THE ONE HUNDRED PER CENT RESERVE PROPOSAL REVISITED

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Now let's take a look at a possible method of converting to a 100% reserve system, a method that E.S. Shaw (Stanford), T. Mayer (U.C. Davis), and Martin Bronfenbrenner (Duke)*, have all said deserves serious consideration. None of them think such a reform is necessary at this time, but they agreed that it would be a good idea to have such a plan "in the offing" just in case the Fed proved unable to achieve the monetary stability our economy needs.

In what follows, I am purposely not going to use any actual figures. Figures aren't important at this time. It's the concepts that are important.

Since the objective is to have a 100% cash reserve (legal tender) behind all demand deposits, the U. S. Treasury would be ordered by Congress to have printed and then loaned to the banks sufficient new currency to fulfill that

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* Each of these professors has been a visiting scholar at the Federal Reserve Bank of San Francisco.

objective. In determining the amount to be borrowed, banks would treat their legal reserves at their local Federal Reserve Bank as cash. Those reserves will become actual cash as explained later.

The debt incurred by each commercial bank to the Treasury could be immediately reduced by the amount of U.S. securities each bank held—simply a cancellation of mutual indebtedness. Henceforth the commercial banks would be prohibited from using the cash reserves behind their demand deposits for their own interest and profit. Those cash reserves belong to the depositors. They are funds against which the depositors wish to draw checks.

On the day the cash reserves of banks are brought up to 100% of their demand liabilities, they would have outstanding loans which I shall call "old loans" as distinguished from the new loans that will be made in the future. As these old loans are paid off, each bank would be required to use these funds to pay off their savings and time depositors, and offer them, as an alternative, negotiable CDs. There would be no restriction of any sort on the issuance of such CDs. The maturity dates, the amounts, and the rate of interest would be set by each bank. But banks would not be allowed to lend the funds so obtained for a longer period of time than those funds were available to them; i.e., they would be required to maintain the back-to-back relation suggested by George Moore.*

After each bank had paid off all its time depositors, it would still have a sizable amount of "old" loans outstanding. As the rest of these old loans were paid off, these funds

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* See page 113.

would be used to further reduce the banks' indebtedness to the Treasury. The Treasury, in turn, would be required to use these funds to retire U.S. obligations held by investors outside the banking system. And as the Treasury did this, these investors would presumably buy negotiable CDs offered by the banks.

Any remaining indebtedness of the banks to the Treasury could be paid off with funds derived from the sale of some of their "Other Securities". Indeed, a good argument can be made for having the Treasury figure in advance how much of each bank's securities are going to have to be sold and require them to start selling those securities gradually, the day the changeover is made.

As for the Federal Reserve Banks, they too should borrow from the Treasury sufficient new currency to bring their cash reserves up to 100% of their demand deposits (funds deposited by their member banks for safekeeping plus all government funds against which checks are being drawn by the government). The indebtedness of the Federal Reserve Banks to the Treasury could immediately be canceled by a mutual cancellation of indebtedness as was done by the commercial banks, i.e. by canceling an equivalent amount of U.S. obligations held by the Federal Reserve Banks. The remaining U.S. obligations held by the Federal Reserve Banks should also be canceled in view of the fact that they had originally been bought by the mere creation of bookkeeping entries. That practice would be abolished.

The supply of money would now consist of the total coin and currency in existence, i.e., the amount previously existing plus the amount newly printed and loaned to the commercial banks and the Federal Reserve Banks. There

would no longer be any confusion about what was meant by the supply of money. And the money supply would no longer be altered by such things as the lending activities of banks, or the decisions of individuals to switch funds from a checking account to CDs, or the payment of taxes to the U.S. Treasury, or the disbursement of funds by the Treasury, etc. Whenever an increase in the money supply was needed according to whatever rule of law was adopted (a strong case can be made for a "population dollar", i.e., a constant per capita supply of dollars), the increase could be made with absolute precision by simply retiring that much of the remaining National Debt with the new money.

