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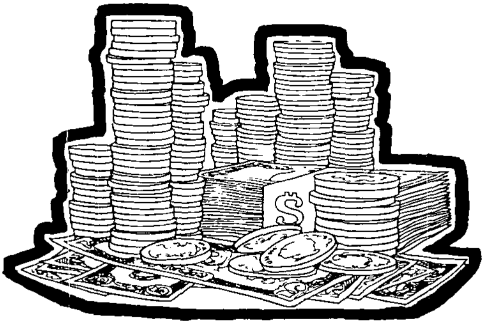
The Free Banking Alternative



ON MARCH 31, 1980, a major piece of legislation was passed by Congress to deregulate commercial banks and other deposit-type financial institutions. This deregulation took the form of phasing out interest rate ceilings on various types of time deposits and of extending the type of assets thrift institutions were authorized to hold. However, this act took three steps in the opposite direction: it required all banks, member and non-member, and all thrift institutions offering checkable deposits to hold the same percentage of these checkable deposits as non-interest reserves, either in vault cash or on deposit with the Federal Reserve; it increased federal deposit insurance to $100,000 per account; and it allowed all these institutions to borrow from the Federal Reserve.

It is apparent that Congress did not intend to unleash the forces of competition on the financial system. If this had been Congress' intention, it would have phased out, rather than increased, deposit insurance and would have left the amount and location of reserve holding to the individual institutions.

The purpose of this paper is to explain how a completely free banking system would operate. Under free banking, all financial institutions are subject only to the general laws of incorporation and against fraud. They would not be restrained by the rules of a central bank and not be audited by any government agency, nor be protected by any government deposit guarantee. The first part of this paper hypothesizes how individ-

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ual banks would thrive in this competitive environment, while the second part shows how the most serious problem this economy faces—inflation—can be controlled without any government agency doing the controlling.

The Individual Financial Institution in a Free Banking Environment

In a free banking system, any firm can enter the banking business by acquiring funds in any non-fraudulent manner and can put those funds to any legal use it wants. A bank may attract funds by offering banknotes (currency) or deposits convertible on demand to specie (gold or silver coin). The bank's success would depend upon its gaining public confidence for holding its banknotes and other bank liabilities, and on the probability that it can use its funds profitably. No bank would have any special privileges, like those currently enjoyed by central banks, such as a monopoly of the note issue or the protection of a legal tender law, giving its notes forced currency. There would be no government agency or central bank on which the bank could rely as a lender of last resort; it would have to borrow in the private market at a rate consistent with the risk involved.

Under free banking, both notes and deposits would be promises to pay on demand some generally accepted medium, such as gold or silver.[1] The particular combination of notes and deposits issued in lending by each bank would be determined solely by public preference. The bank would be indifferent between the two, but the total amount of sight liabilities would by limited by its reserves of specie. No government regulation would specify that a bank had to hold certain assets, such as low-yielding government bonds, as backing for its banknotes, as was the case under the National Bank Act.

Not only free entry, but freedom of exit is a necessary condition of free banking. Banks unable to redeem their demand obligations, and unable to obtain private credit, would be forced to liquidate. This market pressure, along with the knowledge that there is no central bank acting as a lender of last resort, would force banks to act prudently.

Without a central bank, the check clearing process would be privately operated at its true cost, to the mutual benefit of banks and the public. Any cost reductions resulting from innovations would, by force of competition, be passed along to the public. Banks would have total freedom to branch anywhere. They would extend their operations nationwide, as have banks in Canada, England and other countries.

The unit bank system was not a natural development but a result of restrictive legislation. The unit bank system led to correspondent banking, not only for holding reserves, but also for performance of services which small unit banks found too expensive to undertake individually. In the United States, these reserves tended to accumulate in financial centers, where they were subject to the fluctuations of speculative markets. But with a branch banking system, even if a remote bank's reserves did find their way to financial centers, they would be held at a branch of the remote bank, which would retain total control over the funds. Each bank's own liability structure would determine how these funds were invested and in what maturities, in order to maintain adequate liquidity. With no need for a correspondent relationship, non-bank corporations could have a single banking connection nationwide as in Canada.

Branch Banking

Evidence from the depression clearly shows that branch banking was safer than unit banking, but that safety increased with the widening of the geographical area over which a bank could branch. Without branching, few banks could grow to a size large enough to handle the more desirable accounts. One study showed that 80 percent of the bank closings were in unit bank states,[2] and furthermore, that two-thirds of the branch banks that did fail were those that were restricted to a city.[3] Canadian branch banks gained millions of dollars of American deposits, especially in border cities like Windsor, Ontario.

