embark upon desperation management. Backed by federal deposit insurance, all managers have an incentive to invest in assets of the highest possible yield, and therefore highest risk; but it takes an extraordinarily reckless manager to test the limits of yield and risk. The federal deposit insurance scheme is most inviting; it guarantees that the gains accrue to him, the losses are heaped on the deposit insurer.

Some legislators and regulators even point at certified public accountants as the perpetrators of the dilemma. The GAO now charges that the audits by the CPAs of six of eleven savings institutions that subsequently failed were not done in accordance with professional standards. It urges the regulatory and professional bodies to launch an investigation and review the practices and qualifications of these CPAs.

To spread the blame around, GAO also is critical of the American Institute of Certified Public Accountants for not responding quickly to changes in the industry. American Institute of Certified Public Accountants' auditing guide contains too little discussion of recent regulatory changes pertaining to land acquisition, development, and construction loans.

Not to be outdone by GAO, Representative Henry Gonzalez, chairman of the House Banking Committee, and Representative Frank Annunzio, chairman of the Financial Institutions Subcommittee, in a joint statement, charge the auditing firms with "dereliction" of their sworn duties. They plan to schedule early hearings on CPA dereliction, and intend to ask the Justice Department to seek damages from negligent accounting firms.²⁵

Abuse and mismanagement, fraud and favoritism, are human vices that tempt man in all walks of life. They undoubtedly appear also in public accounting, but the fresh air of competition tends to purge all wrongs from the profession—in contrast to government, which is the monopoly of force and the fountain of favors. Accountancy cannot possibly hold back the vise of regulation and inflation, or prevent the evils of cartel regulation and insulation, of overinvestment and maladjustment, or of federal deposit insurance. In short, it can neither inhibit nor correct bad economic policies that are mandated by legislators and conducted by regulators.

The temptations to abuse and mismanage, defraud and favor undoubtedly are greatest at the centers of power and favors, the seats of government. Power over others intoxicates the best minds, as liquor does the strongest heads. The words of Lord Acton continue to ring true: "Power tends to corrupt, and absolute power corrupts absolutely." It follows that economic intervention such as that practiced by federal regulatory authorities tends to corrupt; in command system it would corrupt absolutely.

For years, the thrifts and their regulators collaborated to hide the true state of affairs. Congress and regulators devised or sanctioned accounting gimmicks that helped to preserve an illusion of prosperity. Thrifts were encouraged to defer losses and hide the lack of capital. Many thrifts remained solvent only because regulators issued special certificates that were counted as capital. Whenever a regulator actually questioned the high-flying practices, and exerted pressure on thrift managers, friendly members of Congress immediately intercepted the regulator. Former House Speaker Jim Wright personally intervened on behalf of a Texas thrift owner who is now on trial for defrauding another thrift institution. It is not surprising that former FHLBB Chairman Edwin J. Gray observed that the S&L dilemma is a product of the ties "between the industry and Congress."²⁶ In reality, the disaster is the inevitable product of political manipulation of economic activity.

The legacy of abuse and mismanagement, fraud and favoritism that is plaguing the Department of Housing and Urban Development (HUD) is a cogent example in case. Representative Charles Schumer of New York estimates that the known waste, fraud, and abuse at HUD amounts to some \$2.175 billion, infecting programs such as the Moderate Rehabilitation Program, the Coinsurance Program, FHA

mortgages, Retirement Service Centers, Ginnie Mae FHA guarantees, and many others.²⁷

Housing and Urban Development Secretary Jack Kemp explains the problems as consequences of "subsidies that are much greater than the cost of providing decent housing." In some programs, only about one-third of the money goes for better housing for the poor. The extra money goes to developers who pay huge fees to consultants who know the workings of HUD and other bureaus. Ex-regulators of S&Ls now prosper as consultants and S&L lawyers; they are the big winners from the industry's predicament.²⁸

Ex-regulators now arrange financings, mergers, acquisitions, or reorganizations. They are involved in dozens of thrift deals amounting to billions of dollars, including federally assisted acquisitions. They may even render consulting services to the government itself. In 1988 alone, the FHLBB and the FSLIC, although they employ 200 in-house attorneys, paid some \$110 million to outside law firms for work on liquidations, management takeovers, mergers, and acquisitions. Some law firms employ no fewer than half a dozen former regulators of the Bank Board. Critical observers cannot escape the conclusion that many regulators leave government service in order to benefit from their actions in government. To them, regulatory agencies are the revolving doors to fame and fortune.

Hysterical Penalties

The enforcement provisions of the Reform Act, perhaps more than any other provisions, reveal the anger and frustrations of the legislators. Civil penalties in cases where a bank, a thrift, a credit union, or an individual connected to the institution violates financial regulations are increased to \$25,000 per day, or to \$1 million per day if the violation is intentional or reckless. Civil penalties for theft, fraud, embezzlement, or the like are increased to \$1 million per day, the amount embezzled or otherwise misapplied, or \$5 million per day, whichever is greater. An individual may be barred from working in an insured financial institution; an individual barred in one type will automatically be barred from working in all types throughout the United States.²⁹

Criminal penalties for an individual convicted of embezzling, stealing, defrauding a federal banking agency, or accepting gifts for procuring a loan are increased two hundredfold, from the previous maximum

of \$5,000 to \$1 million and a maximum prison sentence from five years to twenty years. The statute of limitations on banking fraud is extended from five years to ten years. A person previously barred from working in a financial institution who violates that order is subject to a fine of \$1 million, a prison term of five years, or both.

The Reform Act even applies the Racketeer Influenced and Corrupt Organizations Act (RICO), which relaxes statute of limitations requirements, sanctions seizures of property, and permits federal and private civil suits for treble damages in the case of such crimes. Furthermore, it authorizes the disclosure of information developed in grand jury investigations to federal banking regulators; it allocates \$65 million annually for the prosecution of financial institution crimes, \$10 million annually for civil prosecutions, \$10 million more for other court-related expenses, and orders the Justice Department to establish a special fraud prosecution office in northern Texas to pursue financial crimes in that state.³⁰

These enforcement provisions immediately raise some interesting questions: who wants to work in the banking cartel under such conditions? What kind of a person will seek employment in an industry where violations of regulations are penalized with fines of \$1 million per day? Surely, the threat of knowingly or recklessly violating an ambiguous regulation will hang over him every day of his life.

The provisions reveal an angry and rather hysterical state of mind of the legislators who enacted them, and the media and the public that are supporting them. To increase the fine two hundredfold and mete out fourfold prison sentences, to apply RICO, and allocate special funds for prosecution indicates a state of hysteria that is frightening to sober observers. In all walks of life, the symptoms of hysteria represent reactions to stress. They are apt to appear during situations involving stress, and tend to disappear spontaneously after the stress subsides. Among legislators, hysteria may serve as a justification for avoiding certain responsibilities, or for controlling and manipulating the people they govern. Throughout American history, hysteria among legislators has been a rare phenomenon.

Congressional hysteria in financial matters is clearly visible when we compare federal penalties with those mandated by the states. In Pennsylvania, where this writer resides, a felon of the first degree may be sentenced to a term of imprisonment, the maximum of which is no

more than ten years. A first-degree felony is a wrong such as *arson* that endangers the lives of other persons, *burglary* (entering a building with intent to commit a crime), *kidnapping* (holding a person for ransom or reward, or as a shield or hostage), *rape* (engaging in intercourse by forcible compulsion or threat of forcible compulsion), *robbery* (inflicting serious bodily injury upon another, or threatening to do so in the course of committing a theft), and *murder of the third degree* (committed without intent or perpetration of another felony).

In Pennsylvania, a person convicted of an offense may be sentenced to a fine not exceeding \$25,000 in a case of felony of the first or second degree, \$15,000 for felonies of the third degree, \$10,000 for misdemeanors of the first degree, \$5,000 for misdemeanors of the second degree, \$2,500 for misdemeanors of the third degree. The Commonwealth of Pennsylvania does not, and never did, mete out million dollar fines for any crime, and never levied prison sentences of 20 years for defrauding a state banking official or accepting gifts for procuring a loan.³¹

The severity, yea, cruelty of federal penalties also raises a gnawing question about the comparative severity of penalties in the United States and the Soviet Union, the world center of totalitarianism and the denial of private property in production.

The political hysteria that led to the passage of the Reform and Rescue Act of August 9, 1989, raises yet more frightening questions: what will the legislators' reactions be to the extreme stress of more dismal failures in years to come? How much tighter can they pull the reins, and how much more pain can they inflict on the financial industry? As this observer sees the situation, they may be limited to one final step: to nationalize all financial activity, to incorporate private finance into Treasury finance, and to make every worker in finance a civil servant. This is the only logical step the American financial cartel still can take that is consistent with its basic structure. For many Americans it will be a dark day when Congress takes this final step. They remember the glorious past, rich in individual freedom and prosperous with private enterprise. *While the whole world is gradually turning away from the political command system and moving toward a freer economic order, the United States, at least in financial matters, is still moving in the opposite direction.*

No Accountability for Legislators and Regulators

If it is true that responsibility walks hand in hand with capacity and power, the legislators who created the system and the regulators who guided it throughout the decades must bear some responsibility for the disaster. Like every other party to the spectacle, however, they seek to escape their responsibility, which expresses itself not only in the wild charges they levy at others, especially S&L owners and managers, but also the hysterical punishment they mete out.

All law is based upon the general assumption that the citizen is answerable for what he does; legislators and regulators are under the law and, therefore, answerable for what they do. Law postulates a legally responsible man; it follows that it postulates legally responsible legislators and regulators. The Constitution of the United States does not repeal these axioms of law; it merely protects senators and representatives from arrest during their attendance at the session of their respective Houses, and in going to and returning from the same, except in cases of treason, felony, and breach of the peace. The Constitution also protects them from arrest for any speech or debate in either House (Article 1, Section 6), but it does not release them from all responsibility, legal and moral. It does not grant absolution for whatever iniquity they may perpetrate and the harm they may inflict on their fellow men. It surely does not absolve them from the responsibility for having created a financial cartel that builds on brute force and coercion, rather than individual freedom and voluntary exchange, that suffered hundred-billion-dollar losses and inflicted immeasurable harm on the American people who trusted the system.

The Reform and Rescue Act levies million-dollar fines on individuals who knowingly and recklessly violate regulations or engage in an unsafe or unsound practice. A law is just if it beholds neither plaintiff, defendant, nor legislator or regulator, but only the cause itself. Does justice not require that these penalties apply to all, but especially to the architects and directors of the unsafe and unsound system? The Reform Act imposes a maximum prison sentence of twenty years on individuals convicted of embezzling, stealing, defrauding a federal banking agency, or accepting gifts in return for procuring loans; does justice, which gives to every man his own, not call for the same penalties for legislators who created the system that invites much embezzlement, theft, and fraud, and on regulators who presided over it all? If

any one legislator or regulator should be found to have accepted a gift in return for procuring a loan, or should be found to profit from the system, does justice not demand that he suffer the penalties prescribed by law? Does justice, which consists of doing no injury to others, not command that the innocent bystanders, American taxpayers, be spared the crushing burden, which properly belongs to those who created it: legislators, regulators, owners, and depositors?

Many legislators and regulators who created the system have left the stage of life and can no longer be held accountable; however, there are many on the present stage who helped to fashion the present structure, who drafted and voted for the Depository Institutions Deregulation and Monetary Control Act that stoked the fires of inflation, and the Garn-St. Germain Act that invited crooked appraisals and dubious accounting. There are thousands of regulators who regulated the sinking ship. If the statute of limitations is extended to ten years also for responsible legislators and regulators, as it is for bankers, should these men and women not be brought to justice?

It is probably true that most legislators who cast their votes for the cartel legislation never read it and were unaware of its meaning and potential consequences. Yet ignorance, when voluntary, is doubly reprimandable; a man is properly charged with that evil which, for any reason, he neglected to learn to prevent.

Housing and Freedom

Evil events come from evil causes, and the calamities we suffer generally spring from what we have done. The financial disaster that struck the thrift industry sprang from evil legislation that created the system and infamous regulation that guided it all the way. To impute the blame to a few corrupt managers who made off with the petty cash is rather shallow and unimaginative. It does not explain more than \$200 billion in losses suffered by the financial institutions that succumbed and were seized by RTC, to which should be added the losses suffered by all other members of the cartel that managed to survive. Being in the black with a 5 percent rate of return rather than 10 percent, which may be the market rate, may signal a 5 percent loss. If we add the losses in the form of higher prices and poorer services suffered by millions of customers, the total cartel loss may be estimated in trillions of dollars.

Lawmakers and regulators are convinced that the Reform and Rescue Act of August 9, 1989, provides the proper answer to the S&L dilemma. It mandates tougher government oversight of banking practices and lending rules. It requires all federal bank and thrift regulatory agencies to develop uniform accounting standards and apply stiffer, risk-based capital standards. New rules are to redefine the meaning of capital, and link capital requirements to the risk levels of assets. Better regulation, we are told, is crucial to the protection of the American public from incompetent or fraudulent S&L management.

Government officials and their friends would like to make government regulation more efficient. Some even are pressing their proposals for "genuine" reform. Some would tie insurance premiums to the solvency risk of each institution. They would replace the current system of flat-rate premium with one based on the risk associated with management policies and investment portfolios. Some would lower the level of insurance coverage from \$100,000 back to \$40,000, or to even lesser amounts per account. When the FSLIC came into existence in 1934, it insured shareholders up to \$10,000 for each individual account.

The Reform and Rescue Act goes beyond a plan for better regulation. It "rescued" the industry by seizing complete control over defunct thrifts, which amounts to outright "nationalization" of a large part of an industry.

Unfortunately, where S&L managers failed, S&L officials are not likely to succeed. With thousands upon thousands of assets to manage and liquidate, probably at fire-sale prices, inexperience of the officials, bureaucratic maladies of politics, favoritism, red tape, and outright incompetence are likely to aggravate the situation and magnify the losses. Moreover, taxpayers will be saddled not only with huge liquidation losses, but also with millions in costs from lawsuits by home buyers, contractors, and suppliers. While federal agents may file a few complaints against S&L managers, many more victims of the takeover will sue the agents for violating federal, state, and local laws, from federal plant-closing statutes to state labor laws and contractual obligations. The former will make headlines in the national media, the latter will rarely be mentioned in the local news. In the strange new world of government takeover, government will need many more lawyers to defend its officials.

Astute observers of the financial scene are calling a halt to the

disgraceful spectacle. A fundamental reform of deposit insurance, they tell us, should aim at promoting market incentives in the system. Some even venture to conclude that, ideally, the system should be transferred to the private sector. "Deposit insurance is simply too important to be left in federal hands."³²

Unfortunately, these observers merely point in the right direction, but then proceed in the old direction. Instead of deliberating on the ways of implementing the transformation, they give much thought and energy to improving the command system and making it work more efficiently. They raise the private-property flag, but then ignore it because privatization is too difficult politically. At this point, the reformers turn into politicians who conclude that freedom is inexpedient and not worth their effort.

Even if freedom were expedient, to create market incentives and build a "private sector industry" on the foundation of expediency is to infect the structure with decay from the very beginning. Expedients are for an hour, like the fads of politics, but principles are for the ages. The financial industry must not be rebuilt on the shifting sands of political expediency. No matter what legislators and regulators want us to believe, the cartel system is beyond redemption. Every attempt at reform in the past has failed dismally, and there is no indication that the tinkering by the Reform and Rescue Act will work any better. The structure must be dismantled forthwith, and freedom must be permitted to advance. A banking industry built on private property and individual freedom needs no legislation, no regulation, no implementation; it merely needs the freedom to evolve. Legislators and regulators merely need to get out of the way so that freedom may pass.

Healthy thrifts should go free without delay, be free either to become commercial banks, merge with existing institutions, or embark upon any other line of business they care to pursue. Insolvent institutions should be liquidated by bankruptcy judges, and the losses be assigned to those individuals who caused and suffered them: legislators, regulators, owners, managers, and depositors. The twelve regional home loan banks, which provide easy credit to thrifts, should be liquidated and closed, and their \$12.4 billion equity be returned to the S&L owners. Federal Savings and Loan Insurance Corporation, now SAIF, and FDIC should be privatized forthwith, and instructed to sever all relations and connections with government. Above all, all planners, legislators, and regulators of the defunct system must be

barred from designing, building, regulating, and playing any role in the new system.

American financial liberties have been nibbled away for expediency and by parts. Yet, most people do not miss them, which explains their ready acceptance of a cartel system that is ineffective, corrupt, and bereft of life. They no longer understand the meaning of liberty, permitting legislators and regulators to forge their chains. Yet, in the mind and spirit of man, the spark of liberty is always flickering; at any time, it may burst into flames and scorch all obstacles that stand in the way.

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II. FROM CRISIS TO CRISIS

Fractional Reserve versus 100% Reserve Banking

Morris J. Markovitz

There has been a long-standing conflict among Austrian economists about the nature of the best or most “freedom-consistent” banking system for a true laissez-faire society. The issue is important because the two viewpoints are not merely differences of degree. Both sides invoke the same fundamental moral and economic principles, yet each comes out in opposition to the other.

How can this be? This article contends that it can’t be—that there’s a logical flaw at the base of both arguments, a very minor but logically critical one—and that actually both sides are right when the issue is restated in the proper terms.

To show this, let us first summarize both sides of the debate. The 100-percenters say that in a free society, force is outlawed, a statement both sides can endorse. Next, since fraud is a form of (implicit) force, it too must be banned. Since a fractional reserve system promises to pay specie in amounts greater than what actually exist, that promise is a fraud. Therefore, the 100-percenters contend, a fractional reserve banking system has no place in a free society.

The fractional reserve advocates, who disagree with the 100-percenters, also base their arguments on free market principles. In a free market, they say, anyone can do what he wants as long as he doesn’t use force against others. This includes banks. If a bank issues notes that aren’t 100 percent backed by specie, by what right do we stop them? They aren’t forcing people to accept the notes.

Notes of the less-well-backed banks will circulate at a bigger discount than notes that are more well backed. A promise to pay the bearer doesn’t have to be backed 100 percent at all times. Otherwise, a promissory note from an individual who had no gold, but who expected to be earning a gold paycheck in future weeks, would be just as guilty of fraud. That’s obviously not the case, and yet, the fractional

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reserve advocates conclude, there is no difference in principle between an individual's unbacked promissory note and a bank's fractionally backed note.

In summary, the 100-percenters have shown that the fractional reservers are advocating fraud. The fractional reservers have shown that the 100-percenters advocate force (by legally prohibiting the freedom to issue partially backed notes). This is why the debate, while never really hitting the headlines, is such a serious one: from each side's view, the other side is guilty of a severe moral transgression.

Periodically the debate flares up, and each side reasserts its logically self-consistent argument. Neither side, however, refutes the other's argument. Finally, everyone throws up his hands in exasperation and the debate peters out once again. Each side tries to be cordial to the other, but, because such moral issues are involved, the debate has to be an obstacle to genuine goodwill between the two factions.

Having stated the problem, we now come to the resolution. The apparent contradiction arises out of a subtle fallacy, named "intellectual package dealing" by Ayn Rand. Besides accepting the same explicit moral principles, each side, unfortunately, has also accepted the same implicit "package deal."

A "package deal" is the inappropriate "packaging" of two or more different concepts under a single label. It can be used consciously to mislead, or unwittingly, causing confusion. In this case, two completely separate things are meant by the term "banking system," each of which, combined with the same set of free market principles, will support only one side of the debate while refuting the other. Once we separate the two different concepts, there will be no difference of opinion left.

The package deal arises subtly because, in today's mixed economy, institutions called "banks" actually perform more than one function. They are supposed to be safe havens for capital. They are also loan brokers. Throughout most of modern history, "banks" have performed both functions, and in fact both functions have been melded into differing aspects of a single, complicated banking system.

That's probably why the error occurs so naturally and automatically. The two functions have become inextricable from each other in a government-mandated system that tries to have its cake and eat it: to provide 100-percent guaranteed safety of bank deposits, while employing a fractional reserve method.

The Warehouse Function

One of a “bank’s” functions is to be a safe warehouse. This is obviously a valuable function, and in a free market people who desired this service would pay for it. Its analogy in today’s world would be a safe-deposit box: a protected stronghold for the storage of valuables, for which the user pays. In a free market, those availing themselves of this “banking” service would deposit their specie in a “bank” where it would be held under lock and key. They would receive, essentially, a warehouse receipt or claim check for it, and in some fashion the service would have to be paid for. The claim checks would then circulate as fully backed money substitutes. This is the image in the minds of the 100-percenters, who nevertheless fear that temptation would lead the “banks” to cheat.

Laws against fraud, however, would prevent this, as applied to this particular banking function. Even in today’s market, banks are not allowed to break into private safe-deposit boxes and “borrow” their contents without the owners’ consent. The 100-percenters are correct that the same ought to be true in the ideal laissez-faire economy, and for this aspect of banking, the fractional reservers should be able to agree completely. Clearly, stealing from safe deposit boxes is force.

Banking today, however, also entails another completely separate function. Banks act as loan brokers, accepting deposits for which they pay interest instead of getting paid for safe storage. They then lend out these deposits at higher rates and profit from the difference, as well as (and more so) from the creating of deposits via the fractional reserve system.

Today the citizen has no real choice between the two functions. He has nowhere to put his money for safekeeping except into a loan-brokering operation at a bank. (He could put green cash into a safe deposit box, but the inflation engendered by the very system he’s trying to avoid precludes this as a sensible option.)

As the fractional reservers point out, there’s nothing wrong with loan-brokering. What’s wrong is forcing people to deposit into a loan-brokering scheme by forbidding the alternative, while simultaneously falsely advertising the loan-broker outfit as a safe warehouse. That’s what today’s banking system does and both sides would agree that it’s wrong.

