BANKING AND MONETARY REFORMS TO PRESERVE PRIVATE ENTERPRISE*

by Robert de Fremery
(Excerpts from the article published in The *COMMERCIAL and FINANCIAL CHRONICLE*, June 7, 1956)

An increasing number of articles and speeches have been devoted to the question of whether we should give the Federal Reserve Board standby controls over instalment credit. One need not look far to find the reason we are being asked to sanction these ever-increasing government controls. Wm. McChesney Martin, Chairman of the Federal Reserve Board, stated the reason very clearly as follows: "It should be borne in mind that expansion in commercial banking operations creates new supplies of money in contrast to other financial institutions which lend existing funds." (Testimony before Senate Banking Committee.)

In other words, we must distinguish between the lending of credit, i.e., "new supplies of money" and the lending of "existing funds." If all loans were made with existing

---

* Milton Friedman—after reading this article in full—wrote me as follows: "I thought it an extraordinarily effective piece, well calculated to persuade and inform." (letter, 7/5/56)

funds, there would be no valid reason for any government interference, regulation, or control of the lending of those funds. The lending of bona fide savings is merely the lending of a surplus. That is a civilized process that should be encouraged. It should not be controlled and regulated by the government. Nor should there be any fear over the volume of debt arising from such lending. It is desirable that all our resources—including bona fide savings—be put to maximum use.

Why then do we tolerate government interference in the money market? Why all these "credit controls?" Why all this concern over the volume of debt? Because—as Mr. Martin pointed out—when our commercial banking system expands its operations, it does so by lending "new supplies of money" (bank credit), rather than by lending existing funds.

The importance of this fact can not be over-emphasized. Our entire price structure today is in terms of bank credit originating from earlier expansions of commercial bank operations. Over 90% of what we are using as money is nothing but bank credit. And because our past experience with bank credit has shown that it is highly unstable, and that undue fluctuations in its supply can have disastrous effects upon our economic system, we have been forced to accept ever-increasing government controls of our banking system.

Need we fear these controls? Yes. No man or group of men should have the power to arbitrarily manipulate the supply of money or to determine the channels into which savings should flow. The power to change the supply of money is a tremendous power. It is the power to force

debtors into slavery; it is the power to dispossess people of their property; it is the power to rob people of the value of their savings. And the power to determine the channels into which savings should flow is the power to control the entire economic system. The existence of such powers is totally incompatible with the survival of freedom—both economic and political. And yet, under the existing banking system, if we do not grant these powers to the Federal Reserve Board, a semi-public agency, then they will remain in the hands of our commercial banks and market forces which in the past produced such violent fluctuations in the supply of money (bank credit) as to nearly destroy our free enterprise system.

Dilemma Confronting Us

That is the dilemma that confronts us. How can we preserve the monetary stability that is needed for the proper functioning of a free economic system without being forced into a financial dictatorship that is incompatible with the survival of our free economic system?

If we keep in mind the basic cause of our dilemma, we should have no trouble figuring a way out of it. If the basic justification for government controls of banking is that an expansion in commercial banking operations creates new supplies of money, why not convert commercial banks into institutions that can lend only existing funds? If this could be done without unduly upsetting our financial markets, and if some provisions can be made for additions to the supply of money as needed to serve an expanding population, then we could enjoy monetary stability without the threat of a financial dictatorship.

Why Change Banking?

There are many good reasons why we should seriously consider making such a change in our banking system. In the first place, this reform is the next logical step in the evolution of banking. Over 100 years ago—after the era of wildcat banking—it was recognized that banks should not have the power to issue their own notes. That power was taken away from the banks. What we failed to realize at that time was that the power to create deposits-subject-to-check is equivalent to the power to issue notes. So although one-half the weakness in our banking system was corrected, the other half remained—as has been amply demonstrated by the many bank panics suffered since that time.

