A PROGRAM FOR MONETARY REFORM

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Foreword

The great task confronting us today is that of making our American system, which we call "democracy", work. No one can doubt that it is threatened. However, the danger lies less in the propaganda of autocratic Governments from abroad than in the existence, here in America, of ten millions of unemployed workers, sharecroppers living barely at subsistence level, and hundreds of thousands of idle machines. On such a soil fascist and communist propaganda can thrive. With full employment such propaganda would be futile.

The important objective, therefore, is to repair and rebuild our economic system so that it will again employ our productive resources to the fullest practicable extent. A high scale of living for our people will better protect our cherished American democracy than will all the speeches and writings in the world.

Our problems are not simple and we can offer no panacea to solve them. We believe, however, that certain fundamental adjustments in our economy are essential to any successful attempt to bring our idle men, materials, land, and machines together. These fundamental adjustments would, we believe, be facilitated by the monetary reform here proposed.

Throughout our history no economic problem has been more passionately discussed than the money problem. Probably none has had the distinction of suffering so much from general misunderstanding - suffering from more heat than light. As a result, not only is our monetary system now wholly inadequate and, in fact, unable to fulfill its function; but the few reforms which have been adopted during the past three decades have been patchwork, leaving the basic structure still unsound.

In analysing this problem, we concluded that it is preeminently the responsibility of American economists to present constructive proposals for its solution. But, before organizing a movement for monetary reform,

we wished to determine how many of our colleagues agree with us. For this purpose we drew up "A Program for Monetary Reform" and sent this to the completest available list of academic economists, a thousand in number. This Program consists of 18 sections which, we believe, comprise the essential features of what needs to be done in order to put our monetary system into working condition. Up to the date of writing (July, 1939) 235 economists from 157 universities and colleges have expressed their general approval of this "Program"; 40 more have approved it with reservations; 43 have expressed disapproval. The remainder have not yet replied.

We want the American people to know where we stand in this important matter. The following is the first draft of an exposition of our "Program", and the part it may play in reconstructing America.

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Introduction

The following suggested monetary program is put forth not as a panacea or even as a full solution of the depression problem. It is intended to eliminate one recognized cause of great depressions, the lawless variability in our supply of circulating medium.*

No well informed person would pretend that our present monetary and banking machinery is perfect; that it operates as it should to promote an adequate and continuous exchange of goods and services; that it enables our productive resources - our labor, materials, and capital - to be fully or even approximately employed. Indeed, the contrary is the fact. If the purpose of money and credit were to discourage the exchange of goods and services, to destroy periodically the wealth produced, to frustrate and trip those who work and save, our present monetary system would seem a most effective instrument to that end.

Practically every period of economic hope and promise has been a mere inflationary boom, characterized by an expansion of the means of payment, and has been followed by a depression, characterized by a detrimental contraction of the means of payment. In boom times, the expansion of circulating medium accelerates the pace by raising prices, and creating speculative profits. Thus, with new money raising prices and rising prices conjuring up new money, the inflation proceeds in an upward spiral till a collapse occurs, after which the contraction of our supply of money and credit, with falling prices and losses in place of profits, produces a downward spiral generating bankruptcy, unemployment, and all the other evils of depression.

The monetary reforms here proposed are intended primarily to prevent these ups and downs in the volume of our means of payment with their harmful influence on business. No claim is made, however, that this will entirely do away with "business cycles".

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* This and the subsequent closely printed paragraphs are quoted with minor alterations from the mimeographed "Program for Monetary Reform", circulated among economists as explained in the foreword.

The Gold Standard

(1) During the last ten years the world has largely given up the gold standard. Gold is still, and may always remain, an important part of the machinery of foreign trade and exchange. But it is no longer, and probably never again will be, the sole reliance for determining the "internal value" of monetary units. Even those who advocate some degree of return toward the former gold standard are, as a rule, now convinced that it must be "managed" and never again left to work "automatically".

Up to 1931, the great majority of the countries of the world were on the gold standard. The characteristics of the gold standards may be briefly summarized as follows:

(a) The dollar, franc, guilder, or other monetary unit was the equivalent of, and usually was redeemable in, a fixed amount of gold of a certain fineness. For instance, the American dollar was a definite weight of gold (23.22 grains of fine gold). This made an ounce of gold 9/10 fine identical with $20.67. Conversely, $20.67 was convertible into an ounce of gold of this quality. In other words, "one dollar" was roughly a twentieth of an ounce of gold or precisely 100/2067ths of an ounce.

After the war, chiefly as a result of a shortage in gold reserves, some of the smaller nations changed their currencies by making them redeemable in some foreign currency which, in turn, was convertible into gold. This system was called the gold-exchange standard. For these small nations, our dollar, the pound sterling and similar gold currencies, such as the Dutch guilder and the Swiss franc were "as good as gold".

(b) Because every gold currency was redeemable in a fixed amount of gold, the exchange relationship of these currencies to each other was to all intents and purposes fixed: That is, the foreign exchange rates of gold-standard currencies were constant, or only varied within extremely narrow limits. A grandiose ideology has been built up on this so-called "stability" of gold-standard currencies. The public has been confuxed and frightened by the cry, "the dollar is falling" or "the French franc is falling", which simply means falling with reference to gold; whereas it may well have been that the real trouble was that the value of gold was rising with reference to commodities. Indeed such was often the case. Yet the uninformed public never realized that the so-called "stability" of the golden money had little to do with any stability of buying power over goods and services. In fact, the buying power of so-called "stable" gold currencies fluctuated quite violently, because the value

of gold itself was changing. Perhaps the most vicious feature of the gold standard was that, so long as exchange rates - the price of gold in terms of gold - remained unchanged, the public had a false sense of security. In order to maintain this misleading "stability" of gold and exchange rates, the "gold bloc" nations periodically made terrific sacrifices which not only destroyed their prosperity, and indeed brought them to the brink of bankruptcy, but ultimately destroyed the gold standard itself.

(c) In order to assure the redemption of national currencies in gold, the central banks were accustomed to maintain, behind their note issues, a reserve of upwards of forty per cent in gold or gold exchange.

(d) The extent of gold movements under this system led the central banks to regulatory action. For instance, if large amounts of gold began to vanish from a central bank, either to pay for a surplus of commodity imports or by way of withdrawals for speculative purposes, the banks among other things raised interest rates in order to discourage borrowing from it and thus put a stop to gold withdrawals. Thus the disappearance of gold from the banks led them automatically to take deflationary action; for it curtailed the volume of bank credit outstanding. This feature of gold-standard machinery, in most cases, worked efficiently enough to its end. But it often brought depressions as the price of maintaining a fixed gold unit.

When there was an excess of commodity exports from a given country, or a flight to it of gold from foreign countries, its central bank was similarly supposed to lower interest rates, thus stimulating lending, with a consequent withdrawal of gold from the bank. But after the war this automatic regulatory mechanism worked badly or not at all.

In September 1931 England found it impossible to maintain her gold reserves and was forced off the gold standard. Since then, every other gold-standard nation has either been forced off gold or has abandoned it voluntarily. Those countries which bowed first to this pressure were also the first to recover

from the depression. France was among the last to abandon gold; and she is still suffering from her mistake in waiting so long.

The depression experience of all countries under the gold standard has shown that it is scarcely worthy of being called a "standard" at all. It has shown that the so-called "stability" of gold and of foreign exchange destroyed the stability of the buying power of money and thereby the stability of economic conditions generally. In fact, the effort to retain gold as a "standard" has had such disastrous results all over the world that, for the time being, international trade has been deprived of some of the useful services which gold might still render it.