Another study on California banking in the depression demonstrated that the diversity of California's economy, accompanied by statewide branching, enabled that state to achieve one of the lowest bank failure rates in the country. Again, the two small branch bank systems that failed in that state were those that restricted branches to one city.[4] This study also pointed out that the strong branch banking system in California also strengthened that state's unit banks by competitive example.[5]

Under a free banking system, it might be possible for a well-run unit bank to prosper, but it would have to do so without the currently available privilege of issuing government-guaranteed liabilities. The FDIC coverage is probably responsible for making the deposits of many small banks acceptable at par whereas they might not be so acceptable in a free market.

The specialized financial institution would be unlikely to exist for very long under free banking. Investment banking was part of commercial banking until forcibly separated by the Banking Act of 1933. Many activities of one-bank holding companies are merely tactics for circumventing laws which restrict banks to a narrow line of business. Thrifts, such as savings and loans, mutual savings banks, and credit unions, may have developed because banks were not interested in some particular lines of lending at first, but whenever those activities became profitable, it would have been the natural course of events for thrifts and banks to have merged.

The public would be much better served by a more diversified financial institution than by a single-purpose lender. A legally imposed distinction between deposit-type institutions does not serve the public well, because it leads to further government assistance to these single-purpose lenders, such as Regulation Q, the Federal Home Loan Banks, the FSLIC and the NCUA. None of this intervention is costless: funds are channeled into areas that otherwise would not receive them except at higher interest rates, while other erstwhile borrowers are crowded out of the capital market.

Under free banking, some of the strongest competition for existing banks may be provided by large retailers, brokerage firms and credit-card companies. Sears and Roebuck, Merrill-Lynch, and American Express already have in place nationwide offices from which to conduct a banking business. Automatic teller machines could give a depositor instant cash anywhere in the country. The one-bank holding company has already been responsible for combining banking with other financial services, so free banking would only remove the artificial restraints.

The Market Decides

The market would eventually decide which of the many new services offered by banks would be profitable, but the chief beneficiary would be the consumer. Not only actual competition but potential competition from new entrants would work more to the consumer's advantage than most of the "performance" laws that were specifically designed for consumer protection. Under free banking, there would be no legal requirements for "truth in lending," "equal credit opportunity," or "community reinvestment," and no restrictions on debt collection practices. These performance standards add substantial reporting and regulatory costs, which are at least partially passed on to the consumer.[6]

Compared to a single governmentally issued currency, private banknotes might present a greater temptation to counterfeit. Counterfeiting was prevalent before the Civil War when there were so many different banknotes being used. However, a single government currency does not guarantee a counterfeit-free economy either: today's overdrafts and forged checks are analogous to the antebellum counterfeiting of state banknotes. Furthermore, modern communication technology would strongly discourage counterfeiting. At any rate, insurance companies can underwrite any losses the public may suffer, as they do now for stolen or forged credit cards.

With different banknotes being used, some company or group of retailers might sell fractional coins to be used for small purchases and plastic tokens with electronic markings to be used in vending machines.[7]

How Free Banking Would Prevent Inflation

Deregulation of bank money alone will not give us an environment free of inflation unless there is some way to stop the unlimited creation of the money base by the central bank. When gold or silver is the base into which all banknotes and deposits are convertible, there is a limit on the money supply, because this base cannot be created at will as fiat money can be issued by a central bank.[8] Central banks, being politically sensitive, use their monopoly of the money base to help organized sectors at the expense of the general public, often under the guise of lowering interest rates. It was recognized long ago that free banking restricted credit expansion, whereas central banks were tools for creating an easy-money environment.[9]

The imposition of a money-growth rule on a central bank is not the cure for inflation. Congress has never shown any inclination to impose a fiat-money growth rule as monetarists have advocated, and the Fed could not be trusted to follow it, judging from experience with gold reserve requirements. In 1913, the Fed was ordered to hold gold equal to 40 percent of its note liabilities and to 35 percent of member bank reserve deposits. Every time the limit was reached, these requirements were either suspended (1933), reduced (1945), or abolished (1965 & 1968). Emergency currencies without gold backing were issued in the depression and in World War II.

