

ARGUMENTS ARE FALLACIOUS FOR WORLD CENTRAL BANK

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Elgin Groseclose, financial consultant and Director of the Institute for International Monetary Research, has spotlighted the true nature of credit banking: "The practice of the goldsmiths, of using deposited funds to their own interest and profit, was essentially unsound, if not actually dishonest and fraudulent. A warehouseman, taking goods deposited with him and devoting them to his own profit, either by use or by loan to another, is guilty of a tort, a conversion of goods for which he is liable in civil, if not in criminal, law. By a casuistry which is now elevated into an economic principle, but which has no defenders outside the realm of banking, a warehouseman who deals in money is subject to a diviner law: the banker is free to use for his private interest and profit the money left in trust. ... He may even go further. He may create fictitious deposits on his books, which shall rank equally and ratably with actual deposits in any division of assets in case of liquidation." (*Money: the Human Conflict*, pp. 178-179.)

Disputes Concept of Surplus Reserves

One of the main arguments used by those who defend this unsound banking system is based on a misuse of the word "surplus." The argument is best understood in the context of those who first employed it. The early goldsmith banker noticed that when he operated honestly—with 100% reserves behind all outstanding notes and checking accounts—only a small fraction of the coin entrusted to him was ever withdrawn at one time. He therefore called the remainder "surplus" and determined to lend it out at interest. Actually, however, these "surplus reserves" were not surplus. The coin was idle in a physical sense only. Its ownership was changing constantly while titles to the coin (notes and drafts) were used as a medium of exchange. But the goldsmith-banker naively argued that the coin was not used because it still lay in his vault. With this specious excuse, the goldsmiths called their reserves "idle" or "surplus" and decided to use them for their own purposes.

There is still another way in which the "idle" or "surplus" reserves of these early goldsmiths were really very much in use. The goldsmiths had to have 100% reserves behind their notes and checking accounts in order to maintain the complete and lasting confidence of the public. Panic threatened whenever the public lost confidence in the ability of the goldsmiths to pay their depositors in full. Indeed, panics have shown the weakness of the system ever since it started. Goldsmiths who engaged in credit banking by issuing notes not backed by coin, or by creating imaginary deposits, did so on the assumption that they could eat their cake and have it too. They hoped to inflate the amount of paper money beyond the amount of coin they held, and

still maintain the same confidence. Their inability to do so has been demonstrated repeatedly ever since the practice began. Logic was against the system from the start and all our experience has confirmed that logic.

H. L. McCracken gives another defense of the system: "In short, banks are no longer pure depositories, but rather 'Insurance Companies,' and as such they insure customers against all reasonable probabilities, but not the worst possibilities. It is conceivable that all should die of some epidemic in one year, or that a conflagration should wipe out cities by the score, but insurance rates are not pushed to the point sufficient to cover such contingencies. So in banking, it is practically possible that a banker may be called upon to pay all his liabilities in the form of deposits in a single day, which has been literally true in periods of fear, as revealed by 'runs' on the banks. But just as insurance companies do not anticipate pestilence and wholesale conflagration, so do bankers not anticipate wholesale financial calamity." (*Value Theory & Business Cycles*, p. 62-63.)

Insurance Companies Differ From Banks

The flaw in this argument is not hard to find. An insurance company, by insuring lives or property, does not *cause* a "pestilence and wholesale conflagration," whereas a banking system which is permitted to create and lend fictitious deposits—thereby placing itself in the untenable position of promising to pay on demand more money than is in their vaults—is actually responsible for the loss of confidence that eventually results in "wholesale financial calamity."

Orthodox banking theorists have traditionally slighted

the *confidence* factor. Long treatises have tried to prove the soundness of the credit banking system, but time and again, *lack of confidence* causes it to collapse.

Why do banking theorists persist in telling us that the system is sound, that confidence should not be lost, that depositors should not fear for the safety of their funds?

