

# BANKING REFORMS TO STOP PERIODIC LIQUIDITY CRISES

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Milton Friedman has proposed two solutions to our money problems. Both have the same objective: to stabilize the rate of increase in the money supply. But in one case he would try to do this within the framework of the existing system of fractional reserve banking; in the other he would have us convert to a system of 100 per cent reserve banking.\*

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## Quotes Letter from Friedman

Friedman says either remedy will work. If he is wrong, the consequences could be tragic. This whole matter deserves public debate. To further this, Friedman has given me permission to quote from a letter which, to my knowledge, is the most recent statement he has made on this subject: "I am as you say in favor of the 100 per cent reserve

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\* *Essays in Positive Economics*, Milton Friedman, The University of Chicago Press, 1953, pp. 135-36.

scheme. I have been and I have written in favor of it in my *Program for Monetary Stability* and elsewhere. However, I do not attribute to this reform the importance that you attribute to it. I believe it would be a desirable reform but a relatively minor one. Without the 100 per cent reserve reform I believe it is possible to prevent depressions, liquidity crises, and the rest. Indeed as I said in a talk given in 1953, reprinted in my *Dollars and Deficits*, 'Why the American Economy is Depression Proof,' I believe that the legislation enacted in the 1930's, in particular the establishment of the FDIC, has made almost impossible a major liquidity crisis and monetary collapse of the kind we had in 1929-1933.

"I nonetheless favor the 100 per cent reserve plan for two reasons. The first is that under 100 per cent reserves it would be easier to get rid of government regulation of borrowing and lending. The second is that under 100 per cent reserves it would be easier and more mechanical for the Federal Reserve or a corresponding agency to control the behavior of the quantity of money. However, even without this reform there is no great technical difficulty in the Federal Reserve making the quantity of money behave in any way that it desires including a steady rate of increase in the quantity of money. The only problem raised by fractional reserves is that the authorities must offset changes in the reserve ratio and changes in the ratio of currency to deposits. Since in the absence of crises these tend to move very slowly there is no significant technical problem." (letter, January 21, 1969)

### Banking's Fatal Error

First a word about how fractional reserve banks operate. Most people do not know that the bulk of our money supply is "privately created" by our commercial banks. The process is called "borrowing short and lending long."

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The panic of 1907 led to demands for reform. But instead of facing up to the cause of the trouble we installed the so-called "panic-proof" Federal Reserve System (Fed). The idea was to pool the cash reserves of all banks and use this pool for massive loans to banks that needed more cash in a hurry. The Fed was also given the power to create more cash and lend it to member banks on the security of certain assets designated by law. We found—during 1929-33—that the system was still not panic proof.

### Henry Simons' Proposal

After that debacle, the 100 per cent reserve proposal was made by Henry Simons in *A Positive Program for Laissez Faire*.<sup>\*</sup> The purpose of this reform was to prohibit the practice of borrowing short and lending long—thus stopping the private creation of money by banks. As more money is needed in our country it would be the government's responsibility to provide it "under simple, definite rules laid down in legislation."<sup>\*\*</sup> Our supply of money would henceforth be homogeneous. Gresham's Law would

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\* This originally appeared in 1934. Now found in *Economic Policy for a Free Society*, Henry Simons, Univ. of Chicago Press, 1948, pp. 40-77.

\*\* *Ibid*, p. 57.

cease to bother us. *This reform would have gone to the root of the problem.*

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We should heed the warning given by the Economic Policy Commission of the American Bankers Association in 1957: "Certainly, federal deposit insurance has greatly reduced the danger of widespread currency withdrawals. It should be recognized, however, that *the realization on the part of large depositors that their deposits are not fully covered might cause them in a time of uncertainty to shift some of their deposits.* In this connection, it may be noted that while the proportion of accounts fully protected by deposit insurance is about the same (98 per cent) for all size classes of banks, the proportion of dollar totals covered by insurance varies greatly, ranging from about 90 per cent in the smallest-size banks to roughly a third in the very large ones."\* (emphasis added)

There were \$194.8 billion of *uninsured* deposits in banks insured by the FDIC at the end of 1968. The possibility of a significant shift of some of these deposits could well be the *cause* rather than the *result* of some of the uncertainty existing in our financial markets.

Usually bankers, confronted with the facts about the FDIC and asked what would happen in the event of trouble, shrug their shoulders and reply that the government would simply print more money in a hurry to save the situation. But would it? Following the collapse of the stock market in 1929, President Hoover twice assured the American people that the Federal Reserve System had made our banks "panic

\* *Money, Financial Institutions, and the Economy, A Book of Readings*, Crutchfield, Henning, and Pigott, pp. 79-80.

proof." Yet, 5,099 banks suspended payment during the next three years.\*

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Jack M. Guttentag, Professor of Finance, Wharton School, in a recent address to the Investment Bankers Association, defined a financial panic as: "A general loss of faith in the capacity of those who have promised to provide cash under stipulated conditions to deliver on their promise—and a consequent rush by those to whom the promises have been made to convert them quickly, before others do so and before the resources of the promisor are exhausted."\*\*

He added: "In days past the main promise at issue during financial panics was the promise of commercial banks to convert deposits into currency, but this is not at issue today."