It may be that America cannot solve the problem of the function of gold in the monetary relations among nations without the cooperation of other nations. The Tri-Partite Agreement, concluded in 1936 by England, France, and ourselves - at our initiative - may well serve as a first tentative step in the direction of such a solution. The point here, however, is that we need not wait for international agreements in order to attack our domestic monetary problems.

But now that the central banks no longer operate according to the old rules of the gold standard, how do they determine their monetary policies? What "standard" has replaced the gold standard?

The Standard of Stable Buying Power

> (2) Several of the leading nations now seek to keep their monetary units reasonably stable in internal value or buying power and to make their money supply fit the requirements of production and commerce.

In the determination of a nation's monetary policy, the needs of its domestic economy have taken the place of the arbitrary rules of the gold standard. After the experience of the past decade, it is improbable that many countries will want to give their currencies arbitrary gold values at the cost of domestic deflation and depression. At present healthy domestic economic conditions

are generally given precedence over the maintenance of a fixed money value for gold. This is a great step forward. The countries which have consistently followed this new line have more nearly solved their depression problems than have those that have sought to compromise by permitting considerations other than domestic welfare to determine their monetary policies. And for the United States stability in the domestic purchasing power of the dollar is certainly of far more importance than stability in its exchange value in terms of foreign monetary units.

> (3) Some countries, especially the Scandinavian and others included in the so-called "Sterling Bloc", have gone further than the United States in formulating and in carrying out these new monetary policies.

On abandoning the gold standard in 1931, the Scandinavian countries took steps to maintain for the consumer a constant buying power for their respective currencies. Finland's central bank made a declaration to this effect. The Riksbank of Sweden has done the same, and its action was offically confirmed by the Swedish Government. As a result, since then people of those fortunate lands have never lost confidence in their money. The buying power of their monetary units have been maintained constant within a few per cent since 1931. At the same time, these countries have made conscious use of monetary policy as an essential part of their efforts to promote domestic prosperity. They have been so successful as to have practically eliminated unemployment; to have raised their production figures to new peaks; and to have improved steadily the scale of living of their people.

> (4) Our own monetary policy should likewise be directed toward avoiding inflation as well as deflation and attaining and maintaining as nearly as possible full production and employment.

There is ample evidence that the Roosevelt Administration once had every intention of managing our money on these principles. As early as

July 3, 1933, in his famous message to the London Economic Conference, President Roosevelt declared:

> "... old fetishes of so-called international bankers are being replaced by efforts to plan national currencies with the objective of giving to those currencies a continuing purchasing power which does not greatly vary in terms of commodities and the need of modern civilization.
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> "Let me be frank in saying that the United States seeks the kind of dollar which a generation hence will have the same purchasing and debt-paying power as the dollar value we hope to attain in the near future..."

This was definite notice to the assembled financial representatives of the world's nations that the United States had abandoned the gold standard and adopted in its place a policy of dollar management designed to keep the dollar's buying power constant. In several talks during 1933, the President reaffirmed this principle of a "managed currency". However, some people saw danger of arbitrary changes in the gold content of the dollar and feared that the discretionary powers of the President would serve as a disturbing influence. Apparently the President was influenced by those views, hence after fixing the new gold content of the dollar on January 31, 1934, he has allowed it to remain unchanged. That is, while professing adherence to the doctrine of a dollar of stable domestic buying power, the Administration has compromised and, in effect, followed a policy of giving the dollar a fixed gold content, although Congress had empowered the President to change the dollar's gold content, within certain limits, whenever it should seem to require such treatment.

The purchasing power of our dollar has therefore not been consistently stabilized. Neither, on the other hand, have we had a genuine gold standard - or even any standard. We have vacillated between the two rival systems of monetary stability: The internal and the external. The very rigidity of our

gold price has, however, exposed the dollar to the disturbing influences of "hot money" from abroad and has probably been an obstacle to recovery in this country.

So long as we have no law determining what our monetary policy shall be there will always be uncertainty as to the external and internal values of the dollar. Consequently, there is an ever-present danger of abuse of discretionary powers, not only the President's powers but those of others as well. The Secretary of the Treasury, for instance, has discretionary power to issue silver certificates and, for that purpose, to buy silver. He is also free to use, as he pleases, the two billion dollars in the stabilization account and thus influence foreign exchange. The Board of Governors of the Federal Reserve System may change the reserve requirements of banks, may buy or sell Government bonds in the open market, may change discount rates, and in other ways affect the volume of credit and so the purchasing power of the dollar. Even our gold miners, and still more the miners of gold abroad, may affect the volume of money in circulation in the United States, since for every ounce of gold they turn over to the United States Mint, the Treasury increases our volume of money by $35. Lastly, our 15,000 commercial banks affect the value of the dollar by expanding, or contracting, the volume of demand deposits when they either make or liquidate loans, and when they either purchase or sell securities.

Our monetary system is thus permeated with discretionary powers. But there is no unity about it, no control, and, worst of all, no prescribed policy. In a word, there is no mandate based on a definite principle.

The Criteria of Our Monetary Policy

(5) We should set up certain definite criteria according to which our monetary policy should be carried out.

Up to the present time Congress has merely given our monetary agencies certain broad powers, with no explicit directions as to how these powers should be used. Today we have no clear and definite standard by which to measure success or failure and, consequently, there is no way by which we can tell clearly

and definitely whether the divers agencies are giving us the best service they can.

For instance, our most powerful monetary agency, the Board of Governors of the Federal Reserve System, proceeds on the basis of a broad statement of general principles which it published in September, 1937. This is not law, but merely an expression of opinion on the part of the members of the Board as to what they, at that particular time, thought they ought to do. There is no compulsion about it. It is not binding on the Board itself. It said:

> "...The Board believes that economic stability rather than price stability should be the general objective of public policy. It is convinced that this objective cannot be achieved by monetary policy alone, but that the goal should be sought through coordination of monetary and other major policies of the Government which influence business activity, including particularly policies with respect to taxation, expenditures, lending, foreign trade, agriculture and labor.
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> "It should be the declared objective of the Government of the United States to maintain economic stability and it should be the recognized duty of the Board of Governors of the Federal Reserve System to use all its powers to contribute to a concerted effort by all agencies of the Government toward the attainment of this objective."*

As mentioned before, the maintenance of a substantially constant buying power of the Swedish and Finnish currencies is not inconsistent with the establishment and maintenance of prosperous economic conditions. On the

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* From the Bulletin of the Board of Governors of the Federal Reserve System, September, 1937.

other hand, there is no record of any experience of sustained economic equilibrium without some degree of price-level stability. In a general way, however, the Board's declaration conformed to the general principles of monetary stability enunciated by President Roosevelt in 1933, although the President was much more specific than the Board in mentioning the objective of "stable buying power." The Board declared emphatically what it believed it could not do. As to what it could do, or intended to do, it made, at best, only a vague statement. It may, at any time in the future, in order to justify any action or lack of action to which it may be inclined, interpret this statement as it pleases or repudiate it altogether. That is, the Board is now free to reserve to itself the widest possible discretion in the use of its powers under any circumstances that may arise. What certainty is there that it has not already changed its mind on the subject without having made another declaration? What obligation would a new member of the Board feel for the opinions expressed by his predecessors? What does the public know of the real aims of the Board?