They argue: Even though a banker's cash reserves do not equal his total deposits, he has outstanding loans which, when repaid, can be used to pay the depositors in full. These outstanding loans may be secured by mortgages or other collateral. If for any reason the loans are not repaid, the banker can foreclose, sell the property, and pay the depositors with the proceeds. So why should a depositor ever lose confidence?

However, experience early showed the banking system could not liquidate in this way. Hence the entry in Samuel Pepys' Diary for Sept. 12, 1664, showing his distrust of England's first goldsmith bankers "because of their mortality."

Why does the banking system have trouble liquidating when confidence is lost? A general withdrawal of cash reserves causes the bankers to curtail further loans so as to decrease the outstanding claims against their meager reserves. This contraction of the medium of exchange causes the price structure to collapse, making it impossible for banks to collect their outstanding loans. And even though the banks foreclose, they cannot sell the foreclosed property for what it was originally worth. The same deflation which makes the repayment of all the bank loans impossible also shrinks the dollar value of the foreclosed property. ...

No Protection from Monetary Management

Many banking theorists contend that collapses of bank credit are not inherent in the system but rather result from "unwise" or "unsound" extensions of bank credit. But the validity of the foregoing arguments against the use of bank credit as money depends in no way upon the quality of bank credit. There is no wise or sound way of short-selling or debasing the legal standard of value. There is no wise or sound way for a banker to create imaginary deposits on his books against which checks can be drawn. There is no wise or sound way to indulge in an activity that is basically fraudulent and dishonest.

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Two Principles

Two significant principles emerge.

1. The medium of exchange must coincide with the legal standard of value to have prices in terms of our legal standard. *This rules out credit banking.*
2. The value of a dollar depends upon the number of dollars in use rather than their mineral composition. This is merely an application of the law of supply and demand to money.

As Alexander Del Mar held: "Price implies precision. It is, or is intended to be a precise expression of value; and it approaches actual precision in proportion as the whole number is limited and known of the pricing symbols or denominators; because the whole number of such symbols is the only steady, stable, permanent immovable point from which such precise measure of value can be made." (*The Science of Money*, p. 20.)

... "The more exact the limits of the volume of money are defined in the law of each State the more equitable will it become in its operation upon prices and the dealings between man and man." (*Ibid.*, p. 129.)

There is good reason to believe many of our founding fathers did not intend to have the English system of credit banking imposed upon the newly formed United States. Under the Constitution each State gave up its right to issue bills of credit and Congress alone was given the power "to coin money and regulate the value thereof." Yet it wasn't long before banks were doing what in effect the states were forbidden to do. And we know that Madison, Jefferson and Clay all questioned the constitutionality of the United States Bank.

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C. W. Barron obviously knew what was happening when the Federal Reserve Act was passed: "The purpose of the act most largely in its inception was 'for other purposes,' and these 'purposes' can never be wisely or effectively carried out; if persisted in they spell disaster to the country. The hidden purpose or 'motif' which inaugurated this legislation, however in effect it may work out under wise administration, is to cheapen money." (Requoted from Groseclose, *op. cit.*, p. 223.)

The disaster predicted by Barron hit us in the early 30's. The Federal Reserve System had made it possible to inflate the credit balloon further than ever before. When confidence finally cracked we had the worst deflation in history.

Commenting on this in 1934, Groseclose wrote: "As we survey the monetary situations in this country we discover that the distortions and convulsions which developed were

the result of a people relying increasingly upon money to facilitate its commercial exchanges, while at the same time progressively weakening and deteriorating its money system. We had built a vast and splendid structure of technical economy, of organized commerce and integrated industry, upon the foundation of money, and while we were building this structure we were undermining the foundation by the device of deposit credit. We saddled upon money the burden of our entire economic functioning, the complicated and extensive machinery for the creation and distribution of goods, and then progressively weakened our money until it was no longer able to support the weight. In the years preceding the great stock market collapse of 1929 we had been going through a progressive inflation of the money, comparable in character, if not in degree, to that which occurred in Europe after the World War.