Isn't it? What about the warning in his concluding note: "In addition, increasing attention will have to be paid to defensive open market operations. In this connection, the content of the directive given by the FOMC to the manager requires careful study. As I read the proviso clause that is now incorporated in the directive, *it could cause the manager to desert the market, even to withdraw reserves if there is an unexpected bulge in panic borrowing.*" (emphasis added)

As things now stand the promise of commercial banks to convert deposits into currency is still the main promise at issue today. Just because large depositors are not yet

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\* Annual Reports of the Federal Reserve Board.

\*\* "The Federal Reserve in the Money Market", Jack M. Guttentag, *Commerical and Financial Chronicle*, May 7, 1970, p. 9.

asking for cash doesn't mean they now have confidence in the commercial bankers' promises to pay cash if called upon to do so. It is more plausible that they are not yet asking for cash because they know full well how shaky the whole structure is. Most large depositors are corporations that hope to continue doing business on a profitable basis. They also wish to maintain good banking relations. So when they first fear a liquidity crisis, they evidence that fear in ways other than withdrawing their money from the banks. They engage in anticipatory borrowing—thus causing interest rates to rise. These rising rates—like a falling barometer—have always heralded an approaching financial storm. *And no storm was ever prevented by tinkering with the barometer.*

### Giant Squeeze Play

More needs to be said about the effects of this anticipatory borrowing. When a corporation or a utility floats a large bond issue, the net effect is a transfer of deposits from many small banks (from savings accounts of individuals attracted by the higher yields on bonds) to a large bank with whom the corporation or utility does business. Isn't it possible that some of the anticipatory borrowing actually may be encouraged by the large banks for this express purpose? In other words, a gigantic squeeze play could be going on between the large banks and the small banks for deposits. It isn't too difficult to see who would win that struggle. It would be tragic for many small banks. And the resulting failures could very readily trigger a general loss of confidence that would soon be felt by the larger banks that are even more vulnerable than the smaller ones.

Many frown upon such blunt talk. They say it may

precipitate the very panic that is feared. But we certainly cannot expect to make a rational improvement in the system without talking about the problem. *And a system that is so fragile it can't be talked about certainly needs improving.*

### Discount Window

Friedman's proposal to have the Fed keep the supply of money expanding at a given rate per annum via open market operations would remove the possibility of a collapse of the supply of money. But banks would still be subject to runs because of their method of operation. And if the Fed's power to rediscount were abolished—as Friedman recommends\*—the Fed would no longer be a “lender of last resort.” *Wouldn't this tend to invite a panic?*

Presumably in the event of another panic, the Fed—under Friedman's prescription—would be pumping money into the country via open market operations at the same rate as dollars were being extinguished by bank failures. And, as Friedman pointed out in his letter, the authorities would have to offset changes in the reserve ratio and changes in the ratio of currency to deposits. This does not appear to be a very practical means of achieving monetary stability.

Would it help if the Fed kept its power to rediscount? Banks do not like to borrow from the Fed. It is a sign they have not conducted their affairs with prudence. It also frightens large depositors who know the Fed has first claim against a bank's assets in case of liquidation.

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\* *Money, Financial Institutions, and the Economy*, Op. Cit., pp. 305-6.

Even if banks were willing to borrow on a large scale from the Fed, there is some question whether the Fed would oblige. J.L. Robertson, Vice-Chairman, Federal Reserve Board, in an address before the Ohio Bankers Association, said: "The discount window will, of course, always be there to protect communities and to meet the emergency needs of banks. But it would not be wise to count on its being there to save bankers from the consequences of going overboard in borrowing short and lending long."\*

There is no doubt that banks have gone overboard. Let us face that fact and put our banks on a 100 per cent reserve basis now—thus making *certain* a banking crisis cannot occur.

Friedman said that one reason he would favor the 100 per cent reserve proposal is "it would be easier to get rid of government regulation of borrowing and lending." That is certainly a desirable goal. But the fact is there is not the remotest possibility of getting rid of such government regulation under a system of fractional reserve banking. Marriner Eccles, former Chairman of the Federal Reserve Board, saw this clearly: "Credit must primarily be controlled at the source of its creation, the banking system. This cannot be done on a basis of voluntary agreements in a competitive business involving fifteen thousand banks. There must be adequate powers in the Federal Reserve System to bring about the needed restraint on the part of

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\* "Meeting Changing Banking Problems Before a Crisis," J. L. Robertson, *Commercial and Financial Chronicle*, Feb. 18, 1965, p. 12.



banks as well as on the part of borrowers.”\*

Eccles realizes that the supply of money is a Congressional responsibility that has been delegated to the Federal Reserve System. Therefore, if we use bank credit as money, the Federal Reserve System must have the power to control the banking system. But do we realize the extent of the controls that will be required? Says Louis B. Lundborg, Chairman of the Board, Bank of America: “The time has come to seriously consider expansion of Federal Reserve control. Control over only commercial banks is no longer sufficient for effective control of credit availability. The credit market in the United States is made up of much more than the commercial banking system.”\*\*

The essence of a free market economy is that men are free to work where they please and produce what they think is wanted by their fellow-men. Freedom to produce what you want requires a free banking system that mobilizes the voluntary savings of the community and makes these savings, available on a sound basis to the highest bidder. Centralized control of borrowing and lending means financial dictatorship. The Russians call it “control by the ruble.”\*\*\*

Do we want “control by the dollar?” We are headed in

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\* *Beckoning Frontiers*, Marrison S. Eccles, Alfred A. Knopf, 1951, p. 473.