Once Congress determines the criteria of monetary policy, many current erroneous beliefs in erratic varieties of "managed currency" as a cure-all for our economic ills may be replaced by more rational views as to the many important things that need to be done outside the monetary field in order to put our economic system into working condition. Unless disturbing monetary factors have first been largely eliminated, the relative importance of other necessary measures cannot be determined.

> (6) The criteria for monetary management adopted should be so clearly defined and safeguarded by law as to eliminate the need of permitting any wide discretion to our Monetary Authority.

That is, unless we tell one single responsible Monetary Authority exactly what is expected of it, we can never call it to account for not giving us the kind of policy we wish. When there is no definite direction in the law, the Monetary Authority (or as matters are now, authorities) cannot pos-

sibly function as a united body, but will make decisions under the ever-varying domination of different interests and different personalties. This vacillation cannot be avoided, and, in the past, it has been one of the weak points in the operation of the Federal Reserve System. Mr. Adolph Miller, a member of the Federal Reserve Board for twenty years, brought this weakness to light on the occasion of a Congressional Hearing:

> "I have in mind, vaguely, whatever happens to be the dominant influence in the Federal Reserve System, and that is expressing itself in the line of policy undertaken. It may today be this individual or group; tomorrow it may be another. But wherever any important line of action or policy is taken there will always be found some one or some group whose judgment and whose will is the effective thing in bringing about the result. Their's the ear which does the hearing for the system." *

This uncertain condition is one which a law could and should make impossible.

Constant - per - Capita Standard

(7) Among the possible standards to which the dollar could be made to conform are those which could be obtained by the two following methods:

(a) Establish a constant-average-per-capita supply or volume of circulating medium, including both "pocket-book money" and "check-book money" (that is, demand deposits or individual deposits subject to check). One great advantage of this "constant-per-capita-money" standard is that it would require a minimum of discretion on the part of the Monetary Authority.

(b) Keep the dollar equivalent to an ideal "market basket dollar", similar to Sweden's market basket krona. This market basket dollar would consist of a representative assortment of consumer goods in the retail markets (so much food, clothing, etc.), thus constituting the reciprocal of an index of the cost of living. Under this "constant-cost-

* See page 165 of the Hearings on H.R.11806, 1928

of-living" standard the Monetary Authority would, however, as has been found in Sweden, have to observe closely the movements of other, more sensitive indexes, with a view to preventing the development of disequilibrium as between sensitive and insensitive prices.

Under the former of these two arrangements all the Monetary Authority would have to do would be to ascertain the amount of circulating medium in active circulation and the population of the country. It would then put into or take out of circulation whatever amount of circulating medium seemed necessary to keep unchanged the amount of money per head of population. For this purpose, the statistical information regarding the volume of means of payment should be improved. At present, we have only the weekly figures of leading banks and the semi-annual figures of the Federal Deposit Insurance Corporation.

It is also evident that the Monetary Authority would have to be empowered to regulate the total money supply, including demand deposits of commercial banks, which would have to furnish appropriate data every week. Thus, correct statistical information would, under this constant-per-capita-volume-of-money criterion, clearly prescribe the duties of the Monetary Authority, and automatically reduce to a minimum the possibility of a discretionary, hit-or-miss decision on a given occasion.

It is believed by some competent students that the annual money income of the nation tends to remain in a fairly constant ratio to the means of payment in circulation. This ratio is alleged to be approximately 3 of income to 1 of circulating medium. If this is true, a constant-per-capita volume of circulating medium would be substantially the equivalent of a constant per capita money income. In other words, we could keep per capita money income stable by keeping constant the per capita volume of circulating medium.

One consequence of this would be that technological improvements, resulting in an increase in the national real income, would not change the national money income but, as real income increased, the price level

would fall. Some authorities regard prices falling, to some extent at least, with technological improvements, as a proper result of a successful monetary policy.*

Constant-Cost-of-Living Standard

The constant-per-capita criterion for the volume of money is only one of several possible criteria. The alternative most often suggested is the "constant-cost-of-living", or "market basket", standard as outlined in (b) above.

The experience of Sweden during the past eight years shows that, with the help of monetary management, it is possible to maintain at a substantially constant level the consumer buying power of a currency. This stability in Sweden has not prevented a readjustment in the prices of farm products, and of other raw materials which had fallen to unduly low levels.

Violent changes in the volume of money affect not only the general price level, but also the relationship of prices to each other within the price structure. Conversely, a constant volume of money tends ultimately to stabilize not only the general price level, but the relations within the price structure. The retail prices involved in the cost-of-living index, being relatively "sticky", do not afford all the information necessary for regulating the volume of money. The Monetary Authority might therefore find it desirable to include in its standard some commodities having "sensitive" prices, in order to make its actions respond more quickly to the direction in which things are moving.

Under a "constant-cost-of-living" or "market-basket" dollar technological improvements would not find expression in a falling price level, but rather in a higher per capita money income and larger money wage for labor. With present labor policies, there would be a strong tendency for money wages to

* Professors Douglas and King do not approve of this criterion.

keep pace with technological progress. In fact one of the advantages of the "constant cost of living" standard is its easier comprehensibility and its presumably greater appeal to labor.

Other standards besides the two here mentioned might be proposed.

Whatever technical criterion of monetary stability is adopted, as mentioned under (4) above, the ultimate object of monetary policy should not be merely to maintain monetary stability. This monetary stability should serve as a means toward the ultimate goal of full production and employment and a continuous rise in the scale of living. Therefore, the Monetary Authority should study the movements of all available indicators of economic activity and prosperity with a view to determining just what collection of prices, if stabilized, would lead to the highest degree of stability in production and employment.

Essentially, however, the purpose of any monetary standard is to standardize the unit of value - just as a bushel standardizes the unit of quantity, and an ounce the unit of weight. To furnish a dependable standard of value should therefore be the only requirement of monetary policy. It would be fatal if the public were led to believe that the Monetary Authority, solely through monetary manipulations, were able to assure the maintenance of prosperity, and should therefore be made responsible for it. Any such assumption would probably mean the demise of the Monetary Authority in the first period of adversity.

Legislative Feature A

(8) In order that our monetary policy may be made to conform to the new standard and become the means of attaining a high degree of prosperity and stability, legislation should be enacted, embodying the following features:

(a) There should be constituted a "Monetary Authority" clothed with carefully defined powers over the monetary system of the country, including the determination of the volume of circulating medium.

That is, the "Monetary Authority" would become the agent of Congress in carrying out its function as set forth in the Constitution, Article I, Section 8, - "to coin money, regulate the value thereof, and of foreign coin..." This Monetary Authority would receive all the powers necessary to "regulate" - in particular, the power to determine - the volume of circulating medium and the domestic and foreign value of the dollar. All of the miscellaneous powers now scattered among the Federal Reserve Board, the Secretary of the Treasury, the President and others would have to be transferred to this one central Monetary Authority.

Feature B

> (b) Congress should give to this Monetary Authority a mandate specifying the monetary standard, to maintain which these powers would be exercised. The mandate should also define the part which monetary policy would play in attaining the objective of steadily increasing prosperity.

Not only would such a mandate cause the Monetary Authority to use all of its powers for the purpose of attaining the standard set by Congress; but it would also prevent the abuse of those powers. The Monetary Authority would then have a definite standard to attain and maintain.

Feature C

> (c) The Monetary Authority might be the Federal Reserve Board or another body associated therewith. It should be kept free from any political or other influences and interests which might tend to interfere with the performance of its functions. Its primary concern should be the maintenance of the monetary standard as defined by Congress. This standard and the means of maintaining it should be so narrowly defined by Congress as to leave only a minimum of discretion to the Monetary Authority.