Now that almost all students of the subject agree that there is no basic difference between notes and checks, we should complete the reform of our banking system by making it unlawful for banks to create deposits—taking care to first monetize the existing volume of bank credit (now being used as money) so as to prevent a severe deflation.

A second important reason for making such a change is that bank credit is a fundamentally dishonest type of money. The lending of bank credit is tantamount to the lending of an imaginary surplus. The bank deposits so created are fictitious. The banker—by lending his credit payable in money on demand—places himself in the position of promising to do something that is physically impossible to do. And the further bank credit is extended—the more precarious the position of the banker becomes—until finally confidence is lost and the whole flimsy structure of bank credit collapses.

Bank Credit Causes Inflation

A third important reason for making such a change is that the use of bank credit as a substitute for money is a most unsound procedure. The commonly accepted definition of money is that it is a medium of exchange and a standard of value. Bank credit—even though used as money—is merely a promise to pay money. This is a very important distinction that is too often overlooked. Bank credit is a shortsale of money. And like shortsales of anything else, shortsales of money upset the true value relationship between money and the goods and services to be exchanged for money. In other words, bank credit causes inflation. Prices are inflated whenever they are higher than they ought to be. And if our money is diluted with bank credit, then prices are higher than they ought to be. This concept of inflation is a little different from the orthodox conception of inflation—but it is far more meaningful. No understanding of the cause of deflations (depressions) is possible unless we have a correct understanding of what constitutes inflation.

There are those who believe that once bank credit has been allowed to expand, nothing can be done to prevent a collapse (that is, nothing economically sound and consistent with a free economic system). The Austrian school—best represented by the writings of Ludwig von Mises—takes this stand as evidenced in the following statement: "There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system

involved." (*Human Action*, p. 570).

Dr. von Mises believes that the expansion of bank credit causes malinvestment and a squandering of scarce factors of production that will inevitably lead to a crash and ensuing depression. But a more plausible theory is that all economic activity is continually reaching a new equilibrium between the total circulating medium of exchange and the goods and services offered for it. In other words, an expansion of bank credit leads to a collapse not because of mis-directions in production but rather because of the operation of Gresham's Law. The use of bank credit as a medium of exchange gives us what Bishop Berkeley called a "double money." Even though bank credit is supposedly convertible into money on demand, nevertheless it is not as good as money. It is a short sale of money. And as the volume of these shortsales increases it is inevitable that Gresham's Law will eventually operate, i.e., the undervalued money (gold or legal tender 'fiat' money) will be exported or hoarded—thus causing a collapse of bank credit.

According to this theory, it is possible to avoid a collapse following a period of credit expansion simply by converting the existing volume of bank credit into actual money having an existence independent of debt, and at the same time take away the banking system's privilege of creating any more credit, i.e., force banks to confine their lending operations to the lending of existing funds.

...

Once having stabilized the banking system so that it could no longer be the source of changes in the supply of money, it would then be necessary to protect ourselves

from arbitrary manipulation of the supply of money by the government. That raises the question: What should determine changes in the supply of money?

How to Change Money Supply

Such well known economists as Bradford Smith (U. S. Steel Corp.), C. A. Phillips, F. A. Bradford, Carl Snyder, and James Angell, have suggested that the supply of money should vary directly as population, i.e., as our population increases, our supply of money should be increased proportionately. Then the supply and demand relationship between population and money will result in a dollar of constant value. Such a dollar would buy more physical goods as techniques of production improve and costs are therefore going down. But this would not be deflationary because prices would not fall faster than costs except in those industries suffering from a shift in consumer demand. And prices should fall faster than costs in such industries in order to facilitate a shift in the basic factors of production from "less wanted" forms of wealth into "more wanted" forms of wealth.

Such a dollar would also always do justice between debtors and creditors because it would always be equally difficult to obtain.