"Under the conditions that grew up around a situation of constantly expanding banking operations based on steadily diminishing reserves it was inevitable that a crash should occur. ... The stupendous house of banking had been built upon sand—public confidence in the infallibility and capacity of the institution—and when the sand began to shift, the whole structure toppled like an Egyptian monolith." (*Money, The Human Conflict*, pp. 241-245.)

Still not willing to come to grips with the basic problem, we patched the system again. The Federal Deposit Insurance Corporation was created. But obviously there is no safe way to insure deposits when banks retain the power to create them. The managers of the FDIC are well aware of its limitations. Their annual report for 1957 frankly said: "There is no question that the present deposit insurance

would be entirely inadequate should, for example, a situation similar to that of 1930-33 recur." (p.65) More recently, Sam Fleming, then President of the American Bankers Association, recalled the rediscounting liquidity problem in the 1930's, said it could happen again, and suggested a more flexible administration of the discount window so as to solve once and for all the problem of a possible shortage of bank assets. (*Commercial & Financial Chronicle*, Jan. 22, 1962.)

Criticizes International Bank Moves to Inflate

If we squarely face the basic weakness of our financial system we will see how short-sighted we are to place our trust in the International Monetary Fund and any attempt to increase its lending power. What the world now needs is not some new international props to buoy confidence in a fundamentally unsound system. That will only open the way to further weakening of the credit structure. That is but adding weak links to a weak credit chain. What we need is basic reform of each country's monetary system so that each has a sound, noncollapsible monetary unit.

The creation of money must be divorced from the lending of money. The power to create money must be confined to governments alone *and limited by constitutional safeguards*. Banks must not be allowed to lend their credit, but only money placed with them for that purpose and therefore not subject to withdrawal while out on loan. Then and only then will all investments come from actual savings as they should.

The existing volume of bank credit, which is being used as money, will have to be monetized and completely di-

forced from gold. Some agreement must be reached concerning how to adjust the supply of money to population growth. This should not be difficult. ...

International equilibrium would henceforth be maintained by flexible exchange rates just as national equilibrium can be maintained by flexible prices.

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Quotes Von Mises

A few years ago one of the world's truly great economists, Ludwig Von Mises, pin-pointed the principal cause of our economic ills as follows: "Yet most of the supporters of sound money do not want to go beyond the elimination of inflation for fiscal purposes. They want to prevent any kind of government borrowing from banks issuing banknotes or crediting the borrower on an account subject to cheque. But they do not want to prevent in the same way credit expansion for the sake of lending to business. The reform they have in mind is by and large bringing back the state of affairs prevailing before the inflations of the First World War. ... They still cling to the schemes whose application brought about the collapse of the European banking systems and currencies and discredited the market economy by generating the almost regular recurrence of periods of economic depression." (*The Theory of Money and Credit*, new edition, p. 439.)

Von Mises points to the real tragedy of our times—the "discrediting of the market economy." This means the shattering of man's faith in freedom. More and more men have lost faith in the ability of a free market to regulate itself. The true liberalism that flowered in the latter part of the

18th and early part of the 19th century has yielded to the determined onslaught of humanitarians bent on using the powers of government to alleviate the suffering and injustice they thought was caused by the operation of free market forces. Instead of eradicating the basic weakness in our banking system so as to make it possible for free markets to function properly, we allowed that weakness to continue and questioned instead the ability of free markets to regulate themselves. The western world has been steadily deteriorating ever since. Philosophies detrimental to the survival of freedom have been flourishing *and will continue to flourish* until such time as we are willing to mount a determined counter-attack by putting our financial system on a sound basis. It won't be easy to make the changes that have to be made. But there are no short-cuts to the survival of freedom. And although the task ahead of us is a difficult one, at least it holds the promise of solving the crisis of our times by going to the root of the trouble.

It (banking) is the most important subject intelligent persons can investigate and reflect upon. It is so important that our present civilization may collapse UNLESS IT IS WIDELY UNDERSTOOD AND THE DEFECT REMEDIED VERY SOON.

—Robert H. Hemphill,
former Credit Manager,
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