Unless the Monetary Authority were free from the pressure of both party politics and selfish interests, there would be no guarantee that, in making its decisions, it would be guided solely by the mandate given to it by Congress.

One way to secure the requisite independence is by the exercise of great care in the appointment of members, by paying them adequate salaries and by making provisions for retirement pensions. Politics as well as the pressure of interested financial groups should be ruled out so far as practically possible. The members should be selected solely on the basis of their fitness for the job and should be subject to removal by Congress for acting in opposition to the mandate laid down by it.

The Monetary Authority should, of course, have the widest possible discretion with respect to the methods it might find most suitable for attaining the objectives laid down in the mandate. That is, it should be absolutely free to use any or all of its powers over money and the banks according to its own best judgment; but, as has been stressed before, the Monetary Authority should not be free to deviate from the mandate given to it by Congress.

Feature D

> (d) Neither the President nor the United States Treasury nor any other agency of the Government should have power to alter the volume of circulating medium. That is, none of them should have the power to issue greenbacks, whether to meet the fiscal needs of the Government or for any other purpose. They should not have the power to change the price of gold or the weight of the gold dollar either to increase the cash of the Government or for any other purpose. Any discretionary powers along these lines now possessed by the President or the Secretary of the Treasury should be repealed and such of them as may be necessary for controlling the volume of money, including the power of gold sterilization, should be transferred to the Monetary Authority.
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> However, in determining its course of action the Monetary Authority should take note of all other activities of the Government intended to affect or likely to affect economic conditions, and it should, when necessary, cooperate with other agencies of the Government.

In the emergency of 1933-34, the absence of any permanent

monetary agency capable of handling the situation was a valid reason for giving the President and the Secretary of the Treasury emergency powers over our monetary machine. Even now, so long as we have no single Monetary Authority specifically charged by Congress to carry out a defined policy, there is much reason for continuing these discretionary powers. But once Congress has established a Monetary Authority and given it a mandate, no other agency should then have any concurrent or conflicting powers.

There is less danger in giving to a Monetary Authority of the type described above any or all of the powers necessary to control our monetary system, than there is in the present system under which wide discretionary powers are assigned to several agencies with more or less conflicting interests and with inadequate instructions to any of them concerning the use of them.

The Monetary Authority should be instructed to cooperate with non-monetary agencies in its endeavors to promote stability. This policy should include, in particular, cooperation with the Secretary of the Treasury, but the independence of the Monetary Authority must be scrupulously safeguarded.

The Fractional Reserve System

> (9) A chief loose screw in our present American money and banking system is the requirement of only fractional reserves behind demand deposits. Fractional reserves give our thousands of commercial banks the power to increase or decrease the volume of our circulating medium by increasing or decreasing bank loans and investments. The banks thus exercise what has always, and justly, been considered a prerogative of sovereign power. As each bank exercises this power independently without any centralized control, the resulting changes in the volume of the circulating medium are largely haphazard. This situation is a most important factor in booms and depressions.

Some nine-tenths of our business is transacted, not with physical currency, or "pocket-book money", but with demand deposits subject to check, or "check-book money". Demand deposits subject to check, though func-

tioning like money in many respects, are not composed of physical money, but are merely promises by the bank to furnish such money on the demands of the respective depositors. Under ordinary conditions only a few depositors actually ask for real money; therefore, the banks are required to hold as a cash reserve only about 20 per cent of the amounts they promise to furnish. For every $100 of cash which a bank promises to furnish its depositors, it needs to keep as a reserve only about $20. And even this reserve is not actual cash on hand. It is nothing but a "deposit" with a Federal Reserve Bank, though any fraction of this may, in fact, be borrowed from the Reserve Banks themselves. Even this borrowed money is merely the Reserve Banks' promise to pay money. In other words, the whole of the 20 per cent legal reserve is itself merely a promise by the Federal Reserve Bank to furnish money. Nevertheless, the banks' promises to their demand depositors actually circulate as if they were real money, so that the bank, in fact, floats its non-interest bearing debt as money. The depositor checks against his balance in the bank as if it were really there, and the recipient of the check looks on it in the same way. So long as not too many depositors ask for money, the promises of the bank are thus able to perform all the functions of money.

The question which naturally occurs is: How do these demand deposits affect the volume of the circulating medium?

When a bank makes a loan or purchases bonds, it increases its own promises to furnish money on demand by giving to the borrower, or to the seller of the bond, a demand deposit credit. By so doing it increases the total volume of demand deposits in circulation. Conversely, when the loan is repaid to the bank, or the bond is sold by the bank, the demand deposits are reduced by that much. Thus bank loans first increase, and their repayment later decreases, the total volume of the country's circulating medium.

Ordinarily the increases and decreases roughly balance;

but, in boom periods, the increases preponderate and thus drive the boom higher, whereas, in depression periods, the decreases preponderate and thus further intensify the depression. In booms, many are eager to borrow; in depressions, lenders are loath to lend money but eager to collect. It is this over-lend and over-liquidate factor that tends to accentuate booms and depressions, and it is the tie between the volume of bank loans and the volume of the circulating medium which is responsible. It is this system which permits and practically compels the banks to lend and owe five times as much money as they must have on hand if they are to survive in the competitive struggle which causes much of the trouble.

Despite these inherent flaws in the fractional reserve system, a Monetary Authority could unquestionably, by wise management, give us a far more beneficial monetary policy than the Federal Reserve Board has done in the past. But the task would be much simplified and would require the exercise of much less ingenuity and foresight if we did away altogether with the fractional reserve system; for it is this system which makes the banking system so vulnerable.

The 100% Reserve System

> (10) Since the fractional reserve system hampers effective control by the Monetary Authority over the volume of our circulating medium it is desirable that any bank or other agency holding deposits subject to check (demand deposits) be required to keep on hand a dollar of reserve for every dollar of such deposit, so that, in effect, deposits subject to check actually represent money held by the bank in trust for the depositor.

With such a dollar-for-dollar backing, the money which the bank promised to furnish would actually be in the bank. That is, with the requirement of a 100% reserve, demand deposits subject to check would actually become deposits of money, and no longer be merely the bankers' debts. If, today, those who think they have money in the bank should all ask for it, they would, of course, quickly find that the money is not there and that the banks could

not meet their obligations. With 100% reserves, however, the money would be there; and honestly run banks could never go bankrupt as the result of a run on demand deposits.

The 100% reserve system was the original system of deposit banking, but the fractional reserve system was introduced by private Venetian bankers not later than the middle of the Fourteenth century. Originally they merely accepted deposits of actual cash for safe keeping, the ownership of which was transferable by checks or by a proto-type of what we now call checks. Afterward, the bankers began to lend some of this specie, though it belonged not to them but to their depositors. The same thing happened in the public banks of deposit at Venice, Amsterdam, and other cities, and the London goldsmiths of the Seventeenth century found that handsome profits would accrue from lending out other people's money, or claims against it - a practice which, when first discovered by the public, was considered to be a breach of trust. But what thus began as a breach of trust has now become the accepted and lawful practice. Nevertheless, the practice is incomparably more harmful today than it was centuries ago, because, with increased banking, and the increased pyramiding now practiced by banks, it results in violent fluctuations in the volume of the circulating medium and in economic activity in general.

