OUR UNSOUND MONETARY SYSTEM AND MEASURES FOR REFORM

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When Paul M. Millians, Vice-President of Commercial Credit Company, spoke before the 40th International Consumer Credit Conference in San Francisco on July 19, 1954, he made the following revealing statement: "Most of the 17 major depressions in American history have been money panics. ... They were marked by a scramble of bank depositors to withdraw funds; restricted deposits; restricted credit; forced liquidation of bank loans; and forced liquidation of commodities."

A very similar statement was made by J. W. Gilbart—one of the leading bankers in England during the last half of the 19th Century: "It has been remarked that panics recur at regular intervals of about ten years each; nor can this be wondered at, seeing that the years 1825, 1837, 1847, 1857, and 1866 have, from various causes, been marked by the catastrophes so named. Judging by this recurrence of disasters at an apparently fixed period, it is not surprising that in the popular mind there seems to be a belief that a

cycle exists, fated to bring in its train ruin to the monetary world and to millions outside of it. The dominant causes of the panics of the years specified, and their distinguishing characters, differ in some essential particulars. In one feature, indeed, they are all alike—the unreasoning fear which heralds, accompanies, accelerates and sometimes produces them." (J. W. Gilbart, *The History, Principles, and Practice of Banking*, Vol. 2, p. 334.)

These two men stated indisputable facts that are known to all who have a knowledge of business cycle theory. It is only the *interpretation* of those facts that leads to controversy among economists. One group claims that our banking system is basically sound and that panics are either due to causes originating outside the system or to abuses of that system. The other group claims that there is an inherent defect in our banking system that makes these panics inevitable. This latter group of economists has grown to such an extent that when the late Irving Fisher took a poll of the members of the American Economic Association in 1947 to determine how many of them favored reform of our banking system so as to remove the basic cause of bank panics, over 1,100 of them signified their approval—many of them well-known economists and heads of their departments at their respective universities.

Main Cause for Bank Panics

It is difficult to understand why anybody should be in doubt as to the main cause of bank panics. When men engage in a "run on a bank," they do it for a very obvious reason. They are afraid their money isn't there. They're afraid that if they don't withdraw the money they have a

right to withdraw, they may lose it altogether. And their fear is perfectly justified under a system of fractional reserve banking. Their money is *not* there—nor is it anywhere. Only a small fraction of their money has an actual physical existence. All the rest of it is nothing but *book entries* against which the depositors can draw checks.

"How do the book entries come into existence?" you ask.

Our banks have the privilege of *creating* such book entries and lending them to the public so long as they maintain a certain minimum cash reserve. Hence, the name "fractional reserve banking." And in proportion as banks exercise this privilege of creating deposits and lending them, and as checks are drawn against these imaginary deposits and used to pay for goods and services and then deposited in other banks, the total amount of imaginary deposits grows. This means our banks become less and less liquid, i.e., less able to pay their depositors in cash if called upon to do so on a large scale. The more illiquid the banking system becomes—the more inevitable it is that a loss of confidence will occur. When it finally occurs it takes either the form of a financial panic, or a contraction in business resulting from fear that a panic or "credit crisis" may occur, or a combination of both as in the period 1929-33.

The fact that the National Bank Holiday didn't occur until 1933 has led many people to believe that the Great Depression which was heralded by the stock market crash in 1929 was not caused by the banking system. But as early as 1928 the financial advisers of some of our large corporations were getting increasingly uneasy about the weak condition of our banks. Faced with the likelihood of an-

other financial crisis, the only sensible thing for them to do was to advise the curtailment of capital expenditures, a liquidation of inventories, and a reduction of indebtedness to the banking system. These very actions, of course, hastened the thing that was feared. But the fears were certainly justified—as later events proved: 1,352 banks suspended payments in 1930, and 2,294 suspended payments in 1931. Many of those who hadn't foreseen this financial trouble or who were lulled to sleep by Hoover's repeated assertions that the Federal Reserve System was panic proof, lost their businesses.

An economist for one of our largest banks, when confronted with the foregoing explanation of what it is that causes a loss of confidence at the height of each boom, attempted to disprove this theory with the following argument: The fact that our large corporations did not withdraw their bank deposits when they first began liquidating and curtailing operations is clear evidence they did not fear a collapse of the banking system. Had they feared such a collapse, he reasoned, the first thing they would have done is withdraw their deposits.

The answer to this is that for every dollar of bank deposits held by these corporations, there were hundreds of dollars in inventories that had to be liquidated. Their primary concern, therefore, was to liquidate their inventories before trouble with the banks developed. If they were so rash as to withdraw their bank deposits when they first anticipated trouble with the banks, they would have taken great losses because of their inability to liquidate large inventories produced at an inflated price and wage level.

Are Things Different Today?

Defenders of this unsound system of banking hasten to assure us today that things are different. They claim that the banking reforms made since 1933 have removed the possibility of another collapse such as we had in 1933. They point in particular to the Federal Deposit Insurance Corporation as a safeguard against wholesale bank failure. What they overlook, of course, is the fact that the basic weakness in our banking system still exists. We still operate on the assumption that the process of creating imaginary deposits is sound. The F.D.I.C. is nothing but a gimmick designed to bolster our confidence and trust in an untrustworthy system.

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The time has come for us to face the fact that there is no such thing as a sound method of insuring deposits in a banking system that operates on unsound principles. *The creation and lending of fictitious deposits is not a sound method of banking.*

...

I believe that banking institutions are more dangerous to our liberties than standing armies. Already they have raised up a money aristocracy that has set the Government at defiance. The issuing power should be taken from the banks and restored to the Government to whom it properly belongs.

—Thomas Jefferson to John Taylor