

WHAT TO DO ABOUT THE DOLLAR

By Robert de Fremery

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

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

Bankers “borrow” the money you deposit in checking accounts withdrawable on demand and lend it for as long as 90 days and even six months. They borrow the money

* Chairman of the Federal Reserve Board at that time.

you put into savings accounts withdrawable on 30 days' notice and lend it for as long as 20 years.

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

Fraudulent Deposits

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

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

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

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

The cause-and-effect relationship between bank panics

and depressions was obvious in the early days of the system. But as the wiser members of the business and financial world finally learned the inevitable consequences of steadily increasing the amount of bank deposits that had no existence except as book entries, they began anticipating these panics by curtailing capital expenditures, reducing inventories, and getting out of the stock market.

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

Many hold that if the banking system were based on an essentially fraudulent practice, it would have died a natural death long ago. Yes, that's what would have happened if the bankruptcy laws that apply to most businesses were applied to banks. But they aren't. When panics occur, the bankers (who have borrowed short from their depositors) are favored as compared with those who borrowed from the bankers.

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

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International Extension

After the second world war, the world's central bankers decided to do what the United States did when it formed the Federal Reserve System. They decided to pool some of their reserves. The International Monetary Fund was formed to help any central bank in difficulty with the rest of the world. But after massive aid was given to Britain during the Suez crisis, members of the IMF realized the pool of reserves wasn't big enough, so they each put in still more. Even this was later felt to be inadequate, so the Paris Club was formed—a group of ten countries that agreed on a plan whereby the IMF could borrow from one or more of them in an emergency.

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

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

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When will we come to our senses?

Stubborn adherence to an essentially unsound monetary system has been forcing us to adopt many unsound measures such as deficit financing, the Full Employment

Act, price supports, etc. The further we depart from sound economic principles, the more trouble we get into. This leads to demands for still more government controls.

Public Education

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

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

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During the thirties there was widespread interest in the idea of 100% reserve banking. ... But because it was not considered "politically feasible," interest waned.

For over 200 years we have been doing what is politically feasible rather than what is economically sound.

That's why the world is in such a mess. And we can expect things to get worse if we continue letting expediency determine our actions.

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My choice of a ghost, which could turn out to be a flesh-and-blood menace to our credit structure ... is the business of borrowing short and lending long.

—George W. Mitchell, Member, Board of
Governors, Federal Reserve System,
10/22/65

They (banks) must, after all, pay off most depositors on demand; in effect they, borrow funds for short, indeterminate periods. And to borrow short to lend long has never been a slogan of safe finance.

—Wall Street Journal editorial,
May 29, 1967

Most of England's balance of payments troubles are due to too much borrowing short and lending long ... the classic road to bankruptcy.

—James Callaghan, Chancellor
of the Exchequer, England, 1965