How to Establish the 100% Reserve System

(11) The following are two of several methods of introducing, or rather reintroducing, the 100% reserve system:

(a) The simplest method of making the transition from fractional to 100% reserves would be to authorize the Monetary Authority to lend, without interest, to every bank or other agency carrying demand deposits, sufficient cash (Federal Reserve notes, other Federal Reserve credit, United States notes, or other lawful money) to make the reserve of each bank equal to its demand deposits.

The present situation would be made the starting point of the 100% reserve system by simply lending to the banks whatever money they

might need to bring the reserves behind their demand deposits up to 100%. While this money might, largely be, newly issued for the occasion - for example, newly issued Federal Reserve notes - it would not inflate the volume of anything that can circulate. It would merely change the nature of the reserves behind the money which circulates. By making these reserves 100%, we would eliminate a main distinction between pocket-book money and check-book money. The bank would simply serve as a big pocket book to hold its depositors' money in storage. If, for instance, new Federal Reserve notes were issued and stored in the banks, as the 100% reserve behind the demand deposits, a person having $100 on deposit would simply be the owner of $100 of the Federal Reserve notes thus held in storage. He could either take his money out and make payments with it, or leave it in and transfer it by check. The two types of circulating media would be alternative, not additive. The $100 depositor would have $100. Furthermore, the bank could not inflate by lending out the $100 on deposit, for, under the 100% system, that $100 would not belong to the bank nor even be within the bank's control.

The power of the banks either to increase or decrease, that is, to inflate or deflate, our circulating medium would thus disappear over night. The banks' so-called "excess reserves" would disappear, and with them one of the most potent sources of possible inflation. At present, because of the fractional reserve system, the banks could conceivably, on the basis of their enormous excess reserves, inflate their demand deposits by about twenty billion dollars. The Federal Reserve Board's present powers are inadequate fully to control this situation. The Board realized this danger when it stated, in its Annual Report for 1938:

> "The ability of the banks greatly to expand the volume of their credit without resort to the Federal Reserve banks would make it possible for a speculative situation to get under way that would be beyond the power of the system

to check or control. The Reserve System would, therefor, be unable to discharge the responsibility placed upon it by Congress or to perform the service that the country rightly expects from it."

Moreover, the Board's present machinery is so clumsy that almost any attempt to counteract a threat of inflation might produce deflation.

> (b) A second method of making the transition would be to let each bank count as cash reserve up to a specified maximum, its United States Government bonds (reckoned at par), and to provide for their conversion into cash by the Government on the demand of the bank. This method of transition would be particularly easy today, because the banks already hold nearly enough cash and Government bonds to fulfill the proposed 100% reserve requirement.

According to the Report of the Federal Deposit Insurance Corporation, the country's insured banks had on December 31, 1938:

Expressed in 1,000 Dollar Units

ASSETS (which might serve as reserve behind demand deposits)

Coin and Currency	950,394	
Less three per cent cash reserve requirement behind time deposits of $14,829,482	444,885	505,509
Reserve with Federal Reserve banks		8,694,388
Cash items in process of collection		1,813,703
Government obligations (direct or fully guaranteed)		14,506,807
		25,520,407

LIABILITIES (subject to 100% reserve requirement)

Demand Deposits*	27,695,506
Excess of interbank deposits over interbank balances	1,536,088
	29,231,594

Requirement of new money or U.S. bonds to put the demand deposits of the present commercial insured banks on a 100% reserve basis	$ 3,711,187

* Including demand deposits of individuals, partnerships, corporations, the United States Government, and States and their political subdivisions; and also cash letters of credit, certified, travelers', and officers' checks outstanding, and amounts due Federal Reserve Banks.

Thus, under the proposed arrangement, the banks would need only $3,7 billions of new cash or Government bonds to satisfy a 100% reserve requirement. We could, therefore, today introduce the 100% reserve system and stabilize our banking situation, without causing any very disturbing changes in bank earnings from interest on federal bonds. While, under the plan proposed, these new funds would be distributed among banks automatically, as needed, to raise reserves, in practice almost three-fourths of the required new money would be needed at this time by the large banks in New York, which function as the "bankers' banks" for the small country banks. For New York State alone "interbank deposits" exceeded "interbank balances" by $2,8 billions (December 31, 1938). A similar situation exists in the large banks in the rest of the country. The problem is thus largely one of putting interbank deposits on a 100% reserve basis. The Federal Reserve Board has repeatedly considered taking this step, and it has often been discussed, particularly early in 1939.

The amount of Government bonds which the banks would be permitted to hold on their own volition, as part of their 100% reserve behind demand deposits, should be limited to the amount they held on the day when the 100% reserve requirement went into effect. As to any future additions to that volume (or subtractions from it as the bonds matured) the Monetary Authority would decide from time to time solely on the basis of the legal criterion of stability under which it was operating. The banks would be permitted to sell their reserve bonds to the Monetary Authority at any time, thus converting their reserves into cash.

Government Creation of Money

(12) Under a 100% requirement, the Monetary Authority would replace the banks as the manufacturer of our circulating medium. As long as our population and trade continue to increase there will, in general, be a need for increasing the volume of money in circulation. The Monetary Authority might satisfy this need by purchasing and retiring Government bonds with new money. This process would operate to reduce the Government debt. This means that the Government would profit by manufacturing the necessary

increment of money, much as the banks have profited in times past, though, they do not and cannot profit greatly now because of the costly depression, largely a result of their uncoordinated activities. That is, the governmental creation of money would now be profitable where the bankers' creation of money can no longer be profitable, for lack of unified control.

One of the main reasons why the Board of Governors of the Federal Reserve System is not able to carry out a more effective policy of increasing our volume of circulating medium, thus helping recovery, is that it has no direct and immediate control. The commercial banks have today approximately $4 billions of excess reserves. Open-market purchases of Government bonds by the Board may merely increase bank reserves, and not increase the volume of money, because, as the Board itself said "it cannot make the people borrow," nor can it make the commercial banks invest. Under the 100% reserve system, however, such purchases of bonds by the Monetary Authority would directly and correspondingly increase the volume of circulating medium. Conversely the sale of such bonds by the Federal Reserve Banks would directly and correspondingly reduce the volume of circulating medium when that was desired.

The point is sometimes made, however, that, even under the 100% system, the availability of an increased volume of circulating medium would not necessarily assure a correspondingly increased use of money. For example, the banks might hold an excess of "free" cash and be either unable or unwilling to invest or lend it, with the result that production and employment could not be maintained.

In such a case, it would, of course, be imperative for the Monetary Authority to increase the volume of circulating medium still further. However, instead of purchasing more bonds from banks, or from others, who might not employ the funds thus obtained, it might buy bonds from the public. The circulating medium could be reduced by the converse process whenever this was necessary.

The profit to the Government from the creation of new circulating medium would be a fitting reward for supplying us with such increased means

of payment as might become necessary to care for an increased volume of business.

As we have seen, the banks have often expanded the volume of the means of payment when it should have been contracted, and contracted it when it should have been expanded. For this, bankers are not to be blamed; the fault lies with the system which ties the creation of our means of payment to the creation of debts to, and by, the banks. Moreover, this system has been advantageous to the banks only by fits and starts, chiefly during boom periods when the volume of loans was high. When crash and depression have arrived, the system has resulted in serious trouble for the banks. Thousands of banks failed primarily because of "frozen" assets due in large part to the fact that their demand deposits were based on slow assets like land and industrial equipment which could not yield cash when suddenly needed. This fact greatly aggravated the banks' embarrassment from the fractional reserve system.