In a free market, both functions ought to be permissible, but

clearly defined and separated. This doesn't mean government regulations, but rather legal definitions that distinguish the two concepts, clarify their differences, and serve as the basis for legal redress if and when a loan-brokering operation fraudulently advertises itself as something else, and someone sues.

The 100-percenters want a clean, stable, no-questions-about-it currency that serves the role of money. This they will have without prohibiting the fractional reservers' loan-brokering "bankers." The notes of these loan brokers, in practice, probably will not even circulate as money, but as interest-bearing notes, similar to commercial paper today. If they were clearly identified as a loan-broker's fractionally backed (promissory) notes, then no one would accept them unless the notes paid interest appropriate to the financial risk they entailed. (Remember, it is only the existence of legal tender laws that allows Gresham's Law to work. If people aren't forced to accept bad money, then good money will drive bad money out.)

The 100-percenters can confidently acquiesce in allowing the existence of fractional "loan-brokering" by "banks," knowing that without legal tender laws, these notes will have to show their true colors in the marketplace, as the equivalent of commercial "promissory notes," and never would achieve the status of money. Since a genuine need for safe storage does exist, there will also be someone, somewhere, who issues 100-percent backed notes for the convenience of his customers, and those pieces of paper will circulate as money, by the natural workings of the market.

In practice, it may well turn out to be most efficient to house these two functions under one roof, but never to blend them into one "system." Just as we have money-market versus bond "switch funds" today, a single institution could offer both services. A cautious citizen might avail himself of only the warehouse facility, where his gold deposits could be physically segregated, and he would pay for this service. If he wanted to lend to industry, he could have some or all of his gold transferred to the other side of the "bank" and accept the risk in return for the interest.

In sum, if we: (a) separate the concept of "banking" into its two distinct functions (warehousing and loan-brokering); (b) recognize this distinction in law, as part of the general body of law on fraud; and (c) eliminate legal tender laws, the result will be a money and credit system that satisfies all the requirements of both camps.

The International Debt Crisis

Ken S. Ewert

Once there was a man with a large sum of money. He decided to lend a considerable portion of it to a man from a faraway country who offered him a high rate of return. But the foreigner wasted some of the money in riotous living, he was careless and allowed some of the money to be stolen, and what he did invest soon soured because of his poor investment skills. It wasn't long before he had trouble making the payments on his debt. The lender saw the debtor's poor stewardship, but not wanting to admit his own mistake in lending to the man, lent him still more money in the hopes that the debtor would begin to prosper. But the debtor continued his thriftless ways, and the lender soon found himself in serious financial trouble.

This simple story describes, by analogy, what economists call the "world debt crisis." In our parable, the lender symbolizes the several large commercial banks (American, Japanese, and European) which made substantial international loans during the 1970s and early 1980s, and the debtor represents countries such as Brazil, Mexico, and other less developed countries (LDCs) which borrowed heavily during that period. Most people understand this story as far as it goes—how the international debt problem happened. But most of us are still in the dark as to why it happened, and how this crisis is likely to be resolved.

What Caused the Massive Debt

By 1982 the LDCs owed over \$500 billion to Western banks, governments, and international agencies. This amounted to a fivefold increase in their indebtedness during the previous decade.¹ Clearly there had been a world-wide splurge of credit. But why? Was it because of greedy bankers? Were avaricious LDC governments to blame? Both the banks in their reckless chase after profits, and the borrowing

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countries in their ill-advised pursuit of wealth and power, bear responsibility for the present crisis. But greed alone does not adequately explain why so many people made the same sort of error at the same time. Why did the explosion in international debt occur in the 1970s rather than the 1960s or the 1950s? Was there a reason which caused the lenders to extend credit and the debtors to accrue debt on such a grand scale?

The explanation often given for the huge loans made to LDCs during the mid and late 1970s is that the banks were recycling "petrodollars." This explanation goes as follows: In 1973 the OPEC cartel succeeded in exacting huge increases in the price paid for their oil and found themselves suddenly rich in dollars. These dollars needed to be invested, and many of them were deposited with the "money center" banks in London and New York. These banks, suddenly rich in deposits, turned around and invested these funds in the form of loans to the LDCs. The process was repeated in the late 1970s when OPEC again was able to increase sharply the price of oil. It was this inflow of petrodollars which gave rise to spurts of extraordinary lending in the mid 1970s and again in the latter part of the decade.

This explanation has some truth to it, but it fails to address an important issue. Why did OPEC, an obscure cartel which had been in existence for more than a decade, suddenly, in the early 1970s, find itself in a position to demand four times as many dollars as before for its product? One obvious reason for the cartel's success is that the dollars which the oil producers sought to "buy" with their oil had become more plentiful. But where did these dollars—which eventually became loans to the LDC debtor countries—come from in the first place?

Dollars are created by only one entity—the Federal Reserve System (the Fed). The inflation—the increase in the quantity of money and credit—of the late 1960s forced the Nixon administration to cut the tie between gold and the dollar in 1971. Too many dollars had been created, and the U.S. Treasury no longer had sufficient gold to redeem dollars at their declared value. With the Fed completely freed from the constraints of gold, the rest of the decade of the 1970s, on the whole, was even more inflationary. Between 1970 and 1984, the Eurodollar market (U.S. dollar deposits held in foreign countries) grew from \$100 billion to nearly \$2 trillion.²

It was this monetary expansion which precipitated the massive

amount of international lending that took place in the 1970s. Banks found themselves flush with new deposits (including OPEC's petrodollars) and the money had to be invested somewhere. From the vantage point of many bankers, the developing countries seemed an excellent place to invest.

Why Loan to LDCs

Why did the banks lend to governments and businesses in developing countries?³ One obvious reason was the economy of scale inherent in these loans. It was much easier and potentially more profitable to make a single \$100 million loan to the Mexican government as opposed to hundreds of separate loans to American developers, businesses, or homeowners. Rather than having to investigate a multitude of individual projects, a loan to the LDC meant that the LDC's government investigated (supposedly) and administered the funds to the assorted state and private borrowers. The loans also were alluring because of the guarantee (either implicit or explicit) of the LDC governments. Surely a sovereign government—always having the power to tax—would not go bankrupt.

Another attraction of these loans was the high yield which they offered. Many loans were negotiated for floating interest rates, often at rates of one-and-a-half to two percent above LIBOR (the London Interbank Offered Rate). The fact that these loans had floating rates considerably lessened the risk of future inflation's wiping out the real value of the banks' loan assets. In contrast, domestic loans during the same period usually were negotiated at fixed rates, and were subject to interest rate ceilings and offered substantially lower rates of return.

Reasons for Borrowing

Why were the developing countries so eager to borrow? One important factor was the economic philosophy which had gained prevalence in these nations. Western "development economists" had been influential in shaping economic thought in these countries, as had the prominent Western universities which educated (directly or indirectly) many of the debtor country's most influential citizens. These development economists and prestigious universities, with few exceptions, were teaching that economic development can best be achieved

through a "directed" economy. The views of Nobel Laureate Gunnar Myrdal reflect the prevailing wisdom of development economists during the 1950s and 1960s. According to Myrdal: "All special advisers to underdeveloped countries who have taken the time and trouble to acquaint themselves with the problems, no matter who they are . . . all recommend central planning as a first condition of progress."⁴

Although other development economists were not so blunt in their advocacy of centralized planing, they were essentially in agreement with Myrdal. A group of leading development experts, writing in a volume sponsored by MIT's Center for International Studies, stated that "there are limits to the effectiveness of the private market institutions, especially where development must be accelerated. It may be necessary to plan out in advance the key pieces of a general development program."⁵

Sadly, these Western counselors had rejected the very principles which were responsible for the economic success of their own nations. Private property rights and private investment, the experts advised, stood in the way of swift economic progress. Accelerated economic growth, they said, could be accomplished only through a large-scale inflow of capital, and this inflow could be best accomplished through state borrowing. This was just what LDC prime ministers and finance ministers wanted to hear, since borrowing and planning economic development would mean new power and prestige for their governments.

Another incentive to borrow heavily was the continuing depreciation of the dollar throughout the 1970s. During much of the decade, the value of the dollar depreciated at a greater rate than the rate of interest at which the LDCs could borrow. This meant that during parts of the 1970s these loans, in effect, were at negative interest rates. In this bizarre inflationary environment, borrowers, at times, actually were being paid for borrowing.⁶

In anticipation of continuing inflation, the LDC countries borrowed expecting to repay their debts with less valuable dollars. But they were wrong. The U.S. did not continue to inflate at increasing rates, and by the close of the decade the Federal Reserve, under new chairman Paul Volcker, had begun to slow the rate of monetary growth. Interest rates in 1981–82 were approximately double the level of 1978–79 rates, and the dollar no longer was depreciating so rapidly

in value. By the early 1980s, many debtors were faced with economic stagnation and greatly increased interest burdens.

What had gone wrong? Where had the "development capital" gone? The truth is that a good deal of the money had not been productively invested, but was simply squandered. A significant amount was stolen by government officials. The Mexican government of López Portillo was infamous for its billion-dollar frauds and the *mordidas*—bribes—which were commonly necessary to "arrange matters" with government officials.⁷ And Mexico was not unique. Several LDC leaders are among the world's wealthiest people. President Suharto of Indonesia has an estimated wealth of \$3 billion, President Mobuto of Zaire owns an estimated \$5 billion, and former Philippine President Marcos is believed to be worth \$10 billion.⁸

Consumed by the State

More often than not, the loans were used to aggrandize the state and expand its power. During the heaviest period of lending (1976–1982), the number of state-owned businesses in Mexico was doubled.⁹ The borrowed wealth allowed popular subsidy and transfer programs to flourish, and the public sphere grew at the expense of private freedom. In Mexico, for example, the portion of GNP consumed by the state virtually doubled between 1970 and 1986.¹⁰

To be sure, some funds were invested in bona fide capital projects. Unfortunately, these projects most often represented political and not consumer priorities. In a free economy, what is produced is ultimately decided by consumers who cast their economic "votes" for particular products or services. By buying one product and not another, they communicate their preferences. Profit-seeking producers, eager to anticipate and fulfill consumers' desires, invest capital in the appropriate industries.

The foreign loans of the 1970s, however, went primarily for capital projects chosen by the state. Such grandiose projects as the construction of the Itaipu Dam between Paraguay and Brazil, and the building of roads through the Amazon jungle, undoubtedly benefited some people and boosted the governments' popularity. However, they were not the most efficient use of capital; the same funds in the hands of free-market entrepreneurs would have been put to different uses and

better satisfied the wants of consumers. Contrary to the hopes of the planners, the state investments did not generate the wealth necessary to repay the loans.

With triple-digit inflation, price controls, oppressive taxation, stifling regulations, and basic disrespect for private property rights, many of the debtor nations have almost destroyed private enterprise. Rather than invest in their own countries, many individuals have converted their currencies into dollars and invested them in nations which are economically freer and more stable. This is called "capital flight." One study by a New York bank found that from 1978 to 1983, while Argentina incurred \$35.7 billion in new loans, \$21 billion left the country; the Philippines added \$19.1 billion of new loans and \$8.9 billion left the country; and Venezuela added \$23 billion while its citizens spirited abroad \$27 billion.¹¹

This extraordinary capital flight indicates what the citizens of these nations think of their governments' policies. Fearful of their wealth's being consumed by taxation or destroyed by inflation, they convert it to hard currencies and invest abroad. It is ironic that while the LDC governments were borrowing in order to "direct" capital investment for the good of their economy, the same statist policies were driving out private capital.

Problems for Banks

When in 1982 many countries could not pay their debts, commercial banks and governmental agencies, such as the International Monetary Fund (IMF), scrambled to reschedule the loans. This involved stretching out the payment periods and decreasing the interest rates. The IMF advanced new loans to struggling debtors on the condition that the LDC governments follow certain prescribed "austerity measures." Between 1982 and 1986, billions of dollars of new short-term loans were made to enable the debtor countries to make their interest payments.¹² But this was only a band-aid solution. The banks were extending new loans not because of their confidence in the future ability of these nations to repay, but rather to avoid having loan payments declared in arrears by bank regulators. Recognizing the default of these LDC debtors would mean that many of the large banks would be "insolvent," or in more blunt terms, bankrupt.

In 1985, Treasury Secretary James Baker announced the Baker Plan to address the debt crisis. The plan called for commercial banks to extend \$20 billion in new loans, and for the debtor countries to enact reforms reducing government intervention in their economies. It also called for an increase in funds and a new debt financing role for the World Bank. Under the Baker Plan, the IMF was to continue its role as the lender of last resort or "safety net" to the LDCs.

But by 1986 it was clear that the new loans and IMF rescue packages had failed to solve the debt problem. The big debtors—Brazil, Mexico, and Argentina—showed little sign of improvement, and the money-center banks with large LDC loans were facing declining credit ratings and increasing costs of borrowing from depositors. Despite arm-twisting by federal officials, many commercial banks were becoming reluctant to make new loans.

In February 1987, Brazil, the largest international debtor, announced that it would no longer pay interest on its debt. In May of that year, Citicorp announced a record \$3 billion increase in its loan-loss reserves. It was, in the words of *Business Month*, "a breathtaking public admission that the banks and the governments of the major industrial nations will never recoup the \$1 trillion they are owed by developing countries."¹³ Following Citicorp's leadership, several other major banks increased their loan-loss reserves in recognition of the almost certain default of a large portion of their LDC loans.

What Will Happen?

Is there any chance that more than a fraction of these loans will be repaid? One option that offers a glimmer of hope is "debt-equity swaps," in which the banks sell their loans back to the LDC country at a discount in return for local currency. The currency then is converted into equity investments in the LDC. This approach has its limitations, not the least of which is the lack of respect for private property in many of these countries (such as was exemplified by the nationalization of Mexican banks in 1982). Other problems include the rampant inflation and wild currency swings which make business in an LDC difficult, and the fact that most LDCs are wary of foreign investments and place strict limitations on them.¹⁴ To date there have been only a few billion dollars worth of debt-equity swaps, hardly a

dent in the three to four hundred billion dollars owed to Western banks.

There is little question that apart from a radical and sustained change in the role of government in the LDCs, the bulk of these loans will not be repaid. Most of these countries have long since stopped paying principal and many, such as Brazil and Argentina, are in virtual default. The pertinent question now is: If the debtors won't pay, who will?¹⁵

Recent moves by money-center banks to increase their loan-loss reserves are a significant step toward recognizing and bearing the losses. However, even Citicorp's record increase in reserves last year only amounts to a write-off of 25 percent of its total LDC portfolio.¹⁶ Since the "secondary markets" currently value the LDC loans at somewhere between 45 and 55 cents on the dollar, Citicorp and other banks will likely need to make more large increases in their loan-loss reserves.¹⁷ This may mean several years of low stock prices, difficulty in raising new equity, and high costs on borrowed funds—not a pleasant scenario for bank management.¹⁸

But will the losses ultimately be borne by the banks and their shareholders? There are certainly those in the banking industry who are calling for government action to "socialize" the losses, or in other words to pass them on to individual citizens. Unfortunately, it seems that this call is falling on sympathetic ears among policy makers. There is no doubt that Washington fears the ramifications of one or several large banks' failing.

One way these losses are being socialized is through monetary policy. The Fed has pursued a very loose policy since late 1984, thereby devaluing the dollar and lowering interest rates. This favors the debtor nations, making it possible for them to repay their debts with less valuable dollars. Through monetary inflation, a banking crisis may well be averted as the real value of the LDC debt is inflated away. Who pays in this scheme? All the individuals and institutions who own dollars pay. Dollar holders find the purchasing power of their savings deposits or securities eroding and their standard of living reduced.

But the extraordinary monetary ease since late 1984 has failed noticeably to help the debtor countries climb out of their hole. Bound by their addiction to paternalistic governments, they have only fallen more firmly into the grasp of debt. If these countries cannot service

their debts when interest rates are low and dollars are easy to come by, there truly will be a world debt crisis when, inevitably, the Fed tightens and interest rates rise in recognition of the dollar inflation.

A second way the LDC debt is being foisted on the innocent is through lending by international agencies. Since these organizations are funded by the U.S. and other industrialized countries, new loans are really a transfer of wealth from American (and German, Japanese, etc.) citizens to the commercial banks with problem foreign loans.

During the past few years, the citizens of the industrialized countries unwittingly have picked up an increasing portion of the tab for bad LDC debts. Between 1980 and 1984, transfers via the World Bank to Latin American debtors doubled from \$1.6 billion to \$3.2 billion, and the Inter-American Development Bank (IADB) increased its disbursements from \$1.4 billion to \$2.4 billion.¹⁹ Although these amounts are still relatively small in relation to the outstanding debt, the trend is alarming. It is quite possible that in the future, U.S. and European authorities will "socialize" larger portions of the debt through international agencies such as the World Bank, the IADB, and the IMF.

While the Federal Reserve deserves considerable blame for its role in prompting the excessive lending, we must remember that some banks did lend wisely during the credit expansion. Not every bank was willing to loan more than 100 percent of its equity capital to Latin American countries. Morally, there is no question as to who should bear the burden of these losses. The commercial banks which entered into these loans aware of the risks should face the consequences of what turned out to be their imprudence. The many innocent individuals who had no part in such lending should not be forced to pay for the injudicious behavior of a few banks.

1. Darrell Delamaide, *Debt Shock: The Full Story of the World Credit Crisis* (New York: Doubleday & Company, Inc., 1984), p. 7.

2. Hans F. Sennholz, *Money and Freedom* (Springs Mill, Pa.: Libertarian Press, Inc., 1985), p. 5.

3. At the September 1980 meeting of the International Monetary Fund and the World Bank, the competition to invest in LDCs was such that on some occasions "bankers were literally chasing prime ministers and finance ministers around hotel lobbies in a desperate effort to outlend their rivals." John H. Makin, *The Global Debt Crisis: America's Growing Involvement* (New York: Basic Books, Inc., 1984), p. 5.

4. Gunnar Myrdal, *An International Economy* (New York: Harper and Brothers,

1956), p. 201, quoted in Paul Craig Roberts, "Third World Debt: Legacy of Development Experts," *The Cato Journal*, Vol. 7, No. 1, Spring/Summer 1987, p. 232.

5. Max F. Millikan and Donald L. Blackmer, eds., *The Emerging Nations: Their Growth and United States Policy* (Boston: Little, Brown and Co., 1961), quoted in Roberts, p. 233.

6. During the inflation of the 1970s "the interest rates at which Eastern Bloc nations and LDCs borrowed were generally below the U.S. inflation rate. As a result, the real cost of carrying external debt was negative during this period." Robert Weintraub, "International Debt Crisis and Challenge," *The Cato Journal*, Vol. 4, No. 1 (Spring/Summer 1984), p. 28.

7. George Byram Lake, "Nothing Left to Steal," *National Review*, July 3, 1987, p. 40.

8. George B. N. Ayittey, "The Real Foreign Debt Problem," *The Wall Street Journal*, April 8, 1986, p. 30.

9. Lake, p. 41.

10. *The Heritage Foundation Background*, "A U.S. Strategy To Solve Mexico's Debt Crisis," July 17, 1986.

11. Ayittey, p. 30. According to one estimate involving eight highly indebted LDCs as a group, for the period of 1974–1982, for every U.S. dollar that was lent, 30 cents left the countries. Mohsin S. Khao and Nadeen Ul Haque, "Capital Flight From Developing Countries," *Finance and Development*, Vol. 24, No. 1 (March 1987), pp. 3–4.

12. Total debt for LDCs rose approximately 25 percent between 1982 and 1986.

13. Edward Mervosh, "Unspeakable Debts, Unthinkable Answers," *Business Month*, October 1987, p. 56.

14. Of the big debtors, only Chile has fully embraced the concept of debt-equity swaps. Argentina requires investors to invest an additional dollar for every dollar of debt they swap for foreign currency. Mexico restricts foreign ownership to "non-strategic areas" such as tourism, and Brazil has prohibited foreign investment in its computer industry. Peter Truell and Charles F. McCoy, "Third World Creditors Give Debt-Equity Swaps a Try," *The Wall Street Journal*, June 11, 1987, p. 6.

15. The proposal unveiled by Mexico on December 29, 1987, has been hailed by some within the financial community as "innovative" and a "major breakthrough" in managing Mexico's debt crisis. According to this plan, Mexico will issue \$10 billion of new marketable bonds which will be collateralized by a zero-coupon U.S. Treasury Bond (which will be purchased for \$2 billion and will have a maturity, in 20 years, of \$10 billion). Mexico will swap its newly created bonds—at a discount—for those currently held by its creditors. Under this plan, only the principal of the bond will be collateralized by the zero-coupon Treasury bond. The interest payments are not collateralized and remain backed only by the "full faith and credit" of Mexico. Also, the discount which Mexico has indicated it would like (50 percent) would require a substantial write-down of assets for the participating banks—a larger loss than many of the banks can absorb. Many of the major U.S. lenders to Mexico have indicated they won't take part in the plan. Wendell Willkie Gunn, "Mexico's Old Bonds in New Bottles," *The Wall Street Journal*, January 14, 1988, p. 26.

16. Mervosh, p. 56.

17. Regional banks, which have not lent so heavily in the LDC loan market, are in better shape to weather defaults. Many of the regionals have loan-loss reserves of 50 percent of their Latin American loans. Jeff Bailey and G. Christian Hill, "Regional Banks May Be Eager For Mexican Plan," *The Wall Street Journal*, December 31, 1987, p. 2.

18. It's obvious that in recent months bond investors have taken a grim view of the large money-center banks. Investors, in some cases, are turning the securities into "de facto junk bonds." The average yield of single-A notes issued by money-center banks has risen to a 1.5

percent premium over Treasury issues during recent months (from less than 1 percent). Matthew Winkler, "Some Banks' Debt Is Behaving Like Junk," *The Wall Street Journal*, February 2, 1988, p. 16.

19. Richard E. Feinberg, "Latin American Debt Renegotiating the Adjustment Burden," *Columbia Journal of World Business*, Fall 1986, p. 23.

