OBJECTIONS TO THE 100 PER CENT RESERVE PLAN

Certain objections to 100 per cent reserves are commonly overlooked. In case of bank credit, the real lenders are the depositors including, notably, the recipients of checks. It is these whose convenience waiting is combined and coördinated by the banks and made available to borrowers who pay for free banking service to depositors. The 100 per cent reserve scheme would make this free service impossible unless subsidized and might conceivably bring disappearance of deposit banking. Subsidization objected to; perpetual government debt as means to idea of 100 per cent objected to. Why precisely 100 per cent? A sacred number? Possible resulting growth of new type of financial institution through which we could still get deflation. Why henceforth deprive depositors of possibility of free banking service?

A number of economists who favor a managed currency, with the idea of promoting stabilization of the general level of prices, have accepted—a little too uncritically, I think—the idea of 100 per cent reserves. Objections which I cannot but believe have some importance, seem to have been generally overlooked.

One of the principal features of commercial banking, as we know it today, is free service to depositors, whereby business can be carried on by check and the clerical work of transferring credits from the makers of checks to the depositors of checks is done without fee—though the depression has brought in, to some extent, the service charge. It is because the banks have been able to "lend more than they have," because, in short, they have not been compelled to maintain a 100 per cent reserve, that they have been able to render this service to depositors without charge.

Of course the banks do not really lend more than they have, except as intermediaries or agents for the real lenders. What the banks do is to bring borrowers and lenders together. And the lenders are the bank depositors. Let us suppose the banks to lend, in the aggregate, several times as much money as they have on hand. The borrowing accomplishes nothing for those who receive the deposits until they use their newly acquired credit for the purchase of goods, by writing checks on this credit. When they have done this, they no longer have claims on the lending banks. But the recipients of their checks have these claims. Clearly, the banks could not thus lend more than they have on hand and have the lending mean anything, if the recipients of the checks drawn on this credit were, every one of them, to insist at once upon taking the money out of the banks. *It is the recipients of the checks,* therefore, *who are really the lenders.* They have given up tangible goods or services and are *waiting* for payment. For the checks they have received are but claims on the banks. And the recipients of these checks are still but claimants on the banks after the checks have been turned in, until they have actually drawn out the money owed to them or until they have, in their turn, made purchases and passed to others the claims they hold on the banks. These others then become the claimants on the banks. If all the borrowers of all the banks failed to repay, is it not clear that depositors, even with our present limited deposit guarantee law, must lose? Is it not perfectly clear, therefore, that all of the borrowers (including drawees of commercial drafts) are the debtors, through the banks as intermediaries, of all the depositors?

The reason that bank depositors are willing thus to place their funds at the disposal of borrowers is that this lending costs them nothing. On the contrary, they reap an advantage from it. For thereby depositors avoid having to carry money in their pockets or to put it in large amounts into safes, with the consequent trouble and risk. Furthermore, no one of them has to remain a depositor—and, therefore, a lender—any longer than he chooses. For whenever he finds it convenient to do so, he can pass his claim on his bank to another, by check, in return for goods, and then that other becomes the depositor and lender and the former lender is a lender no longer. "Likewise, any one such lender—not, however, all at once—can cease to be such by demanding the money owed him, from the bank, whereupon the depositor of that money or someone to whom that depositor has given a check, becomes a lender."[1]

It is not necessary, here, to go into all the qualifications and complications of the argument. A further brief statement will make sufficiently clear its bearing on the problem of 100 per cent reserves.

> Depositors are, in general, persons who wish to have available buying power which they can use at any moment. Yet, almost invariably, few of these depositors do spend all of their accounts at once. There is an interval of hours—days—a week—during which they remain creditors who have a right to draw but do not draw and do not spend. And when they have passed this right-to-draw to others, the others in their turn wait, according to their convenience, before spending or drawing. Each depositor is in the position of a lender only so long as convenience dictates. Yet, in the aggregate, since one after another takes up the position of creditor or depositor, there is a great deal of this convenience waiting or lending. And the institution of commercial banking enables this convenience waiting, combined and coördinated, to be put at the disposal of borrowers. No one depositor is a lender for much or for long. But all of the depositors, together and in series, make possible the lending by banks of more than they have cash on hand. . . . This intermediary and coördinating function of banks cannot, however, be carried on without cost. And the demand for loans is great enough to throw the burden of this cost entirely upon borrowers, who pay it, in interest, for loans which, usually, cost the ultimate lenders nothing.