Moreover, the independent and uncoordinated operations of some 15,000 separate banks result in haphazard changes in the volume of money and make for instability, with periodic depressions and losses to the banks themselves as well as to others.

In the past, before bank reserves were greatly weakened, the banks made tremendous profits first by lending out bank notes at interest, and later by lending "deposits" both of which they had themselves created. But as time went on these bonanza profits on bank notes and demand deposits became smaller and smaller as the reserve ratios became weaker and weaker, and the banks' ability to meet their demand liabilities became more and more precarious. Eventually, ruin ensued, both to business and banking not only because operating profits were less but even more because of the havoc played with the value of their capital assets. In the ten years from 1927 to 1937 more than ten thousand banks closed their doors, with enormous losses to the stockholders as well as to the depositors and the public in general.

The assumption by the Monetary Authority of the money-creating responsibility would incidentally benefit the Government, by reducing the

interest-bearing public debt pari passu with every dollar of new currency money put out. It would benefit both the public and the banks, by preventing panics and resulting failures; and it would benefit the public because of the greater stability of prices, employment, and profits.

In early times, the creation of money was the sole privilege of the kings or other sovereigns. And, after all, the privilege is still that of the sovereign - namely the sovereign people, acting through their Government. The principle is firmly anchored in our Constitution and it is a perversion to transfer the privilege to private parties to use in their own real, or presumed, interest.

The founders of the Republic did not expect the banks to create the money they lend. John Adams, when President, looked with horror upon the exercise of control over our money by the banks.

Lending Unver the 100% Reserve System

> (13) The 100% reserve requirement would, in effect, completely separate from banking the power to issue money. The two are now disastrously interdependent. Banking would become wholly a business of lending and investing pre-existing money. The banks would no longer be concerned with creating the money they lend or invest, though they would still continue to be the chief agencies for handling and clearing checking accounts.

Under the present fractional reserve syston, if any actual money is deposited in a checking account, the bank has the right to lend it out as belonging to the bank and not to the depositor. The legal title to the money rests, indeed, in the bank. Under the 100% system, on the other hand, the depositor who had a checking account (i.e., a demand deposit) would own the money which he had on deposit in the bank; the bank would simply hold this money in trust for the depositor and could not lend it out. In other words, the demand deposit, representing actual money, could be transferred only on the order of the depositor who had title to it. As regards time or savings deposits, on the other

hand, the situation would, under the 100% system, remain essentially as it is today. Once a depositor had brought his money to the bank to be added to his time deposit or savings account, he could no longer use it as money. It would now belong to the bank, which could lend it out as its own money, while the depositor would hold a claim against the bank. The amount, in fact, ought no longer to be called a "deposit". Actually it would be a loan to the bank.

Now let us see how, under the 100% system, the banks would be able to make loans, even though they could no longer use their customers' demand deposits for that purpose.

There would be three sources of loanable funds. The first would be in the repayments to the banks of existing loans of circulating medium largely created by the banks in the past. Such repayments would release to the banks more cash than they would need to maintain the 100% reserve behind demand deposits; and this "free" cash they would be able to lend out again. The banks would, therefore, suffer no contraction in their present volume of loans. They would have a "revolving fund" of approximately sixteen billions (as of December 31, 1938) of "Loans, Discounts and Overdrafts (including Rediscounts)" with which to operate under the 100% system. The banks could keep these sixteen billions of loans revolving indefinitely by lending them out or investing them as fast as they were repaid.

The second source of loans would be the banks own funds, capital, surplus, and undivided profits which might be increased from time to time by the sale of new bank stock.

The third source of loans would be new savings "deposited" in savings accounts or otherwise borrowed by the banks. That is, the banks would accept as time or savings deposits the savings of the community and lend such funds out again to those who could put them to advantageous use. In this manner, the banks might add without restraint to their savings, or time, deposits, but not to the total of their demand deposits and cash.

However, there would, of course, be a coming of demand deposits from one bank to another, from one depositor and from demand deposits into cash and vice versa. To increase the total circulating medium would, nevertheless be the function of the Monetary Authority exclusively.

The Government ought, as soon as possible, to retire from the banking and money-lending business, into which the recent emergency has driven it. While depending on our banks to mint our money, we have come more and more to depend upon Uncle Sam to be our banker and source of loanable funds. The appropriate functions of each have thus been perverted to the other. Uncle Sam has been acting through the R.F.C., H.O.L.C., the F.S.C., the Commodity Credit Corporation, the A.A.A., and other lending agencies. Between the Government as a banker and the commercial banks there is, however, an essential difference: The banks can create the money they lend, while the Government borrows this money in order to perform the appropriate function of the banks. The 100% reserve system would put an end to this pernicious reversal of functions. It would take the banks out of the money-creating business and put them back squarely into the money-lending business where they belong, and it would put the Government in the money-creating business, where it belongs, and take it out of the lending business, where it does not. The commercial banks would then be on a basis of parity in short-term loans with lenders on long-term who have no power to create their own funds.

The question has been raised, whether, under the 100% system, the banks would not, through their loan policies, continue to exercise control over the volume of circulating medium. Might not the banks refuse to lend out their own money and the money saved by the community, and thus inevitably cause a shrinkage in the volume of actively circulating money? The answer is that, if such hoarding should occur, the Monetary Authority could readily offset it by putting new money into circulation. But the likelihood that the banks

would wish to hoard money on which they have to pay interest or dividends is not very great.

The Protection of Banking

(14) While there would be no restrictions on the transfer and withdrawal of checking deposits, withdrawals from time or savings deposits (including Postal Savings) should be restricted and subject to adequate notice. Only thus may the bankers ever feel safe in long term investing.

Under the 100% reserve system, demand deposits or checking deposits, being the equivalent of cash, would be withdrawable or transferrable without any restrictions whatever. The cash would belong to the depositor, and ought to be ready at his beck and call. But savings or time deposits would, as at present, normally be covered only fractionally by cash reserves. They represent time loans to the banks and therefore should be withdrawable only upon adequate notice. Their character as loans is often overlooked.

The term "time deposits" is a misnomer - even more so than the term "demand deposits". Demand deposits, when provided with 100% cash reserves, become, as we have seen, true deposits of physical money withdrawable on demand. But time deposits (i.e. the bank's liability) cannot under any circumstances be true deposits of physical money. The actual "deposit" is a loan to the bank, drawing interest, and therefore not appropriately available as money to the depositor.

One reason why time deposits are sometimes thought of as money is that they are guaranteed loans — a peculiar form of investment. The owner of a time or savings account of $1,000 can, under the terms of his contract, sell it back to the bank for exactly $1,000 plus interest. Therefore he thinks he actually has $1,000 plus interest. With other investments this guarantee is seldom given. If, today, $1,000 is "put into" some bond or stock, there is no certainty that tomorrow it can be sold for exactly $1,000. It may bring more or it may bring less. The owner thinks of his property not as $1,000 of money but

as a right in the bond or stock, worth what it will bring in the market. Only the financially ignorant think of a millionaire as possessing $1,000,000 in money stored away in his cellar. Yet one naive investor, who had put $500 into a new company, visited the company's office a year later and said that he had changed his mind and wanted to "take his money out." He imagined "his money" to be lying idle in the company's safe. His case was very much like that of the savings-bank depositor who pictures his money, once "put in", as always "in", because he is assured that he can always "take it out". The truth is, of course, that, in mutual savings banks, the money put in is invested by the bank on behalf of the savings depositor while, in stock savings banks, it is borrowed, on term, by the bank from the depositor and gives him no right to consider it as money freely at his disposal at any time.