The Farm Credit Crisis

E. C. Pasour, Jr.

Farm credit problems are front page news. In early 1987, 104,000 commercial farm operators (17 percent of the total) with \$28.4 billion of debt were considered to be "under financial stress" so that lenders could lose \$6.3 billion on these loans.¹ However, the amount of financial stress in agriculture varied considerably from region to region, being greatest in the Northern Plains, Lake States, and Corn Belt.

The regional variation in problems of farm borrowers is important to farm lending agencies, also under financial stress. The government-sponsored Farm Credit System (FCS) has lost some \$4.8 billion since 1985 through mortgage and loan defaults—more than any other financial institution in U.S. history. Congress responded and in late 1987 a multi-billion dollar package of federal assistance to help bail out the FCS was passed.

The Farmers Home Administration (FmHA) is the primary farm lending agency of the U.S. Department of Agriculture (USDA) with a historical mission of providing credit to high-risk farmers. Thus, the high degree of financial stress by FmHA borrowers in the mid-1980s should not be surprising. A 1986 GAO study found that more than half the FmHA borrowers were either technically insolvent or had extreme financial problems.²

It is not only farmers and government credit agencies that are encountering financial problems in farm credit markets. Many of the commercial banks that have failed in the 1980s have been "agricultural banks."³ Indeed, the closure rate of agricultural banks has been significantly higher than that for nonagricultural banks.⁴

The purpose of this paper is to show how government intervention has resulted in two kinds of problems related to agricultural credit. First, it is shown how subsidized credit has contributed to the current plight of farmers. Second, the relationship of government banking regulations to farm bank lending problems is stressed. The conclusions

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reached are that farm credit woes are inherent in "easy credit" policies by governmental credit agencies and in the current system of banking restrictions that reduce portfolio diversification and increase risk.

Easy Credit in Agriculture

Federally subsidized farm credit programs have increased from a marginal source of farm financing for a few hardship cases to a major source of farm credit during the past fifty years.⁵ Indeed, about half of the farm debt was held by the FCS and the FmHA in 1987.⁶ This figure actually understates the governmental influence on farm credit because the taxpayer-financed FmHA supports agricultural loans by private lenders. For example, a 1984 debt deferral and adjustment program permitted the FmHA to guarantee problem farm loans held by a commercial bank, provided the lender reduced the principal or the interest rate charged by specified amounts.

Easy credit policies in agriculture lead to information problems, incentive problems, and a number of indirect and unintended effects.

Information Problems

In a market system, interest rates and the amount of credit used are determined by market forces. In the absence of a market test, there is no reliable method to determine how low interest rates *should* be or how credit should be allocated. Subsidized credit, in effect, is an income redistribution program. The problem of determining a "fair" interest rate is the same as determining "just prices" generally and is one with which philosophers have struggled for centuries. Economic theory cannot be used to justify credit programs that benefit some farmers at the expense of other farmers and taxpayers—any more than it can be used to justify other income redistribution programs. The conclusion is that any governmentally imposed reduction in interest rates or increase of credit to agriculture is purely arbitrary.

Implementation Problems

Implementation problems arise in subsidized credit programs as they do in all situations in which resources are allocated through the political process. The FmHA, for example, was designed to be "lender

of last resort," lending to borrowers unable to obtain credit from private credit agencies. In the case of FmHA's so-called limited resource loans, credit is extended when farmers "need a lower interest rate to have a reasonable chance of success."⁷ However, when credit is arbitrarily increased to high-risk farmers, too many resources remain in agriculture.

There is also a moral hazard problem in all cases where the FmHA acts as a "lender of last resort." That is, an individual's behavior is affected when he is protected from the consequences of his actions. If subsidized credit is available to a farmer who either cannot obtain credit elsewhere or who needs a lower interest rate to succeed, the farmer is less likely to change his behavior so as to qualify for credit from commercial sources and more likely to continue to need lower rates.

Public choice theory—the application of economic principles to the political process—holds that goods and services are likely to be over-produced when provided through the political process. As the original purpose for a government program is achieved, politicians and decision-makers in a government agency have incentives to broaden the scope of the agency's activities to prevent funding decreases.

The theory of bureaucratic productivity appears to be consistent with actions of the FmHA. The mandate of the FmHA has been broadened considerably over time to include loans for rural housing, community facilities, and business and industry programs, so today FmHA credit is available in rural areas for almost any conceivable purpose.⁸ By 1982, only about half of all FmHA loans and grants were for farm programs.⁹

The FmHA provides a good example of how subsidized credit is influenced by political considerations. A tightening in FmHA rules, especially foreclosure, is politically sensitive. Both Secretary Bergland in the Carter Administration and Secretary Block in the Reagan Administration imposed a moratorium on farm foreclosures. Yet, without a firm foreclosure policy, government lending agencies are likely to get dragged into economic ventures that are progressively more hopeless. In contrast, when credit is available only from private lenders, who expect to profit from lending, there is much less likelihood of over-expansion of landholding or capital facilities in farming.

Indirect Effects

Subsidized credit affects the profitability of production and influences which producers remain in production. When allocated on the basis of its opportunity cost, credit generally is used by those producers meeting the profit test—those who best accommodate consumer demand. On the other hand, some less productive producers are kept in production when credit is subsidized, resulting in higher prices for land and other specialized resources, increased output, and lower product prices. Thus, farmers *not* receiving subsidized credit are harmed, since this results in higher costs and lower product prices.

The market process by which competition weeds out less productive producers and rewards the more productive is altered when subsidized credit is extended to those who are failing and cannot obtain credit elsewhere. Subsidized credit hampers resource adjustments and perpetuates low income problems in agriculture. One economist explains this paradox in which government assistance to agriculture benefits the less productive at the expense of the more productive, thereby reducing overall productivity, as follows:

Financial assistance provided through the subsidies to the least efficient farmers leads to lower farm commodity prices and higher cost of farm resources, especially land, and reduced farm incomes. This tends to place the next group of farmers on the efficiency scale in the failure class. This process of replacing marginal farmers with otherwise submarginal ones results in a gradual reduction in the overall efficiency level of lower income farm groups.¹⁰

Easy credit also has affected production methods and the structure of farming. It has led to the substitution of machinery and other capital inputs for labor in agriculture, resulting in more highly mechanized farms. Lower interest rates also have encouraged farmers to buy more land. In view of widespread public concerns about farm size and capital requirements in commercial agriculture, it is ironic that government credit programs have contributed to the trends toward larger and more highly mechanized farms. It is also ironic that government has subsi-

dized credit, thereby increasing output of farm products while, at the same time, attempting to reduce farm output through various other agricultural programs.

The effect of easy credit policies during the agricultural boom of the late 1970s on farm woes of the 1980s warrants a special note. Cheap credit creates an incentive to expand the size of farm operations through borrowing. And "too much" credit is more likely to be extended when lenders do not bear the full consequences of their actions. In the late 1970s, a period of inflation and favorable product prices, farmers borrowed heavily to invest in land, machinery, and other capital facilities. In retrospect, many highly leveraged farmers borrowed too much. And they would not have borrowed so much if they had had to pay credit rates that were not subsidized, implicitly or explicitly, by the FCS and the FmHA.

As long as farm land prices were rising rapidly, as during most of the period from World War II to 1981, farms generally could be sold for enough to liquidate the debt when high-risk and other farm borrowers went out of business. With the decline in farm real estate values since 1981, however, losses by FmHA and FCS borrowers have been at a high rate. Hence, the evidence suggests that easy credit programs, especially those of the FmHA have "prolonged the agony of many farmers who should have transferred to non-farm occupations at the time the FmHA loans were made."¹¹ Thus, there can be little doubt that the easy government credit policies of the 1970s contributed to the financial distress and farm bankruptcies of the 1980s.¹²

Finally, the cost of subsidized credit in agriculture ultimately is borne by the public. The federal government can finance its programs by raising taxes, deficit spending, or through new money creation. In reality, all these financing methods are likely to be used, resulting in higher interest rates, higher taxes, and inflation.¹³ To maintain political support for subsidized credit, it is important that the costs be widely dispersed and not easily determined, while the benefits be easily seen and heavily concentrated—a phenomenon characteristic of many governmental programs that redistribute income.

Government-Assisted versus Private Credit in Agriculture

The objective of federal credit agencies is quite different from that of profit-seeking private credit institutions. The purpose of the former,

as stressed above, is to offer terms and conditions to selected borrowers that are more favorable than those available from private lenders. When compared with fully private loans, government-assisted credit may include lower interest rates or loan guarantees, less stringent credit risk thresholds in making credit available, or more generous repayment schedules.

Federally sponsored and financed agricultural credit programs have been under a great deal of financial pressure because their loans are specifically for agriculture, which is experiencing the greatest amount of financial turmoil since the 1930s. As suggested above, many commercial banks with high percentages of agricultural loans in their portfolios have also been in trouble during the 1980s. There is no way to diversify risks under current institutional arrangements when credit institutions deal heavily with one sector of the economy, whether the credit institutions be public or private. This is explained in the following section.

A problem is likely to arise when a credit institution in a predominantly agricultural location is not able to diversify its risks outside its geographic area and outside of agriculture. This inability to diversify risks is inherent in the FCS and FmHA. It is also a problem for commercial banks located in predominantly agricultural areas, such as those in parts of the Corn Belt, which cannot diversify their risks because of government restrictions on branch banking. Branching within states is governed by state laws, and only about half the states allow unlimited branching within their borders.¹⁴

A recent study of agricultural bank lending practices by the Federal Reserve Bank of Dallas found that branch-banking regulations have increased the probability of bank closure. One of the advantages of branching is increased diversification. Greater diversification means less risk and, consequently, a lower probability of banks' closing. In states with a broad mixture of industrial, commercial, and agricultural businesses, but with geographical concentration of agriculture, statewide branching can reduce significantly the risk of bank loan portfolios.¹⁵

The significance of portfolio diversification through branch banking in states with a great deal of diversity is illustrated by the banking situation in California (which allows statewide branching). Although California is the most important agricultural state, the state is so diverse that less than 5 percent of all bank loans are to farmers and

ranchers. Consequently, agricultural lenders there have fared much better than agricultural banks generally. Despite the importance of agriculture, California accounted for only one of the 68 agricultural bank failures in 1985.¹⁶

Statewide branch banking would have much less effect on portfolio diversification in states heavily concentrated in agriculture (or in any other line of commerce). In Nebraska, for example, a restricted branching state, loan portfolios are heavily loaded with agricultural loans. In 1984, 38 percent of the loans were to farmers "and probably half again as much was to farm-related businesses."¹⁷ At the end of 1984, there were 413 agricultural banks in Nebraska—19 have since closed.¹⁸ In situations in which agriculture is the dominant activity and there is little opportunity for diversification, statewide branching would have relatively little effect in reducing lending risk.

Interstate Banking

Restrictions on banking make farm lending more risky. Partly as a result of geographical restrictions on banking, two-thirds of all bank failures in 1986 occurred in the Kansas City and Dallas Federal Reserve Districts, home to many poorly diversified farm and energy banks.¹⁹

In states in which there is a heavy concentration in agricultural production, or more generally in a few lines of commerce, geographical restrictions on banking significantly reduce portfolio diversification. Consequently, banks operating across state lines are able to diversify their risks much more effectively than banks restricted to a given geographic area. Although bank holding companies have engaged in a modest amount of interstate banking in recent years, federal laws such as the McFadden Act and the Bank Holding Company Act limit full realization of the benefits of interstate banking.²⁰

A bank that makes loans in different regions does not have its fate tied to the economy of one region. Specifically, under a system of interstate banks, a bank in a farming region would not have all its loans dependent upon the farm economy. Thus, it is not surprising that federal and state restrictions on branching appear to have played an important role in recent woes of agricultural banks.

Restrictions on banking, as they affect agricultural credit, illustrate the point made by Ludwig von Mises that government intervention

creates pressures for further intervention. Government restrictions on bank branching within and between states make it much more difficult for banks in agricultural regions to diversify their portfolios—hence, the government-created “need” for government-operated and government-sponsored credit institutions.

Restrictions on competition in banking are similar in one respect to governmental restrictions on competition in agriculture. In each case, the restrictions represent successful attempts by politically powerful groups to achieve wealth transfers through the political process. Many banks oppose nationwide banking, just as many farmers oppose free markets, because it would subject them to increased competition.²¹ In neither farming nor banking, however, is there any persuasive evidence that current restrictions are beneficial to the public at large.

Conclusion and Implications

Government intervention in credit markets has been harmful in a number of ways. Easy credit has increased the amount of credit used in agriculture—especially by high-risk borrowers. Hence, it contributed to the increased prices of farm real estate and the increased numbers of highly leveraged farmers of the 1970s—and, consequently, to the financial and farm bankruptcies of the 1980s.

Subsidized credit has enabled many farmers who otherwise would have shifted out of agriculture to continue farming. And the resulting higher cost of land and other farm resources, increase in output, and decrease in commodity prices have reduced incomes of farmers not receiving the benefit. Economic logic supports the conclusion of Clifton Luttrell, former agricultural economist with the Federal Reserve Bank of St. Louis: “Instead of alleviating the problem of poverty in agriculture, as often alleged, such credit perpetuates the problem.”²² From a nonfarmer and taxpayer point of view, the increased flow of credit to agriculture means some combination of higher interest rates, higher taxes, and inflation.

Subsidized credit as a public policy poses the same problems as other kinds of intervention affecting market prices. The market process allocates credit on the basis of expected productivity and profits. In the absence of the profit and loss benchmark, there is no objective basis for determining how much credit *should be* used in agriculture. Thus,

it is impossible to determine how effectively credit is being used in government credit programs. Moreover, the moral hazard problem is endemic in easy credit programs where borrowers must demonstrate that they lack other sources of credit.

A number of arguments have been used to justify cheap credit in agriculture. A recent analysis of the most widely used arguments concluded that the arguments were either unsound, counter to economic logic, or not supported by the evidence.²³

Government intervention affecting the abilities of agricultural credit institutions to diversify portfolios also is harmful. Problems arise when lending institutions deal only with one sector of the economy—whether the credit agencies are public or private. Government restrictions on nationwide banking reduce diversification in bank loan portfolios, thereby increasing risk and the likelihood of bank failure. Branch banking regulations, by making lending in agriculture more risky, also increase pressures for easy credit programs through government credit institutions.

The analysis suggests three main points. First, cheap credit has hampered resource adjustments and contributed to current financial stress in U.S. agriculture. Second, government restrictions that prevent nationwide banking have increased risks of banks specializing in farm loans. Third, government intervention affecting farm credit and banking has had unforeseen and unintended consequences. In this respect government programs affecting agricultural credit markets are no different from government programs generally.

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2. General Accounting Office, *Farmers Home Administration: Financial and General Characteristics of Farmer Loan Program Borrowers* (Washington, D.C.: U.S. Government Printing Office, 1986), p. 2.

3. Agricultural banks are defined in different ways, but most definitions are based on the percentage of agricultural loans in a bank portfolio. Hilary H. Smith, "Agricultural Lending: Bank Closures and Branch Banking," *Economic Review* (Dallas: Federal Reserve Bank of Dallas, September 1987), p. 27.

4. *Ibid.*, p. 27.

5. Clifton B. Luttrell, "High Costs of Farm Welfare via Federal Programs: An Analysis of Their Origin, Growth and Effects," unpublished manuscript, 1987. [Editor's note: The reader is also referred to Clifton Luttrell's book, *The High Cost of Farm Welfare*, published by the Cato Institute in 1989.]

6. Emanuel Melichar, *Agricultural Finance Data Book* (Washington, D.C.: Board of Governors of the Federal Reserve System, June 1987), p. 19.

7. U.S. Department of Agriculture, *A Brief History of Farmers Home Administration* (Washington, D.C.: U.S. Government Printing Office, 1983), p. 15.
8. Luttrell, *op. cit.*, p. 114.
9. U.S. Department of Agriculture, *op. cit.*, p. 19.
10. Luttrell, *op. cit.*, p. 133.
11. *Ibid.*, p. 121.
12. Michael T. Belongia, *Agriculture: An Eighth District Perspective* (St. Louis, Mo.: The Federal Reserve Bank of St. Louis, Spring 1984).
13. Luttrell, *op. cit.*, pp. 124–126.
14. Smith *op. cit.*, p. 32.
15. *Ibid.*
16. Lindley H. Clark, Jr., "Interstate Banks Could Ease Farm Credit Woes," *The Wall Street Journal*, January 20, 1987, p. 35.
17. Smith, *op. cit.*, p. 32.
18. *Ibid.*
19. Michael Becker, Steve Horwitz, and Robert O'Quinn, "Interstate Banking: Toward a Competitive Financial System," *Issue Alert* No. 18 (Washington D.C.: Citizens for a Sound Economy Foundation, 1987), p. 9.
20. *Ibid.*, p. 13.
21. *Ibid.*
22. Luttrell, *op. cit.*, p. 133.
23. Dale W. Adams, "Are Arguments for Cheap Agricultural Credit Sound?" Ch. 6 in *Undermining Rural Development with Cheap Credit*, Dale W. Adams, Douglas H. Graham, and J. D. Von Pische, eds. (Boulder, Colo.: Westview Press 1984), p. 75.

How to Solve the Debt Crisis

Christopher L. Culp

The world is in the midst of a debt crisis, though much of the U.S. financial sector has employed extensive rhetoric and artful accounting to avoid admitting it. The world first became aware that there was a problem when the Mexican government informed American banks in August 1982 that it was unable to pay the interest on its loans. By 1987, the problem had compounded. Peru had proclaimed that it would devote no more than ten percent of its total export earnings to interest payments, and several countries such as Bolivia and Brazil, in effect, had defaulted.

The U.S. financial sector greatly fears the word "default," so it employs tidy euphemisms such as "restructure" to avoid acknowledging that most debtors cannot repay their loans. American banks might do well to remember the proverb: If a bank loans out a thousand dollars and the debtor defaults, the debtor is in trouble; but if a bank lends a hundred million dollars and the debtor defaults, the bank is in trouble.

If a bank holds more liabilities than assets, there is a risk of bank insolvency precipitated by "confidence problems." When a debtor nation refuses to pay interest on a loan, it makes it impossible for the lending bank to balance its account. However, to avoid taking losses, banks have engaged in the deceptive process of manipulative accounting. If a debtor nation owes a bank \$50 million in interest and the country cannot pay it, rather than writing off the loan as unrecoverable, the bank lends the debtor \$50 million more to pay off its interest obligation. However, there is interest on that additional loan. Since the debtor could not make the interest payment in the first place, there is little reason to think that it will be able to pay the interest on the additional loan, much less the premium. The ensuing cycle is painfully obvious.

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Unsustainable Debt

Unsustainable debt seems to be the case more often than not in the Third World. This problem is magnified by the fact that most lending institutions within developing countries are plagued by problems of illiquidity and insolvency. This financial crisis causes a serious distortion in the incentive structure for the Third World financial sector, in many ways similar to the recent U.S. savings and loan debacle. Once a lending institution is insolvent, it is apt to take greater risks and make more questionable loans. This only aggravates concerns about bankruptcy or bank bailouts. Continued uncertainty inevitably leads to further financial crises as investors begin to doubt the ability of banks to provide liquidity.

Sir Alan A. Walters, former Economic Advisor to British Prime Minister Thatcher, describes this problem as "absolutely critical" because it makes the debt dilemma increasingly harder to solve as time goes on.¹ Furthermore, developing nations are typically becoming more heavily indebted without showing signs of significant capital growth. From 1982 to 1986, gross capital formation as a percent of GDP in heavily indebted countries dropped from 22.3 percent to 16.8 percent. At the same time, the debt-export ratios of these indebted countries rose from 269.8 to 337.9.²

As if the duplicity evident in the official balance sheets of many U.S. banks wasn't enough, the American financial sector has been recklessly irresponsible in its lending practices. Many banks have loaned far more than their equity. Consequently, when debtors cannot make their interest payments, such banks' liabilities will become greater than their assets. Their resulting insolvency will leave these banks unable to guarantee the assets of American investors. Enter the Federal Deposit Insurance Corporation, to rescue the failed banks. But what happens if, unlikely though it may seem, all the debtors default and their creditor banks become insolvent? The entire U.S. financial infrastructure is threatened.

Obviously, the U.S. financial sector wants to avoid this overly pessimistic scenario. Rather than face reality, though, American lending institutions simply resort to policy of dishonorable accounting to temporarily alleviate the imbalance between assets and liabilities. However, the banks are only fooling themselves. Creative bookkeeping may work in the short term, but the problem of increasingly unsustainable

loan exposure will continue, necessitating a solution at some point in the future when the problem is much greater.

Not all U.S. banks have perpetuated the illusion that all is well. John Reed of Citicorp decided in May 1987 to write-down his institution's Third World loans to their actual value and simply absorb the loss. He then increased Citicorp's debt-to-reserve ratio. Reed's actions were six years late in coming, but by June 1987, 43 of the 50 largest U.S. bank holding companies had engaged in similar measures.

Citibank took an important step in starting to pull the U.S. out of the debt crevasse, but its actions and the subsequent actions of other banks cannot solve the crisis. To avert a Third World debt "disaster," it is necessary to address the underlying issue of irresponsible lending *and* to stimulate growth in developing countries. While irresponsible lending is certainly a problem in the short term, it is the much greater problem of Third World underdevelopment that makes the debt crisis intractable under current systemic constraints. The most obvious solution to the crisis, then, is to facilitate development in less developed countries and improve their ability to repay their debt obligations.

The private sector not only provides a means of averting a short-term disaster, but addresses the far greater need of preventing future crises in lending. Three key measure will quell the financial storms and brighten the lending horizon: (1) securitization of outstanding U.S. loans; (2) implementation of debt/equity swaps with debtor nations; and (3) privatization of state-owned enterprises in developing countries.