If a 100 per cent reserve requirement, without some compensating subsidy, should make this free service impossible, the check might, con-

[1] This and a later quoted passage are from my book, *Economic Science and the Common Welfare,* 6th ed., Lucas Bros., Columbia, Mo., 1936, part 1, ch. 4, in which the subject of convenience lending is developed more fully. See, also, article in *Quart. Jour. Econ.,* Aug., 1910, entitled "Commercial Banking and the Rate of Interest" and chapter 2 of part 1 of my *Principles of Commerce,* Macmillan, New York, 1916.

ceivably, become almost altogether a matter of history. For if depositors must pay a fee for the service it may be that many or most of them will prefer to keep large sums of money in their pockets, cash drawers and safes, despite the inconvenience and the greater danger of robbery, and pay bills by cash instead of by check. At any rate, such a possibility ought not perhaps to be entirely overlooked.

When I urged this objection on an advocate of 100 per cent money, several years ago, in correspondence, I was met with the suggestion that, rather than yield to it, deposit banking should be *subsidized* by government. My own view is that the price system is too much interfered with and warped by subsidies already and that a further spread of the principle of subsidization, with the consequent possible introduction of political influences almost inevitably involved, should be looked at with very great suspicion.

The 100 per cent idea has been put into a fancy package that adds markedly to its superficial attractiveness. We are told that the banks can be provided with the required 100 per cent reserves in government issued paper money, in exchange for government bonds, and that thus our great and growing national debt can be liquidated. The subsidizing of the clerical services of banks to depositors will merely, it is said, take the place of the annual interest burden on the debt. Or it is suggested that the bonds, though not themselves money, may be counted in the 100 per cent reserves, the government to stand ready to substitute money for these bonds in case of need, yet meanwhile to pay interest on them.

But the subsidizing must, apparently, go on forever. The debt *might* sometime be paid. In the past, it has been the policy of the United States to pay off its debt. Are we now to adopt the defeatist attitude that our national debt can never be paid, or even nearly paid, in the ordinary way, and so attempt to abolish it as a formal bonded debt by substituting a perpetual obligation to subsidize deposit banking and to subsidize it to an unforeseeable extent?

Is there no way to make deposit banking adequately safe and stable without a 100 per cent reserve? Must it be *precisely* 100 per cent in money, regardless of other value back of deposits? Is this precise 100 to become another sacred number? And is 100 per cent the *only* way of effectively stabilizing the price level? Is 70 per cent, 40 per cent and every per cent other than 100 utterly incompatible with any effective stabilization?

But some of the advocates of a 100 per cent system may contend that no subsidization would be necessary. They may contend—and who can say with certainty that they are wrong?—that depositors in general would gladly pay the full cost of the bookkeeping and clerical work involved in deposit and check service, rather than be deprived of this service and that depositors would thus continue to leave on deposit with commercial banks substantially the sums they now leave. They may argue that the relative safety and convenience of the use of checks rather than pocket money are so marked as to make most corporations and individuals that now use checking accounts continue to use them. They may even point to the fact that some service charges have been recently made by many banks because of the decreased demand for loans during depression, and claim that such service charges have not caused depositors to withdraw their deposits. And, of course, the bookkeeping and other expenses of checking service might be kept down through the limitation of the use of checks to fairly-large payments. But whether depositors, during years of prosperity, would continue to be depositors as largely as in the past, while themselves paying for all the expenses involved, in the form of service charges, would seem to be problematical.

The provision of free service to depositors, by making use of their convenience waiting, may, indeed, be made dependent on some sort of government subsidy, in the hope of thereby somehow preventing an alternate inflation and deflation which can be prevented equally well or better, in all probability, in other ways. It is by no means likely that inflationary and deflationary movements can be prevented *merely* by establishing a 100 per cent reserve system.

Let us suppose the 100 per cent reserve system established and let us suppose, even, that the reserves are so controlled as to appear to warrant the hope—in the view of the 100 per cent advocates—of a stabilized price level and stable business.

Nevertheless, it would seem that there might still be possibilities of sharp fluctuations in potential spending.