As already mentioned, if we could rename time "deposits" and call them "time loans", the general public would gain much in its understanding of these matters. The word "deposit" could then be confined to "demand deposits." The expression "money on deposit" would cease to be a mere figure of speech. As matters are now, the "money on deposit" is not really "money" and is not really a "deposit".

In order to make a clear distinction between true deposits which serve as money and time loans, which are investments, we should also discourage the too easy conversion of these time "deposits" into cash. At present, time deposits seldom turn over as often as once a year; and the fact that they draw interest is, and would continue to be, a considerable safeguard against any attempt to make them function as a medium of exchange. Nevertheless, it is conceivable that abuses might creep in; for example, that the banks might encourage the savings "depositor" to circulate his "deposit" by providing him with some sort of certificates, in convenient denominations of say $1 or $5, as consideration for a lowering of the rate of interest paid to him. This subterfuge should be forbidden. It would obscure the sharp distinction that should always

be maintained between money, a medium of exchange, that does not bear interest, and a time loan, which bears interest, but does not serve as a medium of exchange.

It has become customary to let savings depositors withdraw cash almost as readily as if they held checking accounts. Banks having "savings" departments are thus in constant danger of having to meet unreasonable demands for the withdrawal of such savings and the practice should be stopped. The savings "depositor" is not properly entitled to any such privilege.

Under the 100% system the savings and time deposit departments of banks should be given ample opportunity to sell investments in order to be able to supply any reasonable cash demands made by their depositors. In practice, the banks might require a month's notice before cash could be withdrawn from a savings account. Instead of issuing pass books, the banks might issue debentures with definite maturities after notice. Savings "depositors", moreover, might, in case of need, be entitled to borrow, at low rates of interest, against their "deposits" as security. However, such regulations, though important, are only loosely related to the main change here proposed, that of introducing a dollar-for-dollar reserve behind demand deposits.

In this way, the 100% reserve system would lead to a complete separation, within each bank, of its demand deposit department from its time deposit department. This separation would help substantially toward a greater development of our savings bank system, particularly in small communities, many of which today lack these facilities, largely, perhaps, because savings banks are subject to unfair competition from commercial banks which can pyramid loans on the basis of any cash deposited with them on time account in a way which savings banks cannot do.

(15) The splitting of the two functions of lending and the creation of the money supply would be much like that of 1844 in the Bank of England which separated the Issue Department from the Banking Department. That split was made with substantially the same object as underlies the present proposal; but demand

deposits, being then comparatively little used in place of bank notes, were overlooked. The 1-for-1 reserve behind Bank of England notes then enacted was a 100% reserve system for pocket-book money. The present proposal merely extends the same system to check-book money.

The Bank Act of 1844 provided that, up to a specified maximum, reserves behind Bank of England notes could be held in the form of securities, but required that, above that maximum, reserves must be held in cash, 100%. The present 100% proposal is merely that we follow up the job thus undertaken in 1844 by Sir Robert Peel. In 1844, Sir Robert could scarcely be expected to foresee that demand deposits would in time supplant bank notes as the dominant circulating medium and so require similar treatment - a 100% reserve. Yet, only four years later John Stuart Mill foresaw an increased use of checks and both Fullarton and Mill saw clearly that Peel's reform might be frustrated by the use of checks instead of notes.

The Act of 1844 satisfactorily solved the problem of Bank of England notes, but serious difficulties soon arose with respect to deposit currency. As early as 1847, the Banking Department of the Bank of England was confronted with a run, a pressing demand for cash -- whereupon another step toward the 100% system was taken. With the approval of the British Government, though not at first by authority of law, the Banking Department borrowed cash from the Issue Department. This cash was new money specially manufactured for the emergency and transferred to the Banking Department in exchange for securities. This procedure was called a "Suspension of the Bank Act" (not to be confused with the Suspension of the Bank itself). The practice was soon validated by Parliament; and the same policy has regularly been followed in subsequent crises.

The success of these periodic gravitations toward a 100% reserve system has been so invariable that their essential nature has been but little analyzed. Both the permanent set-up of the Bank of England Issue Department, and the emergency set-up of the Banking Department, are plans to

strengthen reserves, one reserve being gold (now Government paper) behind the Bank's note liabilities, the other reserve being notes behind the Bank's deposit liabilities. The former is a legally required 100% reserve. The latter could readily be made so by a minor legal amendment. Had it been so specified and made applicable at all times and to all banks, it would have finished in England the task begun by Peel. In a word, it would have put the British banks substantially on a 100% reserve system.

Our own National Bank Act was similarly an attempt to put our banking system on a sounder reserve basis. A primary object was to prohibit wild-cat issues of bank notes. Though we have stopped the issuance of these, the creation of demand deposits has circumvented the prohibition. The wild-cat is now represented by demand deposits. The 100% reserve system would give holders of deposits the same protection earlier given holders of bank notes.

Banks Under the 100% Reserve System

(16) Lest anyone think that the 100% reserve system would be injurious to the banks, it should be emphasized that the banks would gain, quite as truly as the Government and the people in general. Government control of the money supply would save the banks from themselves -- from the uncoordinated action of some 15,000 independent banks, manufacturing and destroying our check-book money in a haphazard way.

With the new steadiness in supplying the nation's increasing monetary needs, and with the consequent alleviation of severe depressions, the people's savings would, in all probability, accumulate more rapidly and with less interruption than at present. Loans and investments would become larger and safer, thus swelling the total business of banks. (These new loans and investments would no longer be associated with demand deposits but only with time and savings deposits).

The banks would also get some revenue from the demand deposit business itself in the form of charges for their services in taking care of the checking business.

If the manufacture of money is thus made exclusively a Governmental function and the lending of money is left to become exclusively a banking or non-

> Governmental function, some of the vexatious regulations to which bankers are now subject could be abolished. Moreover, the Government could withdraw from the banking business and again leave this field entirely to the bankers.
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> Incidentally, there would no longer be any need of deposit insurance on demand deposits. Moreover, the principal argument in favor of branch banking, which is often regarded as a way to stabilize banking but by eliminating the small banker, would be removed. Last, and most important, the disastrous effects of depressions would be lessened.

As we have seen, if the banks were permitted to retain as earning assets what private and Government bonds and notes they now have as backing for their demand deposits, there would be no immediate change in the earnings of the banks. However, as business continued to increase, there would be greater demands for the services of commercial banks in their demand-deposit departments. The banks might then be pressed to find additional income to compensate them for the additional work required. They would presumably be able to obtain this income through service charges. According to the "Service Charge Survey of 1938" of the Bank Management Commission of the American Bankers Association, service charges are "a first essential to safe and sound banking." In this Survey, an analysis of earnings from service charges in 1937 reveals that, while these service charges amounted to only 4.5 per cent of the total gross earnings of commercial banks, yet, in a number of instances, they actually made all the difference between profit and loss. As to the soundness of this principle of service charges, the following may be quoted from the Survey:

> "Principles of sound bank management justify service charges on checking accounts. The principle that adequate service charges constitute a necessary step in sound banking operation has been firmly established."

Another important point is that, if the 100% system were adopted for demand deposits, the expenses of the demand-deposit

branch of the business would be decreased, for it would become merely a business of warehousing cash and the Government bonds initially held and of recording the checking transactions.