Securitization of Debt

The first necessary step in allowing the free market to get the world out of the debt trap is to prevent reckless bankers, who are far more concerned about their corporate reputation than the integrity of the U.S. financial system, from continually "restructuring" outstanding, unrecoverable loans. In short, banks need to take their losses for what they are.

Simply because a country cannot pay back its entire loan does not mean that it cannot pay back a part of it. The task becomes one of establishing how much of the outstanding loan is irretrievable. This can be done easily by "securitizing" the loan, or selling it on the open market. In securitizing debt, a bank merely converts part of its loan

into bonds backed by outstanding debt. The primary function of this action is to establish a "market price for the debt." Securitization allows the market to facilitate bank actions such as Citibank's that determine the present value (in real dollars) of problem loans to the Third World.

Dollars loaned to different countries have different market values, depending on the specific country's ability to repay. For example, if a bank holds a \$2 billion loan to Argentina, it is very unlikely that it will ever get the full \$2 billion back. Rather than perpetuating the problem by allowing a banker to make additional loans to Argentina in order to sustain its ability to make interest payments, the bank can literally sell part of its outstanding debt by issuing bonds. By offering the sale of, for example, 1,000 bonds at \$100,000 each (5 percent of the total loan), the bank can effectively determine the current market value for the loan to Argentina.

If these bonds sell at \$50,000 each on the open market, then the market value of each dollar loaned to Argentina is at a 50 percent discount. Once this has been determined, the bank discounts its entire \$2 billion loan on the balance sheet to its market value, \$1 billion. The bank has lost \$1 billion rather than \$2 billion (still no small sum).

Since investors will buy the bonds at a price consistent with the ability of Argentina to repay the loan, the bank now has a loan that can be sustained and repaid by Argentina. Even though the bank has lost a considerable amount of money outright, it now holds a loan that can be repaid, rather than one that must continually be "restructured" or hidden by fictional accounting. There are a number of notable benefits to this process of securitizing loans.

First, it decreases (at least marginally) the risk of default by discounting the loan to a value that can be repaid by the debtor nation. Consequently, the total debt exposure of the nation is reduced.

Second, by selling debt bonds, the risks of default are spread among many investors. Investors will not buy debt bonds unless they see some potential for gain, so the transfer of risk is strictly voluntary. The risk of default is currently held nominally and involuntarily by the American taxpayers, in their support of FDIC guarantees. Securitizing a loan transfers those same risks currently financed by taxpayers to those investors willing to take them.

Third, securitization liquifies the assets of the bank's portfolio by creating convertibility on the secondary market. Furthermore, securiti-

zation gives the indebted country an opportunity literally to buy back its own debt at a discount.

Fourth, securitization restores "truth in accounting." It allows the banks to determine the real market value of debt, cut their losses outright, and consequently reduce the risk of long term insolvency.³

Debt/Equity Swaps

The second way that the private sector can eliminate the debt crisis concentrates not on lending practices, but on the borrower's ability to repay. Increasing the real rate of growth in a debtor nation means its debt can eventually become sustainable. Part of the problem in the current low growth rate of heavily indebted nations is the phenomenon of capital flight precipitated by low or negative rates of return on investments. When the return on an investment is particularly low in a developing nation, its citizens will invest their capital elsewhere.

For example, a bank in the U.S. makes a loan to the government of Argentina in order to foster development. The Argentine government dispenses the money to the private sector, but because the rate of return is so low, private investors merely place the money in U.S. banks. The result is that the government of Argentina owes money that it cannot repay to American banks, and the Argentine economy has nothing to show for it. The loan money, intended to develop Argentina, is sitting in U.S. banks, out of reach of both the Argentine government and its original U.S. lenders.

Until investment can be made profitable in developing nations, their rates of growth will not improve. Debt-for-equity swaps are an effective means of both facilitating growth and contributing to the reversal of capital flight. Such swaps involve the exchange of foreign debt for local equity and have numerous economic benefits.

The success of Chile in this area helps prove the efficacy of debt/equity swaps. In 1986, the market value of Chilean debt denominated in dollars was approximately 67 percent of its face value (i.e., it was trading on the secondary loan market at a 33 percent discount). However, its market value was approximately 92 percent of its original value when denominated in pesos, since most Chilean investors, unlike U.S. bankers, believed that the debt was sustainable.

Loans must be repaid to U.S. banks in dollars, but local equity is denominated in pesos. Consequently, in 1985 Chile changed some of

its foreign exchange regulations to encourage debt/equity swaps so that investors could take advantage of this opportunity for intermarket arbitrage (the purchase and sale of a security on two different markets for the purpose of capitalizing on price discrepancies between different exchange rates) and thereby improve the Chilean investment climate.

Johns Hopkins University economist Steve H. Hanke states that debt/equity swaps are "aimed at investors who wish to purchase external Chilean debt for the purpose of capitalizing it into investments in Chile."⁴ The prospect of converting foreign debt into local equity not only has attracted foreign investment to Chile, but it has stimulated the repatriation of Chilean flight capital. In two years, Chile reduced its debt obligation by four to five percent. As of November 1987, Chile had converted approximately \$1.2 billion in debt into local equity.⁵

Encouraging these swaps will enhance the development of capital markets in indebted countries. By increasing capital flows into an indebted nation, its growth rate will increase, eventually raising the rate of return. Debt/equity swaps are an excellent means of reducing the loan exposure of a debtor nation while also stimulating economic development.⁶

Privatization

A third means of decreasing the developing world's debt obligation is to reduce the size of the public sector in the economy of developing nations so as to stimulate growth and development. The elimination of state-owned enterprises in debtor nations will strengthen their economies by promoting the development of capital markets. Privatization also will decrease public sector expenditures and improve economic efficiency.

Presently, state-owned enterprises are characterized by insatiable demands for continuing subsidies, bloated payrolls, low employee performance, high costs of debt servicing, and underutilized capital.⁷ They typically allocate resources in a very inefficient manner and respond poorly to consumer demands. Transferring state-owned enterprises to the private sector not only will tend to eliminate negative cash flows, but also will stimulate growth by providing opportunities for debt/equity swaps and increasing the economy's productive efficiency.

Privatizing state-owned enterprises also promotes popular capital-

ism through wider share ownership. Furthermore, it strengthens existing capital markets in developing nations by making such markets more liquid. Indeed, privatizing by open stock sale can actually *create* capital markets where previously there were none. Capital market development promotes economic development because capital market liquidity narrows the gap between what a consumer offers to pay for a good and what a producer charges for it, known as the bid-ask spread. In nations without capital markets, it is often the case that particular goods cannot be sold because bids are so much lower than the prices asked, largely due to informational deficiencies in the economy. Liquid capital markets help alleviate this problem.

Privatization, by promoting a liquid capital market through wider share availability, facilitates economic growth and development. Furthermore, by increasing the role of the private sector and limiting state involvement, an important signal is sent to foreign lenders that efforts are being made to improve real domestic rates of return on investments. In this way, privatization promotes foreign investment and the repatriation of flight capital.

However, obstacles to privatizing state-owned enterprises come in many forms. Privatization is a very complicated process which requires economic liberalization to ensure competition, and the preservation of property rights to mitigate against the threat of expropriation. This is often difficult because of the political instability common in most heavily indebted nations. Many Third World leaders feel that a stronger private sector would jeopardize their political supremacy, and they consequently oppose privatization.

Although most political opposition to privatization is founded on misconceptions, disproving these misconceptions is often very difficult. The U.S. financial sector certainly has not helped matters. Because of its unwillingness to acknowledge *de facto* financial losses already incurred, American banks are allowing the developing world effectively to hold the U.S. financial system hostage. Reckless lending coupled with irresponsible use of loan money by Third World governments has led to an escalating problem, most of which is purely political: the Third World's unwillingness to compromise or liberalize, and the U.S. financial sector's unwillingness to use its better judgment in lending practices.

As Heritage Foundation's privatization expert Stuart Butler observes, "Privatization, like nationalization, is first and foremost a politi-

cal exercise.”⁸ A key step in privatizing state-owned enterprises is simply to convince politicians that privatization works. However, as long as the Third World meets with little or no opposition in its tactics of financial blackmail directed at the banking industry, its leaders have no reason even to bother with liberalization and privatization. To many of them, it is simply a risk that they do not have to take.

Deregulating the U.S. financial sector is a virtual necessity for the long-term elimination of the debt crisis. Banks have irresponsibly over-extended their equity and “fixed” their balance sheets primarily because the market does not hold them accountable for their actions. American lending institutions must be made responsible to economic realities. Instituting a system of “market to market” accounting and regularly evaluating the equity of banks can make them accountable to market risks. Under this system, if a bank becomes insolvent, it *immediately* will be closed, removing the need for the taxpayer-funded insurance system (the FDIC).

Any long-term solution to the debt crisis eventually requires accountability in finance. Securitizing debt enables the banks to determine the real value of their loans and to “cut their losses.” Upon cutting their losses, a new system of market to market accounting will ensure that banks no longer make loans they cannot guarantee. Securitization also allows investors voluntarily to assume part of the banks’ risk of loan default, thereby removing the burden from the unconsulted taxpayer.

Through securitization and financial sector deregulation, the banking system of the United States will be held accountable to the market. The long-term solution to the debt crisis then comes from stimulating growth and development within debtor nations. Through debt/equity swaps and the privatization of state-owned enterprises, capital market development is promoted. Then, the real rate of growth can be raised to make Third World debt sustainable.

The debt crisis can be solved. But until U.S. lending institutions decide to confront the crisis it will continue to escalate. Citibank and many others have made steps in the right direction. Indeed, it is true that most banks have markedly improved their loan portfolios in the last few years. But the current financial system could easily aggravate existing problems. Until the system is changed, recurrent crises in lending will continue to be an underlying threat.

1. Sir Alan A. Walters, before "Capital Markets and Development," part of the seminar series "Including the Excluded: Extending the Benefits of Development," sponsored by the Sequoia Institute, Washington, D.C., June 3, 1988.

2. The heavily indebted countries referred to in this data are Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

This data comes from the International Monetary Fund, *World Economic Outlook*, April 1987.

3. I am grateful to Sir Alan A. Walters for his insights on securitization. He is, however, blameless for the above views.

4. Steve H. Hanke, "Chilean Flight Capital Takes a Return Trip," *Wall Street Journal*, November 7, 1986.

5. Peter A. Thomas, "Debt Equity Swaps: A Review of an Underutilized Privatization Mechanism" (Washington, D.C.: Center for Privatization, November 1987), p. 3.

6. The positive effects of debt/equity swaps can, however, be lessened by the intervention of non-market forces. With the exception of Chile, all Latin American nations which have engaged in debt/equity swaps to date have witnessed government intervention in the process. Often, the host governments either inform investors which equity investments may be considered for conversion, or they approve each investment on a yes/no basis. In either case, the government has the final say in determining which equity investments are candidates for these swaps.

It should also be noted that, while government intervention in Chilean debt/equity swaps is much less pervasive than in other Latin American nations, the government does play an active role in the process. Internal conversions of debt to equity, for example, have restrictions on the total amount of debt that can be converted by investors, primarily to prevent massive expansion of the money supply.

7. "Why Privatize?" (Washington, D.C.: Center for Privatization), May 15, 1987, p. 6.

8. Stuart Butler, "How to Privatize the Postal Service," before the Cato Institute, April 7, 1988, p. 2.

Banking Without the “Too-Big-to-Fail” Doctrine

Richard M. Salsman

Since the failure of Continental Illinois in 1984, the U.S. government has pursued a deliberate policy of bailing out large commercial banks deemed “too-big-to-fail.”¹

The “too-big-to-fail” doctrine has arisen not simply because of the growing number of bank failures in the past decade, though indeed failures have increased. In fact, the doctrine’s historical origins go back much further than a decade. More than 40 years ago, a 1950 amendment to the Federal Deposit Insurance Act of 1934 introduced the “essentiality doctrine.” As codified, that doctrine states that in its sole discretion the government can rescue any failed bank when “continued operation of such bank is essential to provide adequate banking service in the community.”² None of the key terms in that provision—such as “essential,” “adequate,” or “community”—has ever been defined, permitting arbitrary discretion to rule. Coupled with the diminishing financial condition of banks in subsequent decades, the “essentiality doctrine” has given government wide latitude to bail out failed or failing banks for whatever reasons it deems necessary.

Of course, deposit insurance legislation itself arose out of the bank failures of the early 1930s. These failures in turn were largely the result of Federal Reserve monetary mismanagement.³ In short, today’s “too-big-to-fail” doctrine can trace its roots to the very establishment of central banking in this country in 1913. Before we examine the merits of the manner in which government has decided to handle bank failures, it is helpful to understand why banks are failing today in such large numbers to begin with.

The main theme of my own research on U.S. banking history has been that central banking is detrimental both to sound money and safe banking. In particular I have found that the U.S. commercial banking industry has suffered a secular decline in financial strength in the 80

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years since the Federal Reserve System was established in 1913. For example, capital ratios have fallen from 20 percent at the turn of the century to around 6 percent today. Banks are also far less liquid today than they were in earlier decades. The loan quality of banks has declined steadily over our central banking era. Profitability has been weak and irregular compared to the period before central banking. Finally, bank failures have been more a problem under central banking than under previous banking eras in U.S. history.⁴

To be sure, these measures of banking system strength have ebbed and flowed cyclically over the past eight decades—for example, the dissolution of the 1930s, the seeming calm of the 1950s, and the renewed turbulence of the past two decades. But in my own work, I've identified an undeniably pronounced secular decline in the financial condition of banks, in good times and bad. This leads me to question the legitimacy of central banking as such. I'm encouraged to find that other scholars are also questioning the conventional wisdom about central banking.⁵

I attribute the secular decline to central banking not only because that has been the predominant structure governing our money and banking system for most of this century, but because the main features of central banking bear directly on the worsening finances of the banks.

For example, central banking involves a legal tender monopoly on the production of paper currency, and to the extent this money is produced in excessive supply and forms the base of banking system deposit expansion, it inflates bank balance sheets and invites malinvestment of resources. Central banking is characterized by a lender of last resort function that can be seriously mismanaged, as it was in the 1930s, causing widespread bank failures. Central banking is usually accompanied by a system of flat-rate federal deposit insurance, a system known by all to promote excessive risk-taking and imprudence among banks.

It should not have taken decades to see this would happen. Back in 1908, when earlier versions of government deposit insurance were advanced, the president of the First National Bank of Chicago, James Forgan, asked the following: "Is there anything in the relations between banks and their customers to justify the proposition that in the banking business the good should be taxed for the bad; ability taxed to pay for incompetency; honesty taxed to pay for dishonesty; experience and training taxed to pay for the errors of inexperience and lack

of training; and knowledge taxed to pay for the mistakes of ignorance?"⁶

As I have argued elsewhere, "deposit insurance is a scheme put in place because the Federal Reserve mismanaged the discount window in the 1930s, and it is a scheme that has been expanded ever since in concert with the Fed's inflation of the money supply (which consists predominantly of bank demand deposits)."⁷

Finally, systems of central banking involve extensive regulation of bank branching, lending, and product offerings—regulations that prohibit sound diversification and invite still greater instability.

Unsafe and Unsound

If the purpose of central banking is to ensure sound money and safe banking, then central banking has been an unmitigated failure. I have already summarized the relative decline of banking's strength as captured in financial ratios. But the purchasing power of money has also declined, so that a 1913 dollar is worth ten times more than a 1992 dollar. We enjoyed much sounder money and safer banking in the eight decades before central banking was established here in 1913 than we have in the eight decades since. I conclude that this is so because central banking represents a special case of the general failure of central economic planning, a failure that most of the world is only now beginning to recognize.⁸

The fact that central banking flies in the face of free-market alternatives is recognized by some of its most prominent practitioners. In a symposium sponsored by the Federal Reserve Bank of Kansas City in August 1990, Paul Volcker noted that, "Central banks were not at the cutting edge of a market economy. . . . Central banking is almost entirely a phenomenon of the 20th century. . . . Central banks were looked upon and created as a means of financing the government. . . . If you say central banking is essential to a free market economy, I have to ask you about Hong Kong, which has no central bank at all in the absolute epitome of a free market economy. Yet it does quite well in terms of economic growth and stability."⁹

My research confirms Mr. Volcker's assessment. The primary purpose of central banking is to finance the government.¹⁰ That's what it does consistently and what it does best—and does so, unfortunately, at the expense of sound money and safe banking. Mr. Volcker would

find results in the U.S. similar to those of Hong Kong, as I did, by examining the decades before the Federal Reserve was established.

In the eight decades before 1913 we had a system which can very loosely be called “free banking and the gold standard.” There was no central bank, no lender of last resort, no federal deposit insurance. Banks issued currency as well as checking deposits, convertible into the precious metals. Bank note redemptions and the gold standard anchored the money supply. Excessive currency issuance was prevented. Money expanded and contracted with the needs of trade, not with the needs of government. Banks formed clearinghouses to settle balances and they lent on an inter-bank basis to temporarily illiquid but solvent institutions. The few banks that failed were absorbed into stronger ones or simply liquidated at a discount to noteholders.¹¹

The free banking era was not totally free, of course. Bank note issues were restricted by laws requiring currency to be backed by state or federal bonds—an indirect means of financing government. Branching was restricted as well, preventing full diversification. But the U.S. free banking era was more in line with a free market system of money and banking than our present era. As such, it should not be surprising that it produced relatively higher quality money and much safer banking. I document these facts in my book. For more background on the favorable history of the free banking era, I recommend the work of Arthur Rolnick and Warren Weber at the Federal Reserve Bank of Minneapolis.¹²

Only with this wider historical and theoretical context can we grasp the full implications of today’s “too-big-to-fail” doctrine. In my view, banking without the “too-big-to-fail” doctrine is not simply banking prior to 1984, the year when Todd Conover, Comptroller of the Currency, said the top 11 banks in the country would not be permitted to fail. For me, banking without “too-big-to-fail” is banking before 1913, the year when the Federal Reserve was established. For as I have indicated, the doctrine is inextricably linked with central banking. No free market system of money and banking would aim to sustain insolvent institutions, and there would be no institutional bias in favor of generating insolvent institutions, as central banking engenders. Free banking minimizes the spread of problem banks from the very start. No central bank monetary inflation or taxpayer deposit guarantees are employed to force-feed a free banking system.

Undermining the Financial Integrity of Banks

In two important respects, the "too-big-to-fail" doctrine represents an unhealthy extension of two central banking features that have already been shown to undermine the financial integrity of banks.

First, the "too-big-to-fail" doctrine has transformed the lender of last resort from one providing cash to temporarily illiquid banks to one providing extended credit to permanently insolvent banks. One of the first theorists of the lender of last resort function, Walter Bagehot, warned us that there would be times when a central bank couldn't effectively distinguish between illiquidity and insolvency.¹³ But in recent years the discount window has been thrown wide open to banks widely admitted to be insolvent. For example, a 1991 House Banking Committee report concluded that the central bank provided subsidized credit to hundreds of banks that ultimately failed. In six years ending May 1991, 530 of the 3000 banks that drew on the discount window failed within three years. Many more, if not outright failures, had the lowest financial performance ratings assigned by regulators.

Even as a provider of short-term liquidity, the lender of last resort offers a safety valve for banks that do not properly manage their liquidity positions. This subsidy for liquidity mismanagement has been in place for years. We were always assured that the Fed would manage access to the window with prudence and discretion. But now this mal-incentive has been extended still further to cover up the insolvency of banks. Perhaps even worse, access to the discount window was widened in the 1991 banking law to include the securities industry. More recently, there was talk among U.S., British, and Canadian central bankers of assisting real estate developer Olympia and York, on the grounds that its bad loans would harm big banks. There appears to be no end to the degeneration of the lender of last resort function.

Second, the "too-big-to-fail" doctrine has unwisely extended deposit insurance coverage from insured depositors to uninsured depositors and creditors. Government guarantees of insured deposits are bad enough in the way they promote reckless banking. The more than doubling of deposit coverage in 1980 institutionalized the recklessness. The extension of coverage to all creditors of banks, as under the "too-big-to-fail" doctrine, is the height of irresponsibility.

Nothing in the 1991 banking law removes the discretion of the

Fed or the Treasury in employing “too-big-to-fail” at any time for any purpose.¹⁴ To the extent the doctrine has not been employed as extensively in recent failures, it seems only because of the insolvency of the deposit insurance funds themselves. “Too-big-to-fail” is not a doctrine which can be effectively scaled back in isolation or in increments. Unless there is an outright rule against it, exceptions will always be made to expand it.

Bad as they already were, discount window activity and deposit insurance coverage have degenerated further in recent decades, in the name of the “too-big-to-fail” doctrine. We need to repeal the structural central banking features that generate failed banks, not simply patch on some extended version of these features, a patch job supposedly justified by pointing to all the failures. Accompanying the unconditional repeal of “too-big-to-fail” must be a scaling back and eventual abolition of federal deposit insurance and discount window lending as well. The sooner this occurs, the sooner banking will be restored to the health it enjoyed before these features were in place.¹⁵

The Fear of Contagious Bank Runs

Opponents of the repeal of the “too-big-to-fail” doctrine often cite the so-called “contagion” effect of bank failures, the domino effect of large bank failures precipitating other failures, allegedly cascading into a system-wide collapse.

In my estimation, no factor contributes more to this risk than government restrictions on branching. U.S. banking historians know all too well that widespread correspondent banking and extensive reliance on inter-bank deposits in this country stem directly from branching prohibitions.¹⁶ In nationwide banking systems, such as in Canada, inter-bank exposures are minimal.¹⁷ But in the U.S., the government has promoted an interlocking banking system, in effect requiring banks to line up like dominos, preventing them from holding their own direct deposits in their own chosen areas of the country. Having created such unstable links, government has then advanced a “too-big-to-fail” doctrine to prevent smaller banks from being harmed by losses on deposits at bigger banks.