\*\* Address before the National Industrial Conference Board's National/International Financial Conference, Waldorf Astoria Hotel, Feb. 14, 1968.

\*\*\* See “Economic Control Through Credit Control”, contained in *The Soviet Financial System*, Mikhail V. Condoide, Ohio State University, 1951, Bureau of Business Research, p. 38.

that direction. We are blaming our troubles wrongly on our free enterprise system instead of our unsound banking system. A dollar is a standard of value. A stable supply of dollars is therefore extremely important. Our society is as dependent on the accuracy of that standard as it is on the accuracy of our standards of length or weight. We foolishly allowed our banks to debase our dollars by the unsound practice of borrowing short and lending long. That led to so many economic ills that our whole economic system is now threatened.

Some say reform is not politically feasible. But can our republic survive without a reliable standard of value? Let's admit that when something is causing trouble, nothing is more impractical than to worry about the effects while ignoring the cause. Borrowing short and lending long—when combined with the clearing operations of a commercial banking system—makes our standard of value unreliable. It is therefore imperative that we:

1. put our banks on a sound basis now so they won't collapse again
2. insist that banks operate on a sounder basis in the future
3. pass a constitutional amendment that will keep our supply of money at whatever level is deemed necessary to support our economy.

This can be accomplished without depriving anyone of a single dollar he has access to today—and without adding to the supply of money. To whom should we look for leadership to bring about this much needed reform? To our bankers. They should see the handwriting on the wall more clearly than anybody. They know the problems that arise

from borrowing short and lending long. They know the long arm of government will control them more and more if they persist in continuing this practice. And they know there is a sounder method of intermediation—the method suggested by George S. Moore, President, First National City Bank of New York. His bank first introduced the negotiable certificate of deposit (CD) in the early 1960's.

Misuse of CDs led to the credit crunch in 1966. Banks had been making five year loans with funds obtained by the sale of one year CDs. This led to a runoff of CDs when the return on good commercial paper exceeded the interest rate banks were permitted to pay. The resulting liquidity squeeze was so acute even during 1965 that there was some talk of restricting the issue of CDs. It was then that Moore proposed a more sensible solution: "It would reduce the risk of being illiquid if there could be a 'back-to-back' relationship between term loans and CDs—i.e., a five-year loan with a 5 ½ per cent yield would be based on a five-year CD paying a 4 ½ per cent interest rate. That way the banks could budget their income and obligations more precisely."\*

This is refreshing rationality. Although Moore was referring only to CDs as currently being used, he stated a principle upon which *all* financial intermediation by banks should be based. All funds loaned by banks should come from the issue of negotiable CDs with maturities and yields tailored to meet the needs of borrowers and savers. And banks should be required to maintain a 'back-to-back' relation between loans and CDs. Banks would then have

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\* *Fortune Magazine*, September, 1965, pp. 269-270.

100 percent cash reserves behind their checking accounts. There would be no savings accounts. Those with savings would buy negotiable CDs. Liquidity squeezes such as we have had in the past would then be an impossibility. There would be no more borrowing short and lending long—none of the multitude of problems and changing expectations caused by that unsound practice—and no excuse for any controls of borrowing and lending except to maintain the 'back-to-back' relation between loans and CDs.

When the above suggestions were brought to the attention of a member of the Federal Reserve Board, he replied: "I certainly have no quarrel with the commercial bank ... or any other financial intermediary that succeeds in *meshing the maturity profile of its assets and liabilities*. More power to it! Every step in that direction has a stabilizing effect on the economy whenever the economy is confronted with real or fancied disturbances affecting people's desire for liquidity." (letter, May 18, 1966. Emphasis added)

Any responsible citizen must mesh the maturity profile of his assets and liabilities. How else can he keep from going bankrupt? Shouldn't we expect an equally high standard of our bankers—those who are entrusted with the life savings of so many of our citizens?

The Panic of 1907 led to the Federal Reserve System—*which did not solve the problem*. The collapse of 1933 led to the FDIC—*which still has not solved the problem*. It is the responsibility of our bankers to spare us another such calamity. They can do it. Congress will pass the necessary legislation when our bankers ask for it. If that legislation is not passed before another calamity occurs, there is grave danger of our being swept into complete "control by the

dollar” or, worse still, of losing our financial sovereignty.  
Will our bankers rise to the challenge?

*In its principle, the reform of the credit mechanism should make impossible the exnihilo creation of money and the borrowing at short term to finance loans of a longer term, and it would permit only loans at maturity terms shorter than those corresponding to the funds borrowed.*

—Maurice Allais, 1989 Nobel laureate  
in economics in a paper delivered  
that year in Montreal.