

HISTORICAL INSIGHTS INTO THE DEREGULATION OF MONEY AND BANKING

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Introduction

Recent, highly publicized bank failures have inspired some observers to advocate reversal of the financial deregulation begun in 1980; they argue that the excessive risk assumed by unregulated private banks and the high social cost of bank failures (runs) justify reregulation and continued government insurance of deposits (Diamond and Dybvig 1983). Others acknowledge that the Federal Deposit Insurance Corporation (FDIC), with its flat-rate premiums, encourages risk taking by banks, but defend the plan on grounds that its very existence prevents bank runs by the public (Benston 1983, p. 229).

Free-market economists have even supported government monopoly of base money, combined with either a central bank serving as lender-of-last-resort or government deposit insurance, as the most efficient way to reduce risk. Without some guarantee, it is argued, banks and the public would hold larger cash reserves, interest rates would be higher, and real investment would be discouraged (Meltzer 1983, pp. 106–09).

In opposition to the foregoing is the libertarian view that all regulation should be abolished and free banking should be allowed to emerge. This paper presents evidence that crises in banking have resulted not from insufficient regulation, but from excessive governmental restrictions on bank behavior, especially limitations on branching and note issue and mandatory reserve requirements.

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Before establishment of the Federal Reserve, banks faced few obstacles to entry and few restrictions on asset choices or interest rates. Nevertheless, the three major restrictions that did exist, namely, limits on branching, forced holding of reserves, and restraints on the issue of banknotes, were the main causes of instability that led to adoption of deposit insurance.

A completely laissez-faire monetary system without a central bank has been characterized as Pareto-optimal since everyone would be better off; the evils of depression, inflation, and fraud would be minimized in a libertarian world (Timberlake 1978, p. 208).

The Cost of Anti-Branching Restrictions

Unlike most other nations, the United States developed primarily a unit-banking system; the branching that was permitted was not allowed to cross state lines. The two United States Banks (1791–1811 and 1816–36) were exceptions. Even during the so-called free-banking period, from 1836 to 1863, banks were not given total freedom to branch, and as a result their notes often circulated at discounts in foreign states. The National Bank Act of 1864 prohibited branching, except for those state banks that changed to a national charter and already had some intrastate branches.

American economists and banking experts recognized that unit banking was an artificial result of government restrictions and that branching was much safer and more efficient. Westerfield (1933, pp. 744–45), in disputing the need for deposit insurance, argued that branch banking was a proven means to stability and that the resort to government insurance was a demagogic attack on essential branch banking. Dunbar (1904, pp. 195–97) criticized the unit-bank system as responsible for the founding of some state banks, particularly in the plains states, with capital as low as \$5,000. He noted that in other countries bank branches served more customers more efficiently, did not require additional boards of directors, could utilize reserves much more effectively, and permitted lower risk by asset diversification. Wernette (1932, pp. 365, 371) revealed that banks in California, then the only true branch-banking state in the country, enjoyed a failure rate of only 5.7 percent between 1920 and 1932, compared to a nationwide average of 25 percent. Furthermore, only two California banks with branches failed, and both of these confined their branching to a single city.

Among present-day banking scholars, Benston (1983, p. 220) regards the anti-branching laws as politically motivated protection for small bankers. He attributes this protectiveness to an irrational fear of size

and centralization. Ironically, a forced unit-banking structure was responsible for the many failures of small banks in the agricultural states in the 1920s and 1930s; they failed because they could not diversify their loan portfolios the way Canadian banks could (Benston, pp. 224–25). The state-run deposit guarantee systems of the 1908–30 period could not stem the failures of all eight systems (Wells and Scruggs 1984, pp. 5–10).

Part of the irrational fear of branching was the notion that large banks would acquire funds from rural areas and lend them in New York. But the unit-bank system itself moved funds to the New York money market via the correspondent system; rural banks were encouraged by interest payments to keep as much of their reserves as permissible (three-fifths of the required 15 percent of deposits) on deposit with reserve city banks, which in turn kept half of their 25 percent requirement on deposit with New York money market banks. Of course, a branch-banking system may well have moved funds to the money centers, but those funds would have been held within the same institution and could have been quickly diverted to the branch in need. The fear of frozen deposits often caused runs in a unit-bank system, whereas each large branch bank would have held its own reserves, as occurred in other countries (Smith 1936, p. 139).

The Cost of Mandatory Reserve Requirements

With the establishment of the Federal Reserve, member banks were required to hold reserves on deposit at the Fed. It has been generally conceded that these required reserves are the least liquid asset owned by the subject depository institutions. Reserves cannot be used, except at a penalty cost, and, therefore, represent a pure tax on the institution and on all users of institutional money (Benston 1983, p. 219). The benefits of imposing reserve requirements accrue solely to the Fed (and, hence, to the government): They permit the Fed to hold more securities and thus to remit more interest on the debt to the Treasury; they provide the Fed with a large constituency; and they provide justification for expansion of the Fed's subsidized activities (Greenbaum 1983, p. 66). The Fed considers (correctly or not) required reserves necessary for controlling the money supply; hence, they are mandated for the (perceived, at least) convenience of the regulators.

Required reserves did not begin with the Fed, however. The National Bank Act imposed them on deposit liabilities, leaving bank notes to be backed by government bonds. These reserves were to be

held either in vault cash or as deposits in reserve-city or central-reserve-city banks. Banks in the latter category (New York, Chicago, and St. Louis) had to hold their entire 25 percent reserves in vault cash, which could not be national bank notes, but had to be "lawful money"; i.e., gold, gold certificates, greenbacks, or other Treasury currency. Since these reserves could not be used, they became frozen assets in a crisis. Although banks held an amount in excess of the minimum, they frequently had to suspend cash payments, precipitating financial panics. The pyramiding of reserves in the unit-bank system exacerbated the problem; when faced with an increased demand for cash during a crisis, each bank had to think first of itself and contract by pulling its reserve deposits from its correspondent. By contrast, the larger branch banks in Canada maintained higher cash reserves precisely for such occasions (Dunbar 1917, pp. 83–84). In a truly free banking system, banks would have been able to use their reserves when needed, but would also have been able to issue bank notes in exchange for deposits without decreasing their cash reserves (Perrin 1911, pp. 863–64).

Restraints on the Issuing of Bank Notes

Before establishment of the national bank system in 1863, state chartered banks were often encouraged to overissue bank notes by state laws that permitted issuance in an amount equal to the face value of state bonds purchased by the banks. These bond requirements often burdened banks with illiquid bonds and set an unhealthy precedent of backing note issue with government bonds rather than commercial assets. Nevertheless, these notes did circulate at various rates of discount, and the public was kept somewhat informed of their relative values by various bank-note reporters.

When the national banking system was established, these state bank notes were taxed out of existence in order to give national banks the sole privilege of issuing notes. To compensate for having established thousands of independent banks, the federal government printed uniform bank notes to be issued by those national banks in the course of lending. Since these bank notes were homogeneous, they were received and paid out by national banks all over the country at par, thereby constituting a federal currency. While this practice by banks of paying out each other's notes mitigated the inconvenience of