Here is an obvious case of government interventions that have bred further intervention, allegedly to remedy the distortions brought about by still earlier interventions. Eugene White and others have

shown that U.S. banking history is replete with evidence of this vicious circle.¹⁸ There is only one solution to this madness, and that is to repeal the interventions across the board. Let's start by permitting what every advanced country permits of its own banks—the ability to branch freely and diversify their operations.

I will not repeat here in detail other important refutations of the so-called "contagion" argument, especially those made by economist George Kauffman.¹⁹ Suffice it to say, he argues that if some banks are weak, depositors will transfer their money to stronger ones. If they don't find stronger ones they will make a flight to quality and acquire government securities, the sellers of which must be confident of finding stronger banks, because in selling they expect to deposit the cash proceeds. In either of these cases, there is a redistribution of reserves, but no destruction of them. There is no deflation of the aggregate money supply and hence no contagion effect.

What if the strength of all banks is doubted by all parties? Then there will be a flight out of deposits into currency, a precipitous drop in the deposit/currency ratio so common to deflations. A loss of reserves could kick off a multiple contraction process that affects healthy banks as well as insolvent ones. But observe that such deflations are exacerbated by fractional reserve banking, and especially by very low fractions. Economists who recognize this potential problem tend to argue for some form of deposit insurance to contain it. I believe, to the contrary, that all government deposit insurance is de-stabilizing. I oppose it on principle, mindful of the fact that even limited forms of it soon grow into uncontrollable excess.

Furthermore, my own research indicates that bank liquidity is far lower—that is, reserve fractions are far lower—under central banking than under free banking. Hence a deposit contraction is potentially more severe when a central bank is in charge. More important, free banking offers a direct solution to the problem. A system of free banking permits private bank currency issuance, so banks can easily meet shifts in customer demand for currency relative to checking deposits. Such shifts are far less easily accommodated by a monopoly currency issuer which can misjudge and mismanage the shift, as did the Federal Reserve in the early 1930s.

On these grounds alone, I believe there is good reason to secure some end as well to the legal tender laws which grant a monopoly on currency issuance to the Federal Reserve. I have offered other reasons

for the repeal of the legal tender laws in my book. As the late Nobel Prize-winning economist Friedrich Hayek argued, we need “a denationalization of money,” and the kind of choice in currencies that brought us stable money and banking in the nineteenth century.²⁰ Parting somewhat from Hayek, I believe this free issuance of bank notes must also involve gold-convertibility, as note issue did during our better banking era.

A proper legal structure upholding property rights is also important. Free banking does not entail anarchy. Contracts must be enforced. The repeal of the “too-big-to-fail” doctrine will not be truly sustainable unless banks are fully subject to the general bankruptcy laws. No other industry is exempt from such laws, nor so harmed by the exemption.

Until and unless banks are subject to bankruptcy, we will continue to see failures handled according to politics and bureaucratic motives—such as agency “image”—not according to simple justice and sound economics. We will continue to witness swings from a regulatory policy of “forbearance” to a policy of “early intervention,” to forbearance, and back again. Both policies are detrimental to the banking system, and not only because of their unpredictable application from one case to the next or one year to the next.

Forbearance, as is known to all, promotes laxity in accounting and financial control, condoning, if not encouraging, recklessness, hiding insolvency, and ballooning ultimate losses. “Early intervention,” on the other hand, has its own dangers. While posing as a remedy for the ills of forbearance, a policy of early intervention actually holds out the very definite prospect of *de facto* nationalizations of the banks. After all, if banks with 2 percent capital ratios are to be closed down or taken over, as provided in the 1991 banking law, what else can such a policy be called but a nationalization, indeed a “taking,” under the Fifth Amendment? The recent nationalization of Crossland Savings Bank offers a chilling precedent for this disturbing new extension of the “too-big-to-fail” doctrine.²¹

If, instead, banks are subject to the bankruptcy laws, the competing interests of management and creditors, including the creditors who are depositors, will prevail. Closures of failed institutions will not be sudden but orderly. They’ll be drawn out in a rational manner, but not forever, as in the case of the thrifts or the Rhode Island credit unions. Neither will closures under bankruptcy take place prematurely, while

there remains value in the franchise. For a more detailed look at this approach, I commend to you the work of Robert Hetzel at the Federal Reserve Bank of Richmond.²²

In conclusion, I want to stress that the "too-big-to-fail" doctrine is part and parcel of a wider system of central banking that undermines the financial condition of the banking system. The sooner we phase out this system in favor of free banking and the rule of law, the better off we will be. In other words, repealing the "too-big-to-fail" doctrine will be a good start, but it won't go far enough in curing what really ails the banks.

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3. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States* (Princeton, N.J.: Princeton University Press, 1963), Chapter 7.

4. Richard M. Salsman, *Breaking the Banks: Central Banking Problems and Free Banking Solutions* (Great Barrington, Mass.: American Institute for Economic Research, 1990).

5. See especially Lawrence H. White's works, *Free Banking in Britain: Theory, Experience, and Debate, 1800-45* (Cambridge: Cambridge University Press, 1984) and *Competition and Currency: Essays on Free Banking and Money* (New York: New York University Press, 1989).

6. James B. Forgan, "Should National Bank Deposits Be Guaranteed by the Government?" Address to the Illinois Bankers' Association, June 11, 1908 (Chicago: First National Bank of Chicago).

7. Richard M. Salsman, *The Credit Crunch: Myth or Reality?* American Institute for Economic Research, October 1991.

8. Economists of the Austrian School of economics, especially Ludwig von Mises and Friedrich Hayek, have been identifying this failure for most of this century.

9. Paul Volcker, "The Role of Central Banks" in *Central Banking Issues in Emerging Market-Oriented Economies* (a symposium sponsored by the Federal Reserve Bank of Kansas City, August 23-25, 1990). Definitive historical evidence for Volcker's summary assessment can be found in Charles Goodhart's *The Evolution of Central Banks* (Cambridge: The MIT Press, 1988).

10. Salsman, *Breaking the Banks*, chapter 8.

11. Salsman, *ibid.*, chapter 6.

12. See especially Arthur J. Rolnick and Warren E. Weber, "Free Banking, Wildcat Banking, and Shinplasters." *Quarterly Review*, Federal Reserve Bank of Minneapolis, Fall 1982, pp. 10-19.

13. Walter Bagehot, *Lombard Street: A Description of the Money Market* (London: Kegan, Paul & Co., 1873).

14. See the misnamed Federal Deposit Insurance Corporation Improvement Act of 1991 (FIDICIA).

15. I have explained in detail how this might be accomplished in Chapter 9 of *Breaking the Banks*.

16. Walker Todd and James Thompson, "An Insider's View of the Political Economy

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17. Lawrence Kryzanowski and Gordon Roberts, "The Performance of the Canadian Banking System, 1920–1940," *Proceedings from a Conference on Bank Structure and Competition* (Chicago: Federal Reserve Bank of Chicago, May 1989), pp. 221–232.

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Toward a Cashless Society

Elizabeth Kolar

The financial system of today's world is the product of centuries of innovation. What began as a barter economy moved through various incarnations in response to the limitations inherent in the evolving systems. Changes will undoubtedly continue to occur in response to social and technological progress. Contemporary discussion of likely changes has focused increasingly on the possibility of a cashless society. The technology for such a society exists. However, the benefits of cashlessness are not yet perceived to outweigh the supposed disadvantages.

This article will discuss the progress toward cashlessness and its relevance to free banking. Free banking historically involved the issuance of bank notes that were redeemable for a "base" money such as gold or silver. Modern proponents of free banking such as Lawrence White have continued to think of it in these terms. White's colleague at the University of Georgia, George Selgin, has, on the other hand, envisioned a regime under which the existing (U.S. dollar) monetary base would be frozen, and banks could then issue notes that would be exchangeable for base dollars. Both writers apparently envision a society that will continue to use currency and coin as pervasive media of exchange.

A cashless society would mean, of course, the absence of currency and coin. Therefore, a cashless society could mean a barter society in which commodities were traded for commodities. However, barter would represent a major step backward. The cashless society envisioned and discussed herewith refers instead to the widespread application of computer technology in the financial system. Increasingly, funds are being transferred via "Electronic Funds Transfer Systems" (EFTS).

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The EFTS

As it became apparent that electronic banking was here to stay, Congress in 1974 established the National Commission on Electronic Fund Transfers. The commission studied the infant EFTS, and published its recommendations in 1977. The commission concluded that an EFTS developed in an "orderly" manner would be beneficial to consumers of financial services and suggested that such a system operate outside the public sector. The commission went on to state that "a national EFTS could be supported by as few as 225,000 on-line terminals installed in general merchandise stores."

As the commission completed its research, the Federal Reserve established "Fed Wire." Fed Wire is a nationwide electronic communications network that links the 12 Federal Reserve District Banks, all member commercial banks, and the U.S. Treasury. It represents a considerable investment on the part of the Federal Reserve, and has been interpreted by the member banks as Federal Reserve endorsement of a nationwide EFTS.

Transition to an EFTS involves overcoming structural barriers such as high start-up costs as well as the establishment of cooperation and communication among competing banks and retailers. In a sense, by the creation of Fed Wire, the Federal Reserve has provided not only an endorsement of EFTS, but a subsidy as well. Large institutions have capitalized on the Fed's investment, and smaller organizations must now subscribe to the changes in order to remain competitive.

An EFTS is made up of many components, the most widely known and accepted being Automated Teller Machines (ATMs). Additional integral elements are Automated Clearing Houses (ACHs) and Point of Sale terminals (POSS). As we shall see, the ACHs and POSSs, not ATMs, are probably the keys to further progress toward a cashless society.

Federal Reserve economist Michael Keeley has argued that "... trends in cash usage and holdings suggest that cold, hard cash is becoming an even more popular means of payment." He goes on to say that, "Since most ATMs use \$20 bills, it is interesting to note that the growth in volume of \$20 bills has been greater than that of other denominations since 1977—about the same time that the number of ATMs installed started to grow nationwide."

Federal Reserve reports on currency have shown a significant increase in the number of bills in circulation, and an increase in the average denomination being used; for example, the number of \$20 bills has increased faster than the number of \$10 bills. The number of checks being written and the average size of each check have also increased, but at much slower rates.

ATMs and POSs

Keeley uses such facts to support his view that a cashless society is "... far from reality." However, a provocative argument can be made that the transition to a cashless society involves an *increase* in cash usage prior to its disappearance for all but low-dollar and "discrete" transactions. Before the spread of ATMs, a greater percentage of retail transactions involved payment by check. Because of processing delays, checks present opportunities for buyers to make purchases prior to the receipt of the requisite funds in their accounts—i.e., there is a so-called "float." However, checks also involve a certain amount of time and inconvenience for the parties to a transaction. Before the spread of ATMs the most common method of obtaining cash was from tellers at bank branches. With the limited banking hours of the day and the associated long lines, it was far more common for consumers to endure the inconveniences associated with check writing than to visit a bank branch to obtain cash. ATMs made cash easier to obtain, however, and it increasingly became the preferred method of payment.

The use of POSs may displace the use of cash obtained from ATMs just as the use of ATM cash has displaced checks. POS use reduces many of the liabilities of cash. For example, crimes such as mugging and purse-snatching would decrease in the absence of cash, and the opportunity costs of cash would be eliminated insofar as a consumer's funds would always be in interest-bearing accounts.

The shift away from cash and toward POSs may be obscured for a time by the use of currency to engage in tax evasion or illegal activities such as drug dealing. Progress toward cashlessness may also be obscured by the use of U.S. dollar bills in the former Soviet Union and elsewhere. But as such areas stabilize and adopt more sophisticated technology, their payments practices will probably start to resemble those in the United States.

Transition Problems

The transition to a fully electronic transfer of funds system will not be impeded by households; through the use of debit cards they are already in the process of becoming comfortable with the advantages of EFTS. Rather, some of the parties engaging in high dollar transactions will provide resistance until the issue of float costs and benefits is resolved. Insofar as there are delays in processing checks, there is a float cost to the businesses getting paid. This cost is equivalent to a working capital expense for receivables. There is a corresponding benefit to payees who can continue earning interest until their checking accounts are finally debited. Elimination of this float would result in a significant redistribution of income among businesses, and this may explain some of the present resistance to EFTS conversion. The amount of interest earned via check float is now estimated to be between 40 and 50 billion dollars annually. Understandably, the recipients of this interest will resist its disappearance.

Canada has addressed the float issue by way of a banking industry and central bank accord that provides for same-day accounting of checks presented for payment. The float has been significantly reduced by the implementation of a retroactive interbank settlement process. This innovation has removed the float associated with the check clearing process, but not that which occurs when a payee holds a check for a period of time before processing it.

In order for the U.S. to overcome the barriers to an EFTS created by the float, it appears that voluntary conversion on the part of businesses, rather than regulation, is the answer. The U.S. Treasury has already reduced check use and shifted many government payments to electronic transfer. Among these are Social Security, federal payroll, and even large federal contract payments. It can be expected that the spread of electronic transfer practices will continue in the private sector as well, with the loss of float costs and benefits being considered in the terms on which parties are willing to do business with another.

Free Banking

The progress toward an EFTS could further complicate the Federal Reserve's attempts to manage the U.S. money supply. As economists are well aware, the public's demand for cash influences the quan-

tity of money in circulation. Perhaps more serious is the internationalization of money flows and the proliferation of new types of accounts. With electronic systems shifting funds from one type of account to another, and from one country to another, it has become difficult or perhaps impossible to say what "the" money supply is.

Part of the appeal of free banking is that it makes such issues moot. Financial institutions and customers could pursue their interests independently with their actions being coordinated by the invisible hand of the market. A cashless society would pose no special problems in this context. The twelve Federal Reserve District Banks could be privatized in the form of Automated Clearing Houses; the district bank stock to which member banks subscribe upon joining the Federal Reserve System could be converted into transferable shares in the ACHs. The newly privatized ACHs would presumably play a major role in interbank lending and reserve settlements.

In the case of either a gold-based or paper-dollar-based free banking system, base money could be kept at the ACHs, but it need not be. As long as all claims and settlements were continuously recorded, base money would only have to be available at ACHs or member banks to meet occasional customer requests.

In conclusion, the movement toward a cashless society is proceeding incrementally. Cash may continue to be useful for some time, especially for discrete transactions, but even these may become increasingly automated. Given the rapid growth in technology (e.g., pocket-sized cellular telephones), it is not difficult to imagine devices whereby even the most informal purchases could be automatically debited from the buyer's bank account.

EFTS is likely to have a profound and visible impact on everyday decision-making. Some of the more obvious benefits are reductions in financial transaction time and cost, and a reduced need for cash which would, in turn, decrease the amount of interest forgone. The opposition to a cashless society is likely to become increasingly silent as it is defeated by subtle economic pressures exerted by the federal government and financial industry giants; they continue to realize the benefits of the transition to an EFT system. As this transition continues, the issue of float is likely to fade as well.

While we may not see a completely cashless society in the immediate future, the foundation has been laid, and the available evidence indicates that we are indeed moving in that direction. The fate of the

Federal Reserve depends, of course, on political considerations, but the progress toward EFTS could ultimately prove to be a key factor leading to its replacement by free banking.

III. THE RETURN TO SOUND BANKING

Banking Without Regulation

Lawrence H. White

How well would the banking system work if there were no government regulation? One way to begin answering this question is to examine the historical record. In the nineteenth century many countries had relatively unregulated banking systems with few or none of the restrictions that face American banks today: legal barriers to new entry, deposit insurance, geographic and activity restrictions, reserve requirements, and protection of favored banks from failure. Because these systems were so different from today's, they throw valuable light on the possible consequences of completely deregulating banking in the future.

A useful source of historical information is the recently published volume entitled *The Experience of Free Banking*, edited by Kevin Dowd (London: Routledge, 1992). The book's contributors (of which I am one) investigate relatively unregulated banking systems in nine different countries during the nineteenth century: Australia, Canada, Colombia, China, France, Ireland, Scotland, Switzerland, and the United States. An overview chapter by Kurt Schuler shows that there were another fifty episodes that might also be investigated in detail. Fresh historical evidence, of the sort provided in this book, usefully complements the several other studies of free-market money and banking that have been published in recent years.¹

Three Lessons from History

What can we learn from historical episodes of relatively unregulated banking? I will try to summarize three main lessons concisely, without all the details, footnotes, and minor qualifications that might be mentioned. I hope my fellow academics will forgive me for breaching our professional etiquette in this way.

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First lesson: Unregulated banking does not cause inflation of the money supply or of prices.

Because reserve requirements constrain banks today, economists have sometimes feared that banks without reserve requirements will face no constraint against oversupplying checking deposits or banknotes. But the fear is historically groundless. A competitive market compels unregulated banks to fix the value of their deposit and note liabilities in terms of the economy's basic money, by offering redeemability at par (full face value) in basic money. In the past, the basic money was gold or silver coins. The "dollar" was originally a silver coin. To avoid embarrassment, in the absence of government protection, a bank could not issue too many liabilities in relation to its reserves of metallic money.

Under redeemability, the value of money falls (price inflation occurs) only when the supply of the economy's basic money grows faster than the real demand for basic money. Under the gold and silver standards of the nineteenth century, inflation of prices in any single year was minimal by modern standards. Over the long run of generations, price inflation was virtually zero.

Second lesson: Unregulated competition among banks does not destabilize the banking system.

Instability is often the fear of those who think that "free banking" laws in some parts of the antebellum United States led to irresponsible or "wildcat" banking. It turns out that "wildcat" banking is largely a myth. Although stories about crooked banking practices are entertaining—and for that reason have been repeated endlessly by textbooks—modern economic historians have found that there were in fact very few banks that fit any reasonable definition of "wildcat bank." For example, of 141 banks formed under the "free banking" law in Illinois between 1851 and 1861, *only one* meets the criteria of lasting less than a year, being set up specifically to profit from note issue, and operating from a remote location.²

The so-called "free banking" systems in a number of antebellum American states were actually among the most regulated of all the nineteenth-century systems of competitive note-issue. Instability was experienced in a few states, not due to wildcat banking, but due to state

regulations that inadvertently promoted instability. "Free banking" regulations in some states made it easier to commit fraud; in other states the regulations discouraged or prevented banks from properly diversifying their assets. Banking was more stable in the less regulated systems of Canada, Scotland, and New England.

How was stability possible in banking systems with neither deposit guarantees (nothing like FDIC insurance) nor a government lender of last resort (nothing like the Federal Reserve)? Depositors were more careful in choosing banks, and banks correspondingly, in order to attract cautious customers, had to be more careful in choosing their asset portfolios than banks are today in the presence of deposit guarantees and a lender of last resort. Banks did sometimes fail. But bank failures were almost never contagious, or prone to spread to sound banks, for several reasons. Each bank tried to maintain an identity distinct from its rivals, and was able to do so when it was not compelled by any regulation to hold a similar asset portfolio. Depositors then had no reason to infer from troubles at one bank that the next bank was in trouble. Banks were generally well capitalized, so that fear of insolvency was remote. In some cases banks had extra capital "off the balance sheet" in the sense that shareholders contractually bound themselves to dig into their own personal assets to repay depositors and noteholders in the event that the bank's assets were insufficient. Banks diversified their assets and liabilities well, being free of line-of-business and activity restrictions.

Banks were careful to avoid excessive exposure to other banks, which means that they minimized the risk of being stuck with uncollectible claims on other banks. Some degree of exposure is unavoidable in any system in which a bank accepts deposits from its customers in the form of checks written on, or notes issued by, certain other banks. A bank has exposure until it clears and settles those claims through the clearinghouse. Private clearinghouses, particularly in the late-nineteenth-century United States, lowered the risks of interbank exposure by making banks meet strict solvency and liquidity standards for clearinghouse membership. Clearinghouses were a vehicle by which reputable banks as a group voluntarily regulated themselves. Clearinghouse associations pioneered techniques for monitoring and enforcing solvency and liquidity, such as balance sheet reports and bank examinations. Clearinghouse associations also did some "last resort" lending to solvent member banks that were experiencing temporary liquidity

problems. The Federal Reserve System did not introduce but simply nationalized bank regulation and the lender-of-last-resort role.

Third lesson: Banking is not a natural monopoly.

Historical experience shows that there are some tendencies for larger banks to be more efficient, but not beyond a certain size. Nationally branched banks do tend to outcompete smaller banks in many areas of the banking business, but not in all areas. Banks must be large enough to diversify their assets and liabilities adequately, but this does not require being large relative to the entire banking market. Recent developments in the financial technologies of loan syndication and securitization may have reduced the size at which a bank becomes large enough in this respect. In this absence of government regulations that currently favor the largest banks, particularly the pursuit of the “too big to fail” doctrine by the Federal Reserve and the Federal Deposit Insurance Corporation, a stable and deregulated financial structure would result that would likely include both large and small banks.

1. Hans Sennholz, *Money and Freedom* (Spring Mills, Pa.: Libertarian Press, 1985); Kevin Dowd, *Private Money: The Path to Monetary Stability* (London: Institute of Economic Affairs, 1988); George A. Selgin, *The Theory of Free Banking* (Totowa, N.J.: Rowman and Littlefield, 1988); Kevin Dowd, *The State and the Monetary System* (New York: Philip Allan, 1989); David Glasner, *Free Banking and Monetary Reform* (Cambridge: Cambridge University Press, 1989); Lawrence H. White, *Competition and Currency* (New York: New York University Press, 1989); Richard Salsman, *Breaking the Banks: Central Banking Problems and Free Banking Solutions* (Great Barrington, Mass.: American Institute for Economic Research, 1990); Steven Horwitz, *Monetary Evolution, Free Banking, and Economic Order* (Boulder, Colo.: Westview Press, 1992).