No Inflation or Deflation

Were we to adopt such a system at this time, we would remove the threat of inflation and deflation while at the same time removing the necessity for any government controls of the lending operations of banks. We could henceforth cease to worry about the amount of consumer

debt. All savings should be loaned so as to keep money in circulation. Debts that arise from the lending of actual savings are perfectly sound so long as ordinary caution is used by the lender. It is debts that arise from the lending of credit that cause our price level to become inflated. And the threat of deflation that faces us today is due to the fact that our price level is in terms of bank credit rather than in terms of money having an existence independent of debt. By converting that bank credit into money, we will have removed the threat of deflation.

Perhaps the most important result of such a change would be that our bankers and our business men could now rely on the stability of the per capita supply of money. Neither our banking system nor our government would have the power to expand or contract the per capita supply of money. Keep in mind that no new purchasing power would be given to, nor would any be taken away from, any person who doesn't already have access to that purchasing power today. We would merely be putting actual money where people now think money is—merely converting credit (which is now being used as money) into money that has an actual existence.

Non-Collapsible Money Market

Bankers would now be free to make the savings of the country readily available for loans without the fear of a possible collapse of the money market. That's not true today. At present bankers are fully aware of the instability of bank credit. Therefore a conservative banker—anxious to protect his depositors as much as possible—is reluctant to lend credit on long term during a boom because his

deposits are withdrawable on demand or at most on 30 days notice. And the government—also aware of how unstable the banking system is—has surrounded bankers with a mass of red tape, rules, and regulations in a vain effort to protect the public from this essentially unsound operation.

Under this new system, the bankers and the government would know that the money market had a solid, non-collapsible base. They would know that the basic cause of bank panics had been removed. The only restriction on banks would be that they would no longer have the right to create credit as they do now.

...

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

...

It might appear that if we stop using bank credit as money there will be a great reduction in the liquidity and

transferability of wealth. That would be true if we did not monetize the existing volume of bank credit. Bank credit is nothing but a substitute for money—and a very poor substitute at that. One of the functions of money is to make wealth liquid and facilitate the transfer of wealth. The curse of using bank credit as money is that when bank credit collapses, the liquidity of wealth is destroyed. That's why we have depressions. If we furnish ourselves with an adequate supply of money—and stabilize that money by making credit banking illegal—we will then be assured of continuous liquidity.

Population vs. Gold Standard

The question arises: Would it be wise to have such a currency convertible into gold? Certainly not. That would make it credit currency—the very thing that has caused so much trouble. ... The stability of international trade depends primarily upon the stability of the currencies used in international trade. And by abandoning the use of credit as money—thereby stabilizing the dollar—we will be doing the most that can be expected of us toward the establishment of conditions that would make possible an expansion of world trade on a sound basis.*

There are some people who look with distrust upon "printing press" or "fiat" money. But they overlook one of the basic facts about money. It is true that we need a "hard" money. But we should not make the mistake of associating "hardness" with convertibility into gold. The essence of a

---

* An excellent book on this subject is *International Monetary Issues*, Charles R. Whittlesey, McGraw-Hill, 1937.

hard money is not determined by the material of which it is composed—or the material into which it is convertible. The essence of a hard money is that its supply is fairly stable and there are precise limits to it. In other words, gold itself is a comparatively hard money because the supply of gold is inelastic. Bank credit convertible into gold is a very soft money because it is elastic and there are no precise limits to its supply, i.e., it expands and contracts. And a purely paper or "fiat" money can be a hard money if we set precise limits to its supply, or it can be a soft money if we set no precise limits to its supply. A population standard, as described above, would obviously give us a much harder money than the orthodox gold-credit system gave us prior to 1933—and certainly a much harder currency than the money-managers are giving us today.

The time is ripe for a thorough study of the principles upon which our monetary system ought to operate. ... We must think solely in terms of sound economic principles.

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

Be it not a mighty Privilege for a Private person, to be able to create an hundred Pounds with a Dash of his Pen?

—George Berkeley, *The Querist*, 1735

All the perplexities, confusion and distress in America arise ... from downright ignorance of the nature of coin, credit and circulation.

—John Adams, in a letter to Thomas Jefferson, 1787