Even though deposit currency, as such, is thus rigidly controlled, what is to prevent the development of institutions, in boom times at least, to take deposits *not subject to check* but which depositors are allowed to withdraw on short notice (say three or four days) with the understanding that these deposits may be loaned or invested and that the depositors are to receive interest. Such institutions might be able, then, to induce many commercial bank depositors to keep their commercial bank deposits at a very minimum, relying on their ability to withdraw funds on short notice, when needed, from the interest-paying institutions. Since all would not need these extra funds at the same time, such an interest-paying institution could ordinarily rely on a considerable constant fund which it could keep invested or loaned. In other words, even though non-checking deposits were subject to withdrawal on short notice, not all of these deposits and, indeed, probably only a fraction of the total, would have to be kept in ready cash.

Thus there *might* be reintroduced in regard to such non-checking deposits, the system of partial reserves which had been legally ruled out for deposits subject to check. And it can easily be shown that deflation would then be possible through the oscillation of deposits in such institutions, very much as in the case of the deposits subject to check in commercial banks.

For such institutions, just as in the case of less-than-100-per-cent-reserve deposit banks, would be a means of economizing money, of making a limited amount of cash do more work; and so, in case of a withdrawal of the cash relied on for reserve, and the consequent loss of this economy, there would be an effect similar to the effect of deflation of our modern commercial bank credit.

I have sometimes tried to bring home to my students in "principles" the way in which the sporadic waiting of depositors is put at the disposal of borrowers, by showing how this could happen without any formal deposit system at all, if only the convenience waiting of some could be effectively combined and coördinated individually. Thus, in a class of 100, I may point out how I might secure a loan of $50 for ninety days if able to find some member of the class with that sum which he does not immediately want, but which he is likely to want at any time, provided there are others, in series, who can take his place as lender to me whenever he needs his money. Thereby each member of the class has his money whenever he needs it and yet I, too, have the money when *I* need it. Money which might have served the need only of A and, later, of B, C, *et al.*, now serves *my* need while continuing to serve theirs.

Assume now, a financial institution which accepts the money of A, B, C and the others, promising to pay each on very short notice, yet, because there are always some who for the moment do not want their money, lending it to W, X and Y. But checks are not used, we shall suppose, since the law is assumed to forbid checking deposits without 100 per cent reserves. So W, X and Y withdraw in actual money whatever they borrow. Then suppose the development of such an attitude of mind among the depositors that few of them longer dare to leave their money on deposit. In that case, the money so withdrawn can no longer be spent by others in the intervals during which its owners do not individually desire to spend it. In other words, the withdrawal of this money by frightened depositors would have a deflationary influence even though the money was not a reserve for any checking accounts at all.

No doubt we might attempt legislation prohibiting any individual or corporation from taking any money from others for investment except on the understanding that such money is in no case to be withdrawn on less than sixty or ninety days' notice, so that this money cannot be, in effect, available spending power for two persons at the same time. But such legislation, interfering so greatly with the individual liberty of choice of those who have money, does not seem very probable. And in the absence of such legislation, is it so unlikely that depositors in commercial banks which not only are unable to pay any formal interest on checking accounts but must even make service charges, should reduce their commercial bank deposits to a minimum and endeavor to secure some interest elsewhere to offset these charges?

And, of course, any anticipation of a falling price level may affect the velocity of circulation of money, altogether independently of the considerations detailed above.

If, then, the possibility of undesired and unplanned deflation would still be with us under a 100 per cent reserve system, if the gain from such a system is highly problematical, if methods of control such as open-market operations, adjustment of interest rates, etc., would still have to be resorted to, if the 100 per cent system might require subsidization and might result in purposeful perpetuation of the national debt, and if adequate safety and control can be had as well with a smaller reserve as with the sacred 100 per cent, then why must we deprive depositors of the privilege of receiving a sort of interest (in the form of free banking service) on their deposits?

We have a banking system which has grown up, through the centuries, in a particular way. There is reason to believe that we can, through wisely planned control, adapt this system to the need for a fairly stable standard of value. Unless it can be shown that it is practically impossible so to adapt it as well as that the 100 per cent system can be and is likely to be a much more effective and satisfactory way of attaining this end, it would seem better to cease turning our attention to such a system and, instead, concentrate on the task of working out less revolutionary changes and techniques for attaining the desired stability.

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