As to federal regulation of the activities of commercial banks, what we need is not more, but less, of it. At present, banking operations are complicated and impeded by conflicting regulations and controls. Three separate Government agencies now send their examiners into the banks. Deposit insurance is a heavy burden; and, even though it is an important protection to the small depositor, it does not afford full protection to the banks themselves. Their trade is still dangerous. The larger banks bear what is probably an unfairly large share of the burden of this insurance. The smaller banks, face an increasing trend towards more concentration of economic power in the hands of the big banks. Under the 100% system, the demand deposits of both the smallest and the largest banks would be absolutely secure. The pressure toward the concentration of banking and the establishment of branch banking would thus be greatly reduced.

These trends are manifestations of the basically fallacious set-up under which all banks, large and small, are now functioning. This cannot be remedied by merely multiplying the regulations or increasing the concentration of banking power, or by deposit insurance. What is needed is to put the system as a whole on a sound reserve basis. Under the 100% system, insurance of demand deposits would become superfluous. Since our small banks would be strengthened they could better perform their important function of directing the flow of our circulating medium into appropriate channels.

Another important influence of the 100% system, not only for bankers but for the community as a whole, would be the effect on the rate of interest. The fractional reserve system distorts the rate of interest, making it sometimes abnormally high and sometimes abnormally low. When excess reserves are high, the rate of interest is abnormally low. Banks often lend

money at nearly zero per cent when they can manufacture without apparent cost the money they lend and are even forced to do so on some forms of loans when so many banks compete for this privilege, and when investment opportunities have been killed by depression conditions. When, on the other hand, the money lent has to be saved, the rate is a result of normal supply and demand and is much steadier.

Incidentally, abnormally low rates injure endowed institutions such as Universities, which derive their income from interest. Moreover these low rates greatly increase the savings necessary to provide a given amount of insurance and operate to reduce the independence of all holders of fixed interest securities.

On the other hand, if and when the present abnormally low rates of interest are succeeded by higher rates, two great perils will confront the banks and the country - unless the 100% plan is first put in force.

One of these two perils is a drastic fall in the price of U. S. Government and other bonds. This may wreck many banks now holding large amounts of these bonds. Under 100% reserves, however, the banks would have a special need for the bonds as a sort of interest-bearing cash against their deposits and solely for the revenue they yield so that their value could not fall.

The other peril is that the three billions of "baby bonds" in the hands of the public, redeemable at par on demand, may be presented for redemption and embarrass the Government.

The 100% Reserve System May Be Inevitable

(17) There are two forces now at work which are tending silently but powerfully to compel the adoption of the 100% reserve plan:

(a) Short-term commercial loans and liquid bankable investments other than Government bonds are no longer adequate to furnish a basis for our chief medium of exchange (demand deposits) under the fractional reserve system. Capital loans are inappropriate for this purpose. As time goes on this inadequacy will grow far worse. Under the present fractional reserve system, the only way to provide the nation with

> circulating medium for its growing needs is to add continually to our Government's huge bonded debt. Under the 100% reserve system the needed increase in the circulating medium can be accomplished without increasing the interest bearing debt of the Government.

Under the Federal Reserve Act our banking system, is supposed to function on the principle of "automatic expansion": That is, as the volume of goods and services increases, means of payment are expected to expand automatically as a result of borrowing from the banks. The circulating medium thus created is expected again automatically to shrink whenever business repays its bank loans after being paid by its own customers. In this manner, the volume of our means of payment is supposed to expand and contract with the volume of short-term, self-liquidating, or "commercial", loans. In other words, the banks are supposed to "monetize", temporarily, the goods in process of production or distribution. But the volume of these commercial loans has never closely paralleled the increased needs of our expanding economy. Sometimes they have expanded too fast. At other times they have contracted drastically.

Moreover, the banks have "monetized" not only self-liquidating commercial loans, but also long-term loans and investments. The funds, for long-term investments pre-eminently, ought to be provided out of voluntary savings. The banks have trespassed on that function and have thereby disturbed the rate of interest on long-term investments. Moreover, as mentioned before, by creating demand deposits based upon long-term loans, the banks have filled their portfolios with "slow assets" which have become "frozen" whenever they were supposed to be repaid during times of depression. The too easy monetization of securities has facilitated the sky-rocketing in the stock market and has provided the banks with inflated assets which have collapsed and broken the banks and the public when the stock boom collapsed. During the depression of the early 30's the preceding monetization of long-term loans substantially contributed to the failure of thousands of banks.

In recent years, attempts have been made to press the banks into making loans on real estate and other slow assets. The banks being thoroughly frightened, have balked. They have been unwilling again to risk that sort of expansion - at least for the present. To get the banks to make such loans, the Government has been compelled to guarantee mortgages on homes. Even so, it appears doubtful that the demand for short-term or commercial, loans by banks will in the future increase rapidly enough, or soon enough, alone to furnish the volume of demand deposits requisite to the maintenance of the present price level. Business has developed methods of its own for financing its operations without benefit of banks. It has added to its cash reserves, and has obtained additional resources, not by borrowing from the banks, but by offering investments directly to the public. Hence the natural trend seems to be toward less and less, rather than more and more, commercial loans. Thus it seems that the bottom has been knocked out out of the original basis underlying our circulating medium. In short, we cannot now depend on short-term bank loans for furnishing us the money we need.

> (b) As already noted, a by-product of the 100% reserve system would be that it would enable the Government gradually to reduce its debt, through purchases of Government bonds by the Monetary Authority as new money was needed to take care of expanding business. Under the fractional reserve system any attempt to pay off the Government debt, whether by decreasing Government expenditures or by increasing taxation, threatens to bring about deflation and depression.
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> Some competent observers think that the two forces above noted will eventually compel the adoption of the 100% plan, even if no other powerful forces should be at work.

A slow reduction of the Government debt might be made an incidental by-product of the Government method of increasing our circulating medium. But the fundamental consideration is that whatever increase in the circulating medium is necessary to accomodate national growth could be accomplished without compelling more and more people to go into debt to the banks, and without increasing the Federal interest-bearing debt.

(18) If the money problem is not solved in the near future, another great depression, as disastrous as that of 1929-1938, seems likely to overtake us within a few years. Then our opportunity of even partially solving the depression problem by removing its monetary causes may be lost, and, as in France, Germany, and other countries where this opportunity was lost, our country could expect, if not chaos and revolution, at least more and more regulation and regimentation of industry, commerce and labor -- practically the end of free enterprise as we have known it in America.

If we do not adopt the 100% reserve system, and if the present movement for balancing the budget succeeds without providing for an adequate money supply, the resulting reduction in the volume of our circulating medium may throw us into another terrible deflation and depression, at least as severe as that through which we have just been passing.

To the extent that monetary forces play a part in our great economic problems -- as, for example the problems of full production and employment, and equitable prices for farm products -- to that extent the monetary reforms here proposed are a part of our task to make our form of Government work and enable it to survive. When violent booms and depressions, in which fluctuations in the supply of money play so vital a part, rob millions of their savings and prevent millions from working, constitutions are likely to become scraps of paper. We have observed this phenomenon in other countries. It is probably no accident that the world depression coincided with the destruction of popular Government in many parts of the world. In almost every case where liberal government broke down, the money system, amongst other disturbing elements, had broken down first. That free exchange of goods and services on which people in industrial countries depend for their very existence had stopped functioning; and, in utter desperation, the people were willing to hand over their liberties for the promise of economic security.

In this manner the decline of democracy has set in elsewhere, and unless we take intelligent action, it may happen here.