2. This statistic, from a study by Andrew J. Economopoulos, is cited by Kevin Dowd, “U. S. Banking in the ‘Free Banking’ period,” in Dowd, ed., *The Experience of Free Banking* (London: Routledge, 1992), p. 218. Pioneering modern work on the U. S. experience with “free banking” laws, which is the source for the information in the next paragraph of the text, has been done by Hugh Rockoff and by Arthur J. Rolnick and Warren E. Weber.

Time to Abolish the Fed?

Elgin Groseclose

To propose that the time has come for abolition of the Federal Reserve System will appear novel, if not heretical, considering how most conservative inflation fighters regard it as the lever by which the careening wagon of inflation will be braked to a halt without jarring its occupants. Note, for instance, the reverence toward it in the Republican Party platform (that tactfully omits mention of the Reserve's responsibility for the bloated currency circulation). Note that the President vows to "respect the independence" of the System. Note finally the enormous new powers conferred upon the Reserve by a compliant Congress in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Yet it is this very legislation that will demonstrate the incapacity of the System to meet the continually widening responsibilities laid upon it and force re-examination of its *raison d'être*. For in a supposedly free market and private enterprise society it has become an economic Politbureau with authoritarian power for state planning and control of the economy approaching that of totalitarian governments. As with a Politbureau, its power has been concentrated in a Presidium (the Open Market Committee) of twelve persons (11 men, 1 woman) with terms of 14 years that isolate them from reality and make them independent of any influence from the elected government.

Baffling Rise in Interest Rates

If evidence were needed of the inability of this select company to make the profound decisions and judgments required to manage an economy so vast and complex as the U.S., one need only note the consternation in the market at the current surge in interest rates, "money supply," and unabated price rises, all contrary to the design

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of the policymakers. To many Fed watchers, the actions of the Presidency are like those of an amateur hijacker of a 747—pulling this lever and pushing that, now playing with federal funds rates, now with reserve ratios, now with meaningless concepts like M , M_1 , M_2 *ad infinitum*, meantime leaving the market lost in the wild blue, not knowing whether the economy is headed for a crash, or aboard a Voyager soaring toward an outer nebula.

Good men (and woman) though they may be, skilled no doubt in the intricacies of banking, it is doubtful if they are acquainted with the elementary composition of money which they are supposed to govern. (We will mention this later.) For that matter, the Federal Reserve System was never designed to deal with money but only with debt—bankers' debt. When the National Monetary Commission was set up in 1908 to devise a means of preventing credit crunches—"panics" such as that which struck Wall Street in 1907 and frightened the country, it produced some 24 volumes of reports on banking practices around the world and one thin volume on money itself that is less than a primer on the subject.

A Pawnshop for Indigent Banks

Actually what emerged in the Federal Reserve Act of 1913, and what has remained ever since, under a catalog of euphemisms trotted out every time a crisis arises, is a glorified pawnshop for indigent banks. That is, under the guise of a "flexible currency" for seasonal or sporadic needs, it allowed member banks to sell to the Fed qualifying debt instruments in exchange for cash.

There were certain safeguards, however, in the System as originally enacted. Thus, accommodation to banks was limited to advances collateralized by short-term commercial paper of not more than three months' maturity (six months for certain agricultural paper). Reserve banks could also buy short-term government bonds in the market. Cash meant gold coin, or depository receipts therefor, but Federal Reserve notes, redeemable in gold, were unfortunately authorized as legal tender up to $2\frac{1}{2}$ times the amount of gold held in reserve for their redemption.

These narrow limits were soon broken. To finance World War I, the powers of the Reserve were expanded to acquire vast quantities of

government debt, issuing its circulating notes therefor. In 1922 the Presidium began—tentatively at first—to use its powers in the direction of state planning of the economy, first to influence the price level, later the amount of debt the country could stand (the volume of bank loans) and eventually the level of employment. The Federal Reserve Act was heralded as an instrument that would end panics; despite the fact that within 20 years of its establishment the country was plunged into the worst financial debacle in its history, Congress and the public have continued to confide to the System more and more authority, climaxed with the Monetary Control Act of 1980.

New Inflationary Powers to Fed

This Act, in essence, brings every check-paying institution in the country under the authority of the Reserve, and requires them to maintain in Reserve banks such reserves as the Reserve authorities determine. Heralded as a measure to control inflation, its effects are the opposite. By concentrating reserves in Reserve banks, the System was furnished with enormous new lending powers. Yet it is all like playing with mirrors, for the Reserve, freed from any necessity to maintain gold in its vaults can increase bank reserves at will simply by buying government bonds in the market and paying for them by deposit credit or notes. Moreover, in exchange for greater supervision, the Act gave the check-paying institutions certain goodies in exchange. They can now hold their cups—or buckets—at the gushing fountain of Reserve credit. That is, under almost any conditions that the Reserve authorities determine under Regulation A banks can exchange their secured or unsecured debt obligations for the Reserve's legal tender currency. (Of course, since the Reserve notes are irredeemable, this is only an exchange of one frozen asset for another.)

Not only can banks obtain cash in this manner but the Act permits the Reserve to bail out corporations in trouble, even individuals in financial straits.

The capstone of the Act is the provision that allows the Reserve to bail out banks' holdings of frozen foreign securities—such as those of Poland and Turkey—so long as they are “guaranteed” by the government of the borrower.

Outdoing John Law

Thus, the Reserve enjoys a power greater than that of John Law, the eighteenth-century financial wizard who captivated France by his undertaking to “coin the soil of France.” The Reserve may now liquify the wealth—pardon, the debts—of the entire world.

Here, then, is the flood that no fiscal restraint can dam, no balanced budget prevent. While the Reserve authorities no doubt will hope to use these enormous powers sparingly, that is an idle hope. If the Reserve attempts to tighten its purse strings a howl from the market will rise so overpoweringly as not to be resisted. No power sitting in Washington with such a wand to convert debt into cash at the stroke of a pen will be able to resist a demand that it be used. If examples are needed, we need only look at New York City, the Franklin National Bank, the Chrysler Corporation. Others will follow.

If then the Federal Reserve were abolished, and its pawnshop functions transferred to, say, the Federal Deposit Insurance Corporation, what system of money regulation should follow? An answer to this question is that referred to earlier—an understanding of the essence of money. Contrary to fractional reserve and monetarist theory, that regards money as purchasing power from created debt, rather than a store of value, money consists of a substance and a principle: the substance may be anything from the great stones of Yap to such fragile items as tobacco, used in Colonial Virginia—but historically, gold or silver. The principle is that of integrity. This may be illustrated in the first commercial transaction of which we have account—the purchase of a field for a burial ground by the Patriarch Abraham from the Hittite Ephron for 400 shekels of silver, recorded in Genesis, which states that Abraham *weighed* the silver unto Ephron. (The shekel was a weight, never a coin.) The account does not explain who certified the accuracy of the scales or the fineness of the silver—it was unnecessary. Abraham was a man of integrity.

True Nature of Money

Later in history precious metal was struck in pieces of uniform size and fineness known as coins. This permitted trade to proceed by tale rather than weight. As certification of the weight and purity of the coinage the first mints were established in the temple and under the

aegis of the presiding deity and the coins bore the image or symbol of the deity. This was true in Athens, where drachma bore the image of the sacred owl. In Rome, where the mint was that of Juno Moneta (the Warner), the coinage was known as moneta.

When coinage passed from the temple to ruler, after Alexander the Great began to put his effigy on the coins, integrity gradually seeped away and coinage began to suffer debasement by clipping and alloy—so that coinage eventually lost its prestige as money. Nevertheless, throughout history to the present time money has always meant coinage, and is so meant in the U.S. Constitution.

Stable money will not return to the economy until money again means coinage and not spurious Federal Reserve notes.

The Loss of Integrity, Gold Contracts Repudiated

The second ingredient of money that of integrity or public credibility, was lost in 1934 when the paper circulation was made irredeemable when the government repudiated its gold contracts, when it violated the Constitutional prohibition against impairment of contract by annulling all private contracts for payment in coin, and finally when, again contrary to Constitutional provision, all privately held gold was sequestered without due process of law.

Restoration of public confidence requires first the restoration of free coinage, which means that anyone can bring metal to the mint and have it coined.

Free coinage is an English innovation in 1666 during the reign of Charles II. By opening the mints to the public, the government's monopoly of money that had been the historic practice since Roman times, was surrendered to the free market. So successful were the results in providing an abundance of circulating media that England in the succeeding centuries became the premier commercial power of Europe, and when the U.S. was founded, free coinage became the rule here until 1934.

Here is the great regulator of the “money supply”—the market. Worries about an adequate supply of money under such conditions are groundless, as experience with petroleum supplies has demonstrated once governmental controls are removed.

A second measure necessary to restore public confidence in the monetary system is a Constitutional amendment securing the elector-

ate in their private possession of monetary metal, by excluding such metal from seizure under government power of eminent domain. This would remove the fear of a second seizure as occurred in 1934.

A final necessity for restoration of confidence in the money is that of making explicit what is explicit in regard to the states but only by inference in regard to the federal government—namely a Constitutional amendment declaring that the federal government may declare as legal tender only gold and silver coin.

Banking Before the Federal Reserve: The U.S. and Canada Compared

Donald R. Wells

The recurring financial panics in the U.S. during the nineteenth and early twentieth centuries led Congress to establish the National Monetary Commission in 1908 to study the problem and recommend a solution. After several years of study and debate, Congress passed the Federal Reserve Act in December 1913. Even though the Federal Reserve did not prevent the Great Depression, and even though it has permitted substantial inflation since World War II, many observers still believe that some federal control over private banking is needed to prevent the bank suspensions and failures that brought such instability to the economy in the pre-1914 years.

The purpose of this paper is to show that it was only government interference into banking before 1914 that prevented the U.S. from having a stable monetary system. Restrictions on banknote issuance, severe limits on branching, and regulations forcing banks to hold useless, idle cash reserves made the American banking system vulnerable to panics while other nations, such as Canada, avoided these crises. It also will be shown that even though Canadian banks were allowed more freedom of action, the few restraints that did exist led the Canadian government to intervene further into banking to undo the harm that otherwise would not have existed.

U.S. Banking Before 1863

Only two quasi-governmental banks were allowed to establish interstate branches in this period, the First United States Bank (1791–1811) and the Second United States Bank (1816–1836). The federal government owned one-fifth of the capital of each bank, causing political resentments which resulted in neither bank's twenty-year charter being renewed.

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When the charter of the Second United States Bank was not renewed, all banks were either chartered by the various states, or given permission to operate without a charter under the so-called "free banking" laws. No banks were allowed to branch across state lines, and some states prohibited branching altogether. This prevented a natural system of nationwide clearinghouses from developing to exchange banknotes and later, deposits. Thus, when these banknotes ended up at great distances from their point of issue, they often fell to a discount. Banknote reporters tried to keep the public informed about the value of these various notes, but some fraudulent issuers were able to take advantage of the lapse of time until this information was disseminated.¹

Some banks, particularly in cities along the eastern seaboard, were able to maintain a stable value of their notes. The best known was the Suffolk system, which operated in the Boston area. The Suffolk Bank was able to keep smaller regional banks from overissuing by means of a clearinghouse. Banks that refused to join the Suffolk system had their notes collected and immediately presented for payment in specie; those that joined were able to count on their notes being received at par.

One problem with the so-called "free banks" was the requirement that they hold an amount of state bonds equal to the banknotes they issued. These bonds often proved to be an illiquid investment for the banks, preventing them from holding the desired amount of specie to redeem their notes on demand. Since this requirement usually specified par rather than market value of the bonds, these securities in many cases were an inadequate protection for the noteholder.² Six states attempted to ease public fears about irredeemable banknotes by establishing a note guarantee system³—which might not have been necessary had banks been free to branch and to hold the type of assets they preferred.

The National Banking System

Two of the methods used to finance the Civil War involved money manipulation. One was the issuance of a fiat currency (greenbacks) which was given legal tender status, and the second was the establishment of the National Banking System as a convenient place to sell low-interest bonds. The war led to the federalization of the U.S. currency because national banks were the only issuers of banknotes after

Congress taxed the state banknotes out of existence. These new, uniform national banknotes were almost a government currency because they were printed by the Bureau of Engraving and the banks were forced to hold \$100 of these 2 percent government bonds for each \$90 of notes they issued.

This system proved to be no improvement over pre-Civil War banking; it was just as prone to panics and to suspension of cash payments. The three main weaknesses of this new system, which were avoided in Canada, were: lack of branching, forced holding of a specific cash reserve, and a government bond-backed banknote. These governmentally imposed restrictions put the U.S. banking system in a strait jacket, making it vulnerable to shocks.

All national banks were forced to be unit banks except for those state banks that converted to a national charter were allowed to retain their intrastate branches. Nationwide branching would have been more stable and efficient, permitting safer bank portfolios through geographical and industrial asset diversification. Unit banks in farm states were at a special disadvantage during agricultural depressions, whereas Canadian banks could carry a non-performing loan to a farmer much more easily.⁴ Branch banks can be opened more easily in new areas without the trouble of acquiring a new charter and establishing a separate board of directors.⁵ In addition, branch banks can move reserves to where they are needed more quickly, and at lower cost, since they are held within the same institution and no other bank need profit on the transfer of these funds.⁶

Secondly, national banks were forced to hold a fixed cash reserve against their deposit liabilities, even though any reserve that must be held is no reserve at all, since it cannot be used. The law mandated that country banks hold two fifths of their 15 percent reserve in vault cash while the rest could be on deposit in a reserve city bank. These reserve city banks were required to hold half of their 25 percent reserve in vault cash while the other half could be deposited in a central reserve city bank in New York, and after 1887, Chicago or St. Louis. The latter banks were forced to hold all their 25 percent reserve in vault cash, which meant gold, greenbacks or other treasury currency. Only state-chartered banks could count national banknotes as part of their reserve.

Since banks could not use these required reserves, they had to carry an excess amount in order to operate; in a crisis, banks often had to

suspend cash payments precipitating financial panics. The pyramiding of reserves in a unit bank system aggravated the problem. When faced with an increased demand for cash, each bank had to think of itself first and would pull its deposits from its correspondents. By contrast, each Canadian bank held its own reserve in whatever amount it felt adequate, with the one provision that government-issued Dominion notes had to consist of 40 percent of whatever cash reserve the bank chose to hold.⁷ The pyramiding of reserves in the U.S. made American bank runs contagious; in Canada, a bank failure did not cause the public to distrust other banks.

The third restriction on national bank behavior that weakened the system was the requirement that each bank deposit with the Comptroller of the Currency \$100 worth of 2 percent government bonds for each \$90 of banknotes they issued. (In 1900, banks were permitted to issue notes equal to the amount of bonds deposited.) Since these notes were printed by the Bureau of Engraving and were uniform in appearance, they were received and paid out by banks throughout the country. This system failed to test the ability of each bank to redeem its own notes as did the Canadian system with its distinctive banknotes.⁸ Yet underissuance rather than overissuance was the problem with national banknotes because of the government bond restriction.

Liquidity Crises

The value of these special bonds, rather than the demand for banknotes, became the constraint on banknote issuance. Some national banks never issued notes at all while others charged higher interest rates to borrowers who demanded loan proceeds in banknotes instead of deposits. The reduction of the federal debt in the 1880s intensified the problem as evidenced by a decrease in banknotes outstanding from \$325 million in 1880 to \$123 million at the end of 1890.⁹ This underissuance of banknotes led to several liquidity crises which only U.S. banks suffered because they could not exchange one liability for another—banknotes for deposits—as the public demanded. Instead, they had to pay out legal tender cash from their assets, thus depleting their reserves, which often led to suspension of cash payments.

By contrast, Canadian banks have not suspended cash payments since the late 1830s. All banks were allowed to issue their own distinc-

tive banknotes without holding a legally mandated asset to back them. These notes were subjected to the daily market test of public acceptance as each bank sought to get its own notes into circulation while simultaneously driving home rival notes to their respective issuers through note exchanges. Furthermore, these banknotes were an inexpensive till money because they were not a liability until issued.¹⁰ This reduced the cost of establishing branches in newly developed areas.

Canadian banknotes also had excellent elasticity, expanding and contracting as the demand for them changed. This was especially evident during the autumn when crops were moving to market and the demand for banknotes sometimes increased as much as 42 percent of the yearly minimum.¹¹ During the Panic of 1907, some Canadian banknotes even circulated in parts of the U.S. after American banks suspended cash payments.¹²

The only government restriction on the issuance of Canadian banknotes was an unnecessary one that proved to be harmful in the early 20th century. No bank was permitted to issue notes in excess of its paid-in capital, which excluded the surplus account. When passed in 1871, no bank had approached that limit, but by 1908, some had. But instead of removing this unnecessary restriction, Parliament passed a special law that year permitting banks to issue notes to an amount 15 percent over their combined capital and surplus accounts during the crop moving season if banks paid a 5 percent tax on this excess issue. Banks obviously disliked this tax so in 1913, Parliament passed an other law which allowed banks to avoid the tax if their excess issue were fully backed by deposit of gold in the newly created Central Gold Reserve in Montreal.¹³ Banks in Canada had only about a year's experience operating under these new provisions before World War I broke out which saw the Canadian government undertake inflationary wartime measures, such as suspending the gold standard and permitting banks to borrow fiat base money from the Minister of Finance.

Emergency Currency: The Illegal Clearinghouse Loan Certificate

In times of crisis when U.S. national banks were forced to suspend cash payments, these banks cooperated through their respective clearinghouses to issue a free market money which, though illegal, worked quite well in preventing the contagious runs that were to implode the whole system in the early 1930s. The clearinghouse allowed unit banks

to put up a united front in times of panic by marshaling the resources of all the members, thereby stretching the scarce supply of currency. The clearinghouse would authorize the issuance of loan certificates which banks with deficits could use instead of regular currency to settle their balances after these banks pledged acceptable securities as collateral. Banks holding surpluses accepted these loan certificates as payment to earn the 6 percent, interest that was paid on them.¹⁴ If a deficit bank failed and the collateral was insufficient to cover the loan certificates, the members of the clearinghouse had to share the loss.

During the Panics of 1893 and 1907, clearinghouses used small denomination certificates for hand-to-hand currency in addition to large denominations to settle their balances.¹⁵ The public obviously preferred legal currency to these small certificates as evidenced by the fact that the makeshift currency usually fell to a discount until suspension of cash payments ended.¹⁶ Yet these free market arrangements mitigated each panic by preventing the fractional reserve collapse that was to occur after the Federal Reserve was in operation. On the other hand, it is possible that these crises would not have occurred at all if U.S. banks had been allowed to issue banknotes without restrictions, to branch where they wanted, and not made to hold a useless cash reserve.

Emergency Currency: The Legal Aldrich-Vreeland Banknote

In the aftermath of the Panic of 1907, Congress passed the Aldrich-Vreeland Act of 1908 which authorized national banks to issue a legal emergency currency until a permanent solution could be found. This law, which was to expire on July 1, 1914, attempted to overcome two of the three shortcomings of the national bank system: the lack of branching and the rigid restrictions on issuance of banknotes. Any ten or more national banks with an aggregate capital of at least \$5 million could form a national currency association to issue notes backed by commercial paper or other securities, rather than just the 2 percent government bonds to which banks had been restricted. These new banknotes, for which all banks in the association would be liable, could not exceed 75 percent of the market value of the securities backing them and, in addition, could not be issued until the banks in the association had regular government bond-backed banknotes outstanding equal to 40 percent of their capital stock. Con-

gress further imposed a 5 percent tax on this emergency currency for the first month of its circulation and this tax was to increase by one percentage point a month until it reached a maximum of 10 percent.¹⁷

Even though 21 national currency associations were formed during the next six years, no emergency currency was issued, either because the tax was considered to be excessive, or no occasion warranted it. Congress passed the Federal Reserve Act on December 23, 1913, but the new System did not begin operating until November 16, 1914. However, the Federal Reserve Act extended the provisions of the Aldrich-Vreeland Act for one year, until July 1, 1915. Ironically, had it not been extended, the Act would have expired before the need to use it arose. Congress also reduced the tax on the emergency currency to 3 percent for the first 3 months it was outstanding, after which the tax was to rise by half a point each month until a maximum of 6 percent was reached.¹⁸

The occasion for using the new currency was the crisis following the outbreak of World War I in August 1914. Foreign holders of American securities tried to liquidate them for gold, and depositors tried to convert their deposits into currency, both of which put extreme pressure on bank reserves.¹⁹ Before banks could issue the new currency on demand, however, Congress had to repeal the restriction that banks could only issue it if they had bond-backed banknotes outstanding equal to 40 percent of their capital. Congress responded quickly, even increasing the aggregate amount of notes that could be issued.²⁰

For the first time national banks could issue banknotes for deposits on public demand, thereby preventing suspension of cash payments which were so characteristic of past American crises. Even though only 1,363 of the 2,197 banks in the 45 currency associations in existence at that time actually issued the emergency currency, it was the immediate response to public demand that prevented the panic.²¹ Only \$386.4 million was taken out during the emergency that lasted into the spring of 1915, but \$368.6 million, or 95 percent of the total, was issued by the peak period in October.²² By the first week of January, 60 percent had been retired; the remainder was retired by the end of June, except for \$200,000 in a failed bank.²³

Less than a fourth of the legal maximum was ever issued, with banks in New York City taking out 37.5 percent of the total; these banks were the first to issue the currency and the first to retire any and

all of it.²⁴ This Act allowed national banks to act as Canadian banks would under stress, issuing banknotes as demanded and saving their gold and treasury currency for use as a reserve. State chartered, banks could use the emergency currency as part of their reserves, but as often happens, once they realized this currency was readily available, they, along with the general public, stopped demanding it. Much of the emergency currency sent to the interior was later returned to New York in its original wrappings.²⁵

Conclusion

From hindsight we know that both legal and illegal emergency currency outperformed the Federal Reserve during the credit implosion of the early 1930s. Banks can respond to market forces if they are allowed to issue banknotes, which are an "inside money" just as are deposits, but they cannot issue "outside" Federal Reserve Notes. When the public found out that currency was not available, they demanded it all the more, precipitating the fractional reserve collapse during the depression. The problems of pre-1914 banking in the U.S. involved too many government restrictions, not too few. Politicians may have believed that private banking was unstable, but had they looked to the Canadian model as a guide, they could have concluded that market forces can give us a successful banking and monetary system just as it provides us with food, clothing, and other necessities.