S & Ls and MSBs should be made to operate as they were originally intended, i.e., those who place their funds in such institutions must be reminded that they are shareholders and that they can draw their funds out only when those funds are available for withdrawal. A run on such institutions would no longer be a threat to the banking world. Nor would the failure or bankruptcy of any large bank, corporation, or municipality be the threat to the banking world that it is today. Any such poorly managed entity could, and should, be allowed to go through bankruptcy. There would be no danger of precipitating the type of financial stringency or credit crisis that is feared so much under our present financial system, and justifiably so.

The multitude of governmental lending agencies that have arisen since the early '30s should be dismantled. *The lending of money is not a proper function of government.* It has been sanctioned so far because banks operated in such a way as to imperil a continuous flow of funds to areas that needed it. With banks now operating on a sound basis, free

market forces should be relied upon to keep money flowing in the most healthful manner for all.

Having corrected the destabilizing element of our monetary system, we should reject the concept of deficit financing and a compensatory budget. Those concepts arose under the old system because when the business and investment world lost confidence—thus leading to a contraction in the supply and/or velocity of money—the government was forced to indulge in deficit financing to try to keep the supply and/or velocity of money from contracting too far. Under the new system the supply of money is non-collapsible and therefore changes in the velocity of money (caused by changes in liquidity preference) would be minimal and self-regulating.

Government supervision or regulation of banks would now be greatly simplified. In place of all the governmental agencies with overlapping functions that are busily engaged in regulating various activities of banks, we need have only one agency. Its sole function would be to make certain each bank is keeping its cash reserves at 100% of its demand deposits, and that the maturity profile of its outstanding CDs meshes with the maturity profile of its loan portfolio. Except for these restrictions, banks would be free to set the amounts, the maturity dates, and the rates of interest on the CDs they issued. They would also be free to make loans for any purpose they pleased, secured by any collateral they deemed adequate.

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Had a change like this been made in 1970, which is the last time I checked all the actual figures, the National Debt would have been reduced by over $200 billion. About half

of that would have been instantaneous and the rest would still be in process today as the banks continue to retire the rest of their debt to the Treasury. Today, of course, those figures would be much greater.

What effect would all this have upon interest rates? It's hard to say. ... But the important point to keep in mind is that whatever happens to interest rates,—whether they rise, fall, or stay the same—it will be what should happen. Nobody can improve upon market forces for determining the proper rewards for working and saving *if* we have a sound money and tax system.

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Some critics have questioned whether or not banks would be able to obtain sufficient long term lendable funds to meet the demand for such funds. No problem. Most savers will be buying long-term CDs in order to get a higher return because they know they will be able to sell their CDs in a secondary market should they need their funds before their CDs mature. Even today there are large amounts of long-term government securities currently held outside the banking system—securities that will be gradually paid off ahead of time as banks retire their debt to the Treasury. The amount of these is impressive: 1 to 5 years: $127 billion; 5 to 10 years: $35.6 b.; 10 to 20 years: $14 b.; over 20 years: $11.9 b. If many persons today are willing to lock up their savings in these securities whose ultimate real value at maturity is uncertain because nobody knows what will happen to the money supply in the meantime, will they not be even more likely to buy CDs of similar maturities when banks have been put on a sound basis, and the supply of money has been tied to our population by law?

However, let's suppose, for the sake of argument, that banks are unable to compete successfully for as much of the savings of the community as they have in the past. Suppose most savings flow directly into the commercial paper market or the municipal bond market or whatever. So what? Shouldn't market forces determine the use to which our savings are put?

I realize that many economists lack faith in market forces. But aren't they a little like the fellow who lost faith in his automobile because he persisted in using contaminated gasoline in the engine? Let's give free market forces a fair chance to show what they can do. And the first step in that direction is to provide ourselves with a sound and reliable money in terms of which economic decisions can be made.