Prudent Practices Encouraged

By contrast, commercial banks in a free banking system could never go off gold as could a privileged central bank with legal-tender banknotes. A private bank would be forced into liquidation if it could not convert its sight liabilities into specie. However, there is another limit to over-expansion in a free banking system besides exhaustion of gold reserves, and that is the reflux of banknotes. Each bank would only pay out its own notes over the counter, because unlike the notes in the National Banking System, these notes would be distinctive. Therefore, a bank that expanded its lending beyond prudent limits would have its notes and deposits presented for payment faster than those of its rivals. If a bank wanted to protect its "brand-name capital," it would have to curtail its lending or face the possibility of its notes circulating at a discount. The marginal cost of *printing* banknotes may be zero, but the marginal cost of *keeping them in circulation* clearly is not zero.

Central banks could try and compete with private banknotes, but the public would only hold the central bank's notes if they retained their value relative to the private notes. However, the central bank could not monetize government deficits at will, nor bail out any bank or industry in trouble, because an oversupply of notes would result in depreciation. One might envision the Fed and private banks competing through advertising the way the U.S. Postal Service and private package carriers do now.

—FOOTNOTES—

[1]Vera C. Smith, *The Rationale of Central Banking* (London: P. S. King & Son, 1936), p. 149.

[2]Gaines T. Cartinhour, "Branch Banks versus Unit Banks," *Annals of the American Academy of Political and Social Science* 171 (January 1934): 36.

[3]*Ibid.*, p. 37.

[4]John P. Wernette, "Branch Banking in California and Bank Failures," *Quarterly Journal of Economics* 46 (February 1932): 371.

[5]*Ibid.*

[6]Catherine England, *The Case for Bank Deregulation*, (Washington: The Heritage Foundation, 1982), p. 24.

[7]F. A. Hayek, *Denationalization of Money—The Argument Refined*, 2nd ed. (London: The Institute of Economic Affairs, 1978), p. 48n.

[8]Lawrence H. White, "Competitive Money, Inside and Out," *Cato Journal* 3 (Spring 1983): 296.

[9]Ludwig von Mises, *Human Action: A Treatise on Economics* (New Haven: Yale University Press, 1949), pp. 443–44.

The Source of Money

IDEAS ON LIBERTY

UNLESS the creation and issue of money is withdrawn from the State and restored to the private banking system, I believe that parliamentary government and democracy will become impossible to maintain.

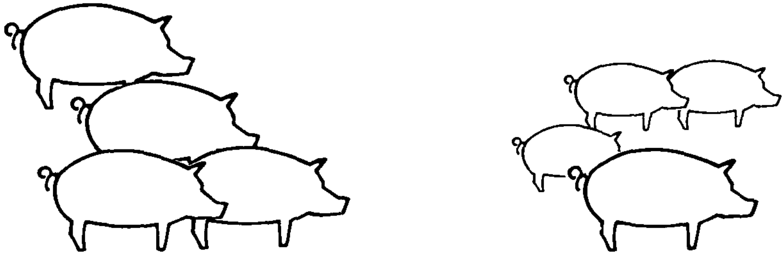
John Maynard Keynes, in *Essays in Persuasion,* referring to the famous statement of Lenin as to the best way to destroy the capitalist system, wrote: "Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch its currency. This process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one in a million is able to diagnose."

The strange thing is that it appears never to have occurred to Lord Keynes that, under a free economy, it is impossible to debauch the currency.

GEORGE WINDER, 1958

Ernest G. Ross

The Deficit Connection



FROM the man-in-the-street, to economists, to politicians, to academics, nearly everyone seems worried about federal deficits.

During Presidential campaigning, Walter Mondale called deficits "a travesty"; in more reserved tones, Ronald Reagan called deficits "a problem."

Distinguished professors write grave tracts warning of deficit repercussions "in the out years" (i.e., in the longer run). In an informal television tabulation of my own, in a single week over 100 interviewees and speakers from different walks of life were quoted making disparaging comments about deficits.

That deficits seem destined to be with this nation for awhile is hardly disputed. Even the more optimistic forecasts project several hundred billion dollars in deficits added to the national debt before the end of the decade. Some estimates push a trillion dollars.

While most people regard deficits as bad, there is considerable controversy over whether deficits are connected—that is, whether they must lead—to higher prices, to what current political jargon terms "an inflationary environment."

Many analysts, such as economist Fred D. Kalkstein, warn or imply that deficits *are* ultimately connected to higher prices via interest rates. Accelerated borrowing to pay for the deficits pushes up interest rates, and the borrowing tends to temporarily dampen or "hide" the

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