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Privatize Deposit Insurance

Jeffrey Rogers Hummel

Amidst all the groping and furor over the savings and loan crisis, no public official has pointed a finger at the ultimate culprit. The Bush Administration admits that the nation's ailing S&L industry will cost the government at least \$90 billion. That would be the most expensive bailout in U.S. history—bigger than those for Lockheed, Chrysler, New York City, and Western Europe (through the Marshall Plan) combined, even after adjusting for inflation. But contrary to popular perceptions, the crisis stems not from too little regulation, but too much. It all can be traced to the perverse influence of government deposit insurance.

The federal government first insured deposits in reaction to the Great Depression. A scramble for currency among depositors had led to runs on nearly 10,000 banks. This liquidity crunch forced otherwise solvent institutions into emergency sales of their assets. Unnecessary bank failures, a one-third collapse in the money supply, and deflation were the result. To protect the economy from future panics, the newly established Federal Deposit Insurance Corporation (FDIC) guaranteed small depositors against any losses.

Comparisons with other countries now suggest that the regulations already existing in the 1920s were responsible for the precariousness of the American banking system. Canada, for example, permitted its commercial banks to open branches nationwide and had yet to set up a central bank. Not one Canadian bank failed during the Great Depression.

However plausible the justification of deposit insurance for U.S. commercial banks, it certainly did not apply to savings and loan associations. Unlike banks, S&L's at that time didn't offer checking accounts or any other deposit that served as a medium of exchange, nor were they plagued by runs. Yet S&L's got similar guarantees with the

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establishment of the Federal Savings and Loan Insurance Corporation (FSLIC) in 1934.

Government deposit insurance may have dampened the danger of bank runs, but only at the cost of incurring another danger. Private insurance companies have long been aware of what is called "moral hazard." If you protect someone from the painful consequences of risk, he will have less incentive to avoid risky actions. Insurance against fire or automobile accidents thus can be so complete that it fosters carelessness and leads to more fires and accidents.

One way insurance companies get around the moral-hazard problem is with a deductible, which makes the insured bear some of the cost of risky actions. Private insurance companies also vary premiums according to actual risks; otherwise they lose money. Government deposit insurance, in contrast, ignores these sound principles. It therefore subsidizes risk-taking by depository institutions. They pay the same premium regardless, and their depositors have no financial reason to impose market discipline by doing business elsewhere.

Not until the 1980s, however, did this moral-hazard time bomb explode. Pervasive government regulation protected banks and S&L's from competition while simultaneously restricting their portfolios to safe assets. Only after the inflation and climbing interest rates of the 1970s required these institutions to bid actively for deposits did the government initiate financial deregulation. Unfortunately, deregulation did not go far enough. By leaving deposit insurance untouched (except to raise coverage), it rewarded the managers of banks and S&L's who gambled with their depositors' money. All the colorful headlines about cowboy bankers and corporate swindlers overlook the way that the regulatory environment distorts the normal market curbs against such behavior.

Government favoritism for insolvent banks and S&L's aggravates the crisis. If the FDIC and FSLIC were truly interested in protecting the small depositor, they would close insolvent institutions and pay off the depositors directly. Instead, they usually arrange purchase and assumption agreements that merge failed institutions with healthy ones. Big depositors are protected as well as small in a short-term solution that merely compounds long-term difficulties.

The crisis has reached such epic proportions among S&L's that the FSLIC no longer has enough resources even to arrange bailout mergers. Growing numbers of bankrupt institutions continue to compete

with sound S&L's, driving the interest paid to depositors still higher. Genie Short and Jeffrey Gunther of the Federal Reserve Bank of Dallas point out in a recent study that "such policies penalize the more conservatively managed institutions over the more aggressive ones."

Indeed, no regulatory sleight of hand can magically transform bad loans into good. Without enough income from these loans, the failed but still operating "zombie" institutions can pay interest to their current depositors only with money from new depositors. The regulators thereby sanction an escalating chain letter that makes the final accounting ever more expensive. When they take over an S&L themselves, the regulators still are powerless to do anything else without outside funds.

None of the Administration's proposals address the root cause. Attempting to re-regulate the S&L industry by imposing, for instance, higher capital requirements, will simply destroy it. Market forces already are unleashed. The competitive survival of banks and S&L's compelled financial deregulation. The regulatory haven that gave banks and S&L's a tidy market-sharing arrangement cannot be reconstructed.

If Congress increases insurance premiums, the sound institutions will be the ones to pay. This will further punish the very kind of management that should be encouraged. Nor can government ever adequately administer variable premiums. "A rational system of risk-based insurance premiums offered monopolistically by a public agency is simply impossible," argues Gerald O'Driscoll of the Federal Reserve Bank of Dallas. Without the feedback of profit and loss, bureaucrats have neither the information nor the incentive for matching premiums to risk.

And foisting the cleanup bill on the taxpayer is not merely unjust but also tempts politicians and bureaucrats to try the same scam again. How much longer will the taxpayer be expected to cough up the cash for the government's self-serving and disingenuous pledges? How much higher will the price tag have to soar? Unfortunately, some undeserving group must take the hit for the irretrievable S&L losses, but the depositors at least voluntarily assumed a risk when they accepted fabulous political promises at face value. If the depositors want compensation, let them turn not to the much-abused and long-suffering taxpayer but to the managers of the failed S&L's, perhaps to the sale of government assets, and ultimately to the personal liability of the politicians and bureaucrats who perpetrated this outrage.

Only one solution can overcome moral hazards in the banking and thrift industries: private deposit insurance. The government must dissolve the FDIC and FSLIC and remove all remaining regulations upon depository institutions. The first step would permit the competitive forces of the market to arrange actuarially sound insurance that protects depositors without subsidizing insolvency. The second step would help depository institutions gain the geographical and asset diversity necessary to shore up liquidity during runs.

The S&L crisis is just the tip of the moral-hazard iceberg. Although not yet visible, deposit insurance creates the same perverse incentives for commercial banks. The FDIC already rates 10 percent of these institutions in the problem bank category, within an industry with \$2 trillion worth of deposits. Unless deregulation proceeds to the privatization of deposit insurance, the nation soon faces a larger crisis throughout the banking industry.

Deposit Insurance Déjà Vu

Kurt Schuler

The mess in the savings and loan industry is the worst thing to happen to the American banking system since the Great Depression. As an indication of how severe the problem is, government estimates of the cost of bailing out bankrupt savings and loans, which were \$30 billion a few months ago, rose to \$60 billion, then to \$160 billion. And the cost is rising by \$1 billion for every month that the federal government lets 350 bankrupt savings and loans stay open because it hasn't budgeted the money to pay off their depositors.

American taxpayers will be footing the bill for this because the federal government guarantees almost all bank deposits. The rationale of deposit insurance is that it is cheaper than the banking panics that supposedly would result without it. But the history of deposit insurance in the United States and other countries indicates that it is neither necessary nor desirable. Outside the United States, deposit insurance, even where it exists, has not been needed. Competition has forced foreign banks to develop nationwide branch networks and to diversify into lines of business forbidden to American banks. This has resulted in the creation of large banks that are very secure because they spread their risks among many regions and types of activity.

In the United States, deposit insurance has been rarely self-financing because government regulation has prevented competition from evolving the strongest banks possible. Indeed, deposit insurance crises are almost as old as deposit insurance itself. The Federal Savings and Loan Insurance Corporation's current problems have many precedents. Besides federal deposit insurance, the United States has had about 30 state deposit insurance schemes. Nearly half operated before the Great Depression, and half since. Their experience has been dreadful. All but a few have gone broke. A brief look at their history shows what we can expect again if Congress doesn't use the current federal

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bailout as an opportunity to free our financial system from the stranglehold of regulation.

New York State started the first deposit insurance system in 1829. Banks paid a tax of 3 percent of their capital into a common "safety fund." New York City banks, which were among the largest and most stable in the nation, opposed the fund. However, the more numerous rural banks influenced the state legislature to establish it. The safety fund's purpose was to instill public confidence in banknotes, although it also covered deposits. (Apparently, the legislature did not intend deposits to be covered, but they were because the law it enacted was careless on that point.) The safety fund benefited rural banks most, because their profits depended more on note circulation. Five other states imitated New York in setting up compulsory bank insurance systems before the Civil War.

The first to fail was Michigan's. It had been in operation only a year when the panic of 1837 dragged down most of the state's banks. Payments into Michigan's insurance fund barely covered supervisory costs, so creditors of failed banks got nothing. A few years later, 11 bank failures depleted the New York fund. The state government eventually issued bonds to bail it out, much as the Bush administration has proposed doing for the FSLIC. But some creditors waited as long as 21 years for payment. A single failure was enough to bankrupt Vermont's fund in 1857. Creditors there got less than two-thirds the value of their claims.

Michigan, New York, and Vermont effectively closed their insurance funds when the funds went broke. Indiana, Ohio, and Iowa had funds that stayed solvent. Oddly, the solvent funds had more potential for causing trouble than the others. Healthy banks were liable for paying failed banks' creditors if the insurance funds should be exhausted. Hence, severe losses at a few banks could have wiped out all banks in the state. However, strong industry pressure counteracted the temptation, in effect, to play fast and loose with other banks' capital.

In contrast to the systems that went broke, where bank examiners were government employees, in the solvent systems examiners were largely chosen by and responsible to the banks. The number of banks was small—41 in Ohio, 20 in Indiana, and 15 in Iowa. That made group action against imprudent banks possible. Today, when federal deposit insurance covers thousands of banks, savings and loans, and credit unions, this element of the successful state systems would be

impossible to duplicate. Ohio and Iowa also reduced the risk to their funds by guaranteeing only notes, which were being eclipsed by deposits as the chief type of bank liability.¹

By 1866, changes in federal banking law induced most banks to switch from state charters to federal charters. Despite a federal prohibition on branch banking, federal charters were attractive because they allowed banks to continue issuing notes. State-chartered banks, in contrast, faced a 10 percent tax on note issue that made it prohibitively expensive. The Indiana, Ohio, and Iowa insurance funds closed still solvent when their members got federal charters. The savings and loan industry began in earnest at the same time, as a product of a provision in the same law that severely restricted federally chartered banks' ability to make mortgages. (These restrictions lasted until the 1970s. Since then, most of the other legal barriers separating banks from savings and loans have fallen as well.)

Bank notes effectively carried a federal guarantee from the 1860s until Federal Reserve notes replaced the last of them in 1934. Issuers had to back notes 100 percent or even 110 percent with Treasury bonds, kept in a Treasury vault. But notes were becoming decreasingly important compared to deposits as the main form in which almost everybody held money.

“Honesty Taxed to Pay for Dishonesty . . .”

The federal government did not insure deposits, despite many proposals in Congress from 1886 onward that it do so. William Jennings Bryan and other populist politicians favored deposit insurance as a way of protecting small depositors and small banks. Leading bankers thought differently. Near the turn of the century, the First National Bank of Chicago's president expressed bankers' objections to deposit insurance in these words: “Is there anything in the relations existing between banks and their customers to justify the proposition that in the banking business the good should be taxed to pay for the bad; ability taxed to pay for incompetency; honesty taxed to pay for dishonesty; experience and training taxed to pay for the errors of inexperience and lack of training; and knowledge taxed to pay for the mistakes of ignorance?”²

Such arguments deterred the federal government from insuring

deposits, but not some states. Oklahoma established deposit insurance in 1908. Seven southern and western states followed suit within the next decade. Their systems insured from 100 to 1,000 banks apiece.

Washington's, the last started, was the first to crack. The depression of 1921 depleted its insurance fund. Since the system was voluntary, many healthy banks deserted it rather than suffer the high fees it would have imposed, and it shut down. The same happened to the other voluntary fund, in Kansas. In the other states, where deposit insurance was compulsory for state-chartered banks, low crop prices throughout the 1920s broke many rural banks, leaving depositors clamoring for their money. By 1930, all the funds were bankrupt. Texas's system eventually paid off depositors in full, but elsewhere depositors lost at least 15 percent of their claims. The North Dakota fund, the worst of the lot, paid only \$1 of every \$1,000 in claims, and even after a tax-financed bailout, depositors lost three-quarters of their money.³

Despite the unfavorable experience of the state deposit insurance systems, the federal government established nationwide deposit insurance in 1934. The failure of nearly 10,000 banks since the Great Depression had begun in 1929 put pressure on the federal government to do something. Many prominent economists and bankers advocated branch banking as the best cure for the American banking system's instability. They pointed to foreign systems that allowed branch banking, where failures had been few. In particular, they saw Canada, where no banks failed during the Depression, as a model for the United States to emulate.

However, the political clout of small banks and the worse than usual public image that big business had at the time kept branch banking from getting political consideration commensurate with its economic merits. Federal deposit insurance, once established, seemed to stabilize the banking system. The banking panic of 1933 was responsible for much of the good reputation that federal deposit insurance enjoyed. It wiped out the weak banks that would have put the greatest strain on federal insurance funds had they begun in 1933 instead of 1934, when the panic was over.

Since 1934, 14 states have chartered deposit insurance systems for certain banks and savings and loans not covered by federal insurance. Though nominally private, most state insurance systems have been so

enmeshed in local politics as to be in reality off-budget government agencies designed to shelter members from the rigors of competition. Their history has been as blighted as that of their predecessors.

New York and Connecticut closed relatively short-lived funds intact decades ago when their members voluntarily switched to federal insurance. Funds have failed in half of the remaining states—Hawaii, Nebraska, Ohio, Maryland, Colorado, and Utah. The 1985 Ohio and Maryland failures required millions in tax money to pay depositors in full. The aftershocks prompted most states with solvent insurance systems to require all participants to switch to federal insurance by 1990. Only three funds still offer insurance for banks lacking federal coverage. One, in Kansas, is winding down as its members leave it. The others, in Pennsylvania, cover just a handful of tiny banks. State deposit insurance is in effect dead.⁴

Success in Massachusetts and North Carolina

The only truly successful state funds were those of North Carolina and Massachusetts. Their good performance was the result of incentives more closely resembling those of the free market than other state systems faced. The story of North Carolina's Financial Institutions Assurance Corporation is particularly interesting because the fund started in 1967 as "a good old boys' hideout from federal regulation," as one of its officers later recalled. A new president appointed in 1977 brought in a new management philosophy. The law governing the fund was changed to require a majority of its board of directors to be unaffiliated with member institutions. (The lack of such a provision in the Ohio and Maryland deposit insurance funds encouraged self-dealing. Unlike the pre-Civil War Ohio fund, the latter-day Ohio and Maryland funds had no counterbalancing liability features to make their members keep an eye on each other's operations.)

The North Carolina fund began basing the premiums it charged its members on the riskiness of their portfolios. It increased the minimum net worth for members to qualify for insurance from it. Furthermore, it closely monitored members' lending practices. For instance, it induced members to reduce their investment in fixed-rate mortgages several years before the rest of the savings and loan industry began having problems with fixed-rate loans. In every respect, the North Carolina fund's actions contrasted sharply with those of the FSLIC,

which was vulnerable to political pressure from members, did not adjust insurance premiums for risk, had lower net-worth requirements, and did little to prevent members from making reckless loans.

The North Carolina fund's record was outstanding. Its stress on preventative measures, and the incentives it gave for its members to avoid making overly risky loans, kept any of them from failing. However, the Ohio and Maryland collapses cast a pall over all state deposit insurance systems. The North Carolina fund closed voluntarily, without losses, when many of its members decided to get federal insurance. At about the same time, the Massachusetts funds, which benefited from that state's long tradition of conservative banking, switched roles from substitutes to supplements to federal deposit insurance.⁵

Of all state deposit insurance systems, then, few have been really successful. The others have existed too briefly to undergo a true test of strength, have folded up at signs of trouble, or have failed. Now federal deposit insurance is duplicating state deposit insurance's sorry record. The cause is the same: too many insured banks, mostly small, unable to withstand bad luck and bad management.

Deposit Insurance in Other Countries

Other countries, by allowing nationwide branch banking, have gained the stability the U.S. hasn't been able to achieve. Competitive pressures have resulted in very large banks, so solid that they have not needed deposit insurance and, in most places, have not had. It is true that West Germany's small Bankhaus Herstatt failed in 1974 and Italy's scandal-ridden Banco Ambrosiano failed in 1982. But there have been no other noteworthy bank failures in developed nations. Britain, which has had nationwide branch banking longer than almost any country, has not experienced a major bank failure since 1878.

Every large Western country except Italy has deposit insurance. But in all except the United States, deposit insurance is a recent innovation, dating from the 1960s or 1970s. The banking systems of those countries took their present shape, and enjoyed stability, long before they got deposit insurance. Furthermore, foreign deposit insurance systems encourage depositors to monitor the health of their banks, which the American system does not. In some countries—notably West Germany—the systems are voluntary, so banks that fear that imprudent rivals are trying to take advantage of the system can quit it.

In Britain and Switzerland, insurance doesn't pay for the full amount of depositors' losses, but only for, say, three-quarters.

Common to all foreign deposit insurance systems is that they have much lower maximum limits than the American system—from one-half to one-tenth as much—and that foreign governments are more serious about imposing those limits in practice than the American government has been. The possibility of suffering losses encourages depositors to entrust their money only to well-managed banks. Depositors abroad rely mainly on the quality of the banks themselves rather than on government insurance for protection.⁶

The exception that proves the rule occurred in Canada, whose federal deposit insurance system is most like that of the United States. In 1985, two Canadian banks went bust in Alberta—that country's equivalent of Texas. Previously, no bank had failed since 1923. The Alberta firms, both founded in the oil boom of the mid-1970s, were small and undiversified, resembling U.S. banks more than the five nationwide giants that have 80 percent of Canadian deposits.

Canada instituted compulsory deposit insurance in 1967 despite the protests of its large banks, who foresaw that it would be their premiums that would pay for small rivals such as the Alberta banks. The government guarantee helped convince depositors to let the Alberta banks take imprudent risks with their money. The failure of the Alberta banks threatened to deplete the deposit insurance fund. To prevent a run on the two banks, the Canadian government pressured the big banks to take them over. When losses turned out to be larger than expected, the government backed out of its previous assurances to the big banks (which technically were not binding), causing them to bear the costs of the small banks' bad management.

Unrestricted nationwide branch banking, such as Canada and other countries have, is scheduled to arrive in the United States in 1991. That will be too late to save hundreds of ailing banks and thrifts. Congress should remove barriers to branching now. In particular, it should allow any bank to buy any savings and loan. (Currently, banks can buy only ailing savings and loans.) Small banks and savings and loans would oppose such a step, because it would make them takeover targets for expanding money-center and "super-regional" banks. But the alternative for many of them is to go broke, putting further strain on the federal deposit insurance system and on taxpayers.

Deposit insurance has repeatedly proven not to be self-financing

under our artificially fragmented banking system. On the other hand, it wouldn't be necessary under a less regulated banking system. Ultimately, Congress should set a date—say, ten years hence—to abolish deposit insurance. At the same time, it should tear down the walls it has erected separating banking from securities, insurance, and commerce. Banks should be allowed to spread risk across lines of business just as branching enables them to spread risks across regions.

American banks are suffering at home and in world competition because they cannot engage in many profitable lines of business open to their foreign competitors. Given freedom, the U.S. banking system can become strong and flexible enough not to need deposit insurance. The alternative is to suffer another crisis when changing economic needs run up against outmoded regulations.

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Toward Free Banking

Donald R. Wells and L.S. Scruggs

Moving Toward a Fully Deregulated Financial System

Most economists consider money to be a special good that should be controlled by the national government. But advocates of free banking consider money a private good which, as any other good, must meet the market test of acceptability. Let us consider the advantages of free banking, and see how such a system might be implemented in the United States.

Under free banking, no government agency would grant a charter to allow a bank to operate. Banks would be free to begin operations as they saw fit, just as other businesses. They could acquire funds from any source: equity, deposits, banknotes, or other liabilities such as debentures; and pay whatever market conditions dictated on these sources. They could then use these funds in the manner most profitable to the bank as long as they avoided deception or fraud. They would hold whatever reserve they wanted—cash, securities or claims on a clearinghouse—wherever they wanted to hold it. Loans and securities would not be subjected to interest controls, nor would investment in any particular industry be mandated or forbidden. If so desired, banks could even acquire equity positions in other firms. The only role for government would be to prosecute fraud and enforce contracts, including settling disputes in court. Banks would not be subjected to government audits or made to pay any special taxes not levied on other businesses.

Money did not originate through some governmental body authorizing its use, but rather by the public and the market deciding what was mutually acceptable. Free banks could continue to offer to exchange their recognized and highly tradeable liabilities for the less well-known and less marketable liabilities of others. Traditionally,

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banks have persuaded the public to use banknotes and checkable deposits as money. The right to issue these notes and deposits was never a government prerogative, but the common right of all.¹ In the quasi-free-banking systems of the past, banknotes and deposits were normally convertible; that is, redeemable on demand in some reserve asset that the bank could not create, such as gold or silver. Central banks entered the picture and eventually monopolized the issuance of currency, leaving deposit creation to commercial banks.

Since currency became an outside money which banks could no longer issue, they could not exchange one liability for another—deposits for banknotes—as the public desired, but instead were forced to use up reserves or borrow from the central bank to placate public demand for currency. The ability to issue their own notes permitted banks to ease public fears about bank runs and to reduce funds tied up in till money, since unissued banknotes were not a liability on the bank's balance sheet, but were instantly available. This was especially helpful to Canadian and Scottish banks in minimizing the cost of operating branch offices.² Banks in an unregulated system would be free to open and close branches wherever they wanted. Branching allows banks to diversify their loans geographically and industrially, since banks would be in a position to acquire loan customers all over the country. An increased need for banking services in a particular area of a nation is met more readily by a new branch of an existing bank than by a new unit bank, which requires new directors and managers. Furthermore, within a given financial center, reserves can be moved among branches of one institution more quickly and cheaply than among institutions.

Branching would not be required, of course, but would face the test of the market. Experience from both Scotland and Canada shows that unit banks found it difficult to compete with larger branch banks and were frequently absorbed by them.³

Many specialized thrift institutions, such as savings banks, savings and loan associations, credit unions, and trust companies, originated because commercial banks were legally barred from, or voluntarily eschewed, a particular field of lending. Free banking implies no restrictions on bank lending or investing; hence specialized thrifts would be necessary only for loan categories systematically shunned by banks.

Limit on Credit Expansion

Unlike the current arrangement, whereby the central bank controls the ultimate expansion of the money supply through its control of the money base, bank loan expansion under free banking would be controlled by the exchange of notes and deposits through clearinghouses. Banks that expanded their lending more rapidly than others would face adverse clearings and would be forced to curtail their lending unless they possessed more cash reserves than their rivals. These reserve assets could be deposits in the clearinghouse, gold, silver or some other "outside" money, such as Federal Reserve Notes (FRNs), which would be frozen in supply as were Greenbacks after the Civil War. If the Federal Reserve (Fed) were abolished, existing FRNs could serve as base money in a free banking system.

An individual bank could increase its reserves by a lending policy more restrictive than that of its rivals. The expanding bank would find its notes and deposits presented for redemption in reserve money; the more restrictive bank would gain reserves, as a smaller volume of its liabilities would be presented, by other banks, for payment through the clearinghouse.

However, the reserve base in an entirely free banking system could expand only if new reserve money entered from the outside. Since no FRNs would ever again be printed, the only avenue open would be an influx of gold or silver from other areas or from mining. But no central bank could expand the money base at will, imparting monetary disturbances to the economy.

Since no bank would be legally required to maintain any specific reserves, each bank would hold only the amount of the reserve assets indicated by its experience and liquidity preferences. Thus, if all banks in the system were to expand their lending by the same percentage, the check on them would not be adverse clearings, since each would be receiving from every other roughly the same amount of notes and deposits. Instead the expansion would be checked by each bank's desired holding of reserves plus the public's desired ratio of base money to notes and deposits. If the public trusted banks it would be unlikely to convert notes and deposits to specie or FRNs, but such a conversion would act as a brake on bank expansion.

White found that Scottish banks, during the late 1700s and early 1800s, were able to reduce their average gold reserves from 10 percent

and higher to 3.2 percent as these banks gained more public confidence.⁴ In any case, credit expansion is limited in a free banking system, since the public will hold only a finite amount of any issuer's distinctive notes and deposits. But under our current system, there is no limit to expansion by the central bank, because the supply of its monopoly money will create its own demand, as the public has no choice but to hold whatever amount is created to support a higher level of nominal income and prices.⁵

Transition to a Free Banking System

The first step to achieve a free banking system is to remove all legal obstacles to the production of "outside" base money plus all restrictions on private banking. The legal impediments to the production of outside money, according to White, include: (1) a prohibition on the minting of private coins; (2) a sales tax on the purchase of commodity monies; (3) a capital-gains tax on the holding of non-dollar currencies; and (4) uncertainty regarding the upholding by courts of the payment of a contract in anything but dollars, even when gold is specified.⁶ Removal of these barriers would signify that the field is open to any type of innovation that might seem profitable to undertake.

Simultaneously, Congress would have to abolish the Fed, freeing the existing supply of FRNs (the Bureau of Engraving can replace worn bills). The Fed would dispose of its assets, after buying back its stock from the member banks. Termination of the Fed could proceed as follows: (1) cease open-market operations and discounting; (2) require the Fed to buy back its stock from member banks by crediting their reserve accounts; (3) send all government securities and gold certificates to the Treasury for cancellation; (4) move the Treasury account to the commercial banking system; (5) let foreign central banks move their accounts wherever they wish; (6) phase out the Fed's check-clearing system, perhaps over one year, as deregulated commercial banks establish branches nationwide and assume the clearing function.

Private Banking. Equally important, however, would be total deregulation of private banking, concurrent with dismantling of the Fed. The immediate steps should be: (1) allow free entry with no charter anywhere; (2) grant freedom to branch anywhere; (3) abolish reserve requirements; (4) remove restrictions on the type of assets held; (5)

abolish limits on interest rates paid or charged; and (6) allow banks to issue distinctive banknotes or even fractional token coins.

The freedom to enter without charter should reduce the forced difference between banks and thrift institutions. The unlimited branching will further erode this distinction as mergers occur between banks and thrifts. In addition, unrestricted branching will expedite the replacement of Fed check-clearing with private clearing. Unlimited branching will also lead to the end of correspondent relationships among banks and the holding of interbank deposits, a feature peculiar to the unit banking system. When allowed to branch, as in Canada and Scotland, banks hold insignificant amounts of the liabilities of other banks, and are insulated from contagious bank runs.

The abolition of reserve requirements would permit banks to escape the implicit tax with which they have been burdened since the beginning of the National Bank System during the Civil War; they could then earn profits on all of their assets, rather than about 90 percent of them. A fixed percentage required reserve is the least liquid asset a bank has. When banks are permitted to hold any amount of reserve they want, their anticipated liquidity needs are the sole determinant of the amount and location of those reserves.

As an example, before the Bank of Canada was founded in 1935, Canadian banks faced no reserve requirements but held as desired reserves: outside money, call loans in New York and London, securities and commercial paper, and deposits in foreign banks.⁷ Cash reserves were normally 10 percent of total liabilities, but fluctuated between 8 percent and 15 percent. Banks watched the balance sheets of their rivals: the stronger ones kept the weaker in line by refusing to take checks drawn on them or refusing to lend to them in a crisis.⁸ Most of the outside money (specie and Dominion Notes) was kept at the financial centers; the branches used mostly unissued banknotes as their till money. Since unissued banknotes are costless, this economy measure helped subsidize some of the branches in remote areas.

A similar situation could evolve in the U.S. under free banking. The cash reserves of banks would probably consist of FRNs at first, and then specie if the public displayed a preference for convertible banknotes and deposits. But secondary reserves would undoubtedly be invested in short term securities (such as Treasury bills, commercial paper, and bankers' acceptances) and call loans. No longer could banks consider themselves liquid merely because they could borrow outside

money from a lender of last resort. Each would be responsible for its own liquidity, and any borrowing would have to meet the standards of the market.

It is also very important that banks again be allowed to issue banknotes if unregulated banking is to succeed. This enables banks to exchange one liability for another—deposits for notes—at the demand of the public, without disturbing the bank's reserves, or any other asset. In addition, these banknotes should be distinctive, not uniform as were the National Banknotes, and issued without pledging any specific asset, such as government bonds. Distinctive banknotes would meet the daily test of convertibility: Each bank would be anxious to issue its own notes; upon receiving notes issued by others, it would return them to their issuers through a clearinghouse. To pay out the notes of another bank would be acting as a broker without fee; to hold them would be lending to the issuer without interest.⁹ Therefore, note exchanges act as a check on expansion just as check clearings do.

Allowing an unrestricted issue of banknotes, with no requirement to pledge certain assets such as government bonds, permits banks to supply the exact amount of currency that the public demands at the instant they demand it. Panics and bank runs can be avoided if the public is allowed to exchange one type of money—deposits for banknotes—when it wants. The panics of 1873, 1893, and 1907 in the U.S. resulted when the public could not convert their deposits to currency (Canadian depositors experienced no such difficulty). Many national banks in the U.S. found it unprofitable to hold the 2 percent government bonds that were required to back their notes, thus were unable to issue enough notes to satisfy the panicky demand for currency. When banks tried to satisfy this demand by paying out their cash reserve (gold certificates, Greenbacks, and other Treasury currency), they depleted their required reserves, and were forced to suspend payment.

Deposit Insurance. Another important step in achieving free banking is terminating the federal deposit insurance that has existed since 1934. Deposit insurance was part of a system of strict regulation designed to save the unit bank system during the credit implosion of the early 1930s. It is rarely found in nations with a small number of large branch banks, even though Canada adopted a plan in 1967. But it is totally incompatible with free banking and thus would have to be phased out.

There are private options to government deposit insurance that should be explored. One such option could lie with the individual depositor. If uneasy about banking, this person could approach an insurance company about insuring his deposit. The insurer could diversify its risk by covering accounts up to a specified maximum in any particular bank, and then asking future clients to deposit in other banks where the insurer is covering smaller deposit volumes.

Another option lies with the banks themselves. They could alleviate public concern over safety by offering low-interest accounts with preferred claims on bank assets in case of liquidation. Another alternative, similar to the existing tax-and-loan account, would be to offer low-interest accounts backed by pledged securities. Other depositors would receive market rates but would have no special protection.

Banknotes vs. Deposits. Holding private banknotes rather than government fiat money would be a new experience for the current generation. Many may be reluctant to accept "funny money" at first, especially since holders of banknotes, unlike depositors, may not be customers of the issuing bank, but merely recipients of its notes in the course of business.

But banks could overcome the aversion to private banknotes in several ways. Banks could assume the risk for counterfeit notes. Scottish banks honored forgeries presented over the counter by innocent persons, but not those accepted by other banks and returned through clearings. This put the burden on rival banks to be on the alert for counterfeit notes. At any rate, counterfeiting is much more tempting in a fiat-money system than in a free-banking system, in which the notes return quickly to the issuer.¹⁰ Banks could also offer to pay interest on any note not immediately redeemed in base money on demand.

Free banks could voluntarily offer multiple liability for stockholders if such proved reassuring to depositors and noteholders. Scottish banks operated with unlimited liability for their owners; Canadian banks and National banks in the U.S. formerly imposed double liability on their stockholders. The market might compel smaller, newer banks, but not large, well-established institutions, to impose multiple liability.

Banks could offer a mutual note guarantee exemplified by the Bank Circulation Redemption Fund (BCRF) that protected Canadian

banknotes from 1891 until they were replaced by Bank of Canada currency. Banks contributed to a fund to redeem the notes of any failed bank, which notes were to earn interest until redeemed.¹¹ While this measure was successful in that the notes of even weak banks circulated at par all over the country, it put the depositor in a position inferior to that of the noteholder. In addition, this was not a voluntary arrangement but was mandated by the Bank Act of 1891. But in Scotland, when the Ayr Bank failed, other banks voluntarily advertised that they would accept Ayr notes, thereby bolstering confidence and gaining customers.¹² A similar offer under free banking could include depositors as well as noteholders.

A Temporary Lender of Last Resort

When a free banking system is established, reliance on a governmental lender of last resort should be avoided, even on a temporary basis. With the Fed abolished, it might be tempting to permit banks to borrow fiat money from the Treasury for a few years during the phasing out of the FDIC. Canadian banks were allowed to borrow Dominion Notes from the Minister of Finance in 1914 as a wartime measure, but this practice was not terminated when the war ended in 1918; it continued until the Bank of Canada began in 1935. Canada did not return to the gold standard until 1926, but this borrowing of base money from the government was incompatible with the gold standard, and the latter was abandoned in 1929.¹³

A government lender of last resort is also incompatible with a free banking system, wherein each bank is to be responsible for its own liquidity. Free banks can borrow from one another at market rates, but a lender of last resort is needed only when one bank holds all of the outside money, as did the Bank of England during the 1800s.¹⁴ Under free banking, no bank would incur liabilities in some money that it could not issue.

Coinage. In addition to banknotes, private banks would also be responsible for new coins: full-bodied coins for reserves, and fractional, token coins for making change. The market gradually developed coins to expedite the assessment of the value of varying amounts of commodity money. Governments intervened to monopolize coinage to extract a profit for themselves. Coinage could have remained pri-

vate, with inferior coins circulating at a discount.¹⁵ Private mints, faced with existing and potential competition, would have much less incentive to debase coins than would a state with a monopoly on coinage.

Establishment of a free banking system requires that the Treasury cease minting its token coins, just as the Fed must stop issuing currency. However, the Treasury could be allowed one last profit by selling all its gold at Fort Knox at market prices, ending any conceivable government role in money creation. This seems easier than the Timberlake proposal to give everyone in the country an equal share.¹⁶ The existing quantity of Treasury coins would be frozen, joining the existing FRNs as part of the base, and still used as a medium of exchange. Banks, however, would issue new fractional coins, as well as banknotes. Professor Hayek has hypothesized that local merchants might collaborate to sell through banks a set of uniform coins or tokens to be used in vending machines, perhaps replacing metallic coins with plastic ones bearing electronic markings discernible to cash registers and slot machines.¹⁷ If the many U.S. railroads could agree on a standard gauge for tracks, banks and retailers can agree on a substitute for Treasury coins.

Possible Concerns over Free Banking

Those who have experienced only a government monopoly of base money, and central bank manipulation of that base, free banking may seem too radical, even though the inflationary record of central banking must inspire a search for alternatives. If money creation were divorced from the government, politicians would have to pay for their spending with taxes or real borrowing, but not by government monetization of deficits.

Critics may fear free banking would be deflationary, as the money base could grow only through additions to the gold or silver stock, since the FRN quantity would be frozen. But this ignores the possibilities of financial innovations to economize on base money, higher money turnover rates, and increasing confidence in the ability of banks to honor redemptions by the public. One Scottish bank in the early 1800s was able to operate with specie reserves of only 0.5 percent of assets, revealing that the public may not demand specie when assured of its availability.¹⁸ Each competitive issuer can observe the demand for his money and adjust the supply thereto, a task no monopoly issuer

can accomplish. Each bank must balance the desires of its depositors, who fear a depreciating money, with those of its borrowers, who would object to an appreciating money. But free banking does promise to end the inflationary bias that has crept into most wage negotiations and other long-term contracting. It is a system that would be consistent with more flexibility of prices and wages.

Other qualms about free banking may afflict bankers themselves who have spent their entire careers in a regulated environment. Older bankers may resist the adjustment; but younger, perhaps better educated ones might find a new, unregulated setting to be a stimulating challenge. Many large retailers and brokerage houses already have in place nationwide offices from which a new type of banking business may be conducted. The field may become dominated by those who were not bankers prior to free banking.

Because the U.S. system currently has no nationwide banks, as other countries do, growth in the number of banks to a competitive level may take longer than it would under unlimited branching. However, the system is not burdened with governmentally encouraged banking cartels that would stifle competition, and most interest ceilings have been abolished. But American banks are still subjected to governmental insuring and auditing, practices incompatible with free banking.

Fortunately, no private U.S. bank is a government pet, like the Bank of Montreal (BOM) or the Bank of England (BOE). No American bank would be the government's fiscal agent: Over 11,000 banks currently hold tax-and-loan accounts of the Treasury; if the Treasury closed its account at the Fed, no single private institution would play the role of the BOM or BOE. Vis-à-vis the banking system, the U.S. government would be neutral, having no independent Treasury funds to deposit at various times, as was the case before 1914.

Finally, free banking is most likely the system that would have emerged from normal market forces, had governments not interfered with banks and money by imposing specific bond-holding for note issue, mandating fixed percentage reserve requirements, forbidding branching across state lines, and creating a central bank to expedite inflationary governmental finance.

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The Gold Standard and Fractional-Reserve Banking

Joe Cobb

There is little doubt that a gold-oriented monetary system is superior to a fiat monetary system, from the perspective of the average citizen and businessman. Monetary systems which are managed by central banks or governments, as opposed to systems which arise in the market and are self-equilibrating, are prone to inflation and repudiation. The arguments against “managed” currency are clearly set forth in the *Theory of Money and Credit* by Ludwig von Mises, and it is not our purpose to argue against the gold standard.

The argument of this essay is that the U.S. dollar should not be “backed” by gold or “tied” to gold or otherwise officially connected to gold in any way. The free economy should have a metallic monetary standard (and gold is probably the best metal for that purpose), but the people who support an Act of Congress which pegs the price of gold in terms of dollars, or which defines the dollar in terms of gold, are making a big mistake. Like Oedipus, they are putting out their eyes and surrendering their monetary assets to the secret management of the U.S. Treasury without the ability to detect mismanagement. The assumption that a gold dollar is not a “managed” currency is an illusion. While it may be true that the quantity of money may be determined by the stock of gold in the nation at any point in time, the total volume of credit—including federal credit, local government debt, and bank credit—is subject to political control and management.

The problem arises because the unit of money (let us call it “one dollar” in gold) has the same name and is traded at a fixed price with the unit of credit (let us call it “one dollar” in deposits). We all understand the process by which banks create credit: the depositor brings

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in a quantity of gold coin and the banker puts this in his vault, issuing certificates to the depositor (or establishing a checking account in his name). At this moment, the banker has 100 percent reserves for his deposits. The next customer in the bank, however, is someone who wants to borrow—let's assume the borrower will buy a house. The banker accepts a secured mortgage from the borrower (the banker's non-monetary asset) and issues to the borrower some certificates *identical to the ones he issued to the depositor*. The total number of certificates is now greater than the supply of gold in the vault, so the banker's reserves are only a fraction of his total outstanding certificates "payable in gold." There is nothing fraudulent about this; the banker's assets equal his liabilities, and everybody knows that bankers are in business to make loans with their depositors' money. Banks perform a valuable service by accumulating small deposits and making large loans. It is not our point here to rant and rave against fractional reserve banking, but we need to understand the difference because there is a critical implication for any proposals to reform the monetary system and re-establish the gold coin standard.

Most students of economics have heard of Gresham's Law: "Bad money drives out good money." What this means is that any holder of both gold coins and paper dollars during an inflation will tend to spend the paper dollars and hold on to the gold coins. He would not spend the gold coins, unless the seller demanded them instead of paper. The vicious aspect of legal tender laws is that they strip the seller of the right to demand coins instead of paper. Yet, Gresham's law only holds true when there is a fixed price between the "good" money and the "bad" money. When there is a floating price, both forms of money circulate with equal frequency and the "price" of one in terms of the other adjusts according to the demand. This is a simple phenomenon arising from the two separate uses for money—the medium of exchange, and the store of value functions. The gold coins would be preferred as a store of value, and the paper dollars would be preferred as a medium of exchange. If sellers wanted coins instead of dollars, they would offer discounts for payment in gold. These discounts can be observed in every country which is experiencing a high rate of inflation. A discount on purchases is the same thing as a floating rate between gold and paper money.

In the United States today, the medium of exchange consists primarily of checks, credit cards, and Federal Reserve Notes. The medium

of exchange is entirely made up of credit. To refer back to the work of Ludwig von Mises, "money" is not in circulation at all—even though many of us are relying on gold as our store of value almost exclusively. What circulates is credit certificates, and it is the rapid expansion of credit which is causing double-digit inflation.

It is always assumed by advocates of a "gold-backed" money that the quantity of gold ("money") will hold the supply of credit ("dollars") in bounds which will prevent excessive credit expansion. I submit that this is a false assumption. It is true that when bank runs begin, the bankers are exposed to failure and disgrace; but bankers are smart enough to know that the government will rescue them. This is why the Federal Reserve System was created. To be sure, maybe we ought to abolish the Federal Reserve System and freeze the ability of the government to expand the supply of credit.

This is a tall order, and it is doubtful that those with some knowledge of economics have sufficient political influence to triumph over (1) those who have a vested interest in the present system of credit expansion, and (2) the ignorant who would be persuaded by the first group that we are either nutty or evil.

There is, however, a more direct and easily achieved solution. Happily enough, also, the monetary authorities are playing into our hands on this one. The solution involves the utilization of two differently named units for the two different kinds of financial assets. Let the store of value be known as "ounces of gold" and let the medium of exchange be known as "dollars" of credit. Let the buyers and traders in a free market use gold-weight coins for their store of value. The solution to the problem of inflation, of course, would remain *putting an end to credit expansion* by the Treasury and the Federal Reserve System. However this small change in tactics would make an enormous long-run difference. It is convenient that the *Krugerrand* is approximately one troy ounce because its availability as an international coin makes the above proposal even easier to implement.

When the unit of credit is called by the same name as the unit of money ("dollar" for example), the citizen simply *must* take the word of the Treasury that the assets are in the vault and that credit expansion is not being indulged in. The indirect consequences of credit expansion, such as rising prices for goods and services, occur only after a lag in time. Even then it is not always clear what may be happening. Aggregate supply and aggregate demand move up and down for many

diverse reasons, and prices adjust accordingly. The political system takes advantage of this random, or unpredictable, free market process. The government long ago learned that it can increase aggregate demand by printing bonds, using the bonds as assets against which to create Federal Reserve Notes and demand deposits in the banking system. As we have observed during the period since 1967, on the other hand, the market price of gold in terms of the unit of credit adjusts to reflect credit expansion. This, then, would be the key to a secure gold coin standard: The coins would be measured by their common weight, and they would command a market value in terms of the national unit of credit. A policy of zero credit expansion could be mandated by law, perhaps, but as a check-and-balance, the traders in the market would keep their eye on the price of gold in terms of credit. If the credit price of gold should rise, there would be strong and compelling evidence that inflation were afoot, unless proven otherwise by reports of physical movements of gold.

With the introduction of weight-measured gold coins, we might expect to see an increasing number of securities and contracts made in terms of gold-weight coins. This should be encouraged, as a manifestation of the free market principle that people will do what is in their own best interests regardless of government policy. Indeed, the greater utilization of gold coins will increase the demand of gold assets and improve the value of private gold holdings (unless the central banks start to dump their gold holdings, but even this should produce only a short term downward movement and represent an excellent opportunity for private investors to buy).

Any attempt by the government to “fix” the value of the depreciated unit of credit in terms of gold, however, should be vigorously resisted by anyone who values either economic freedom or private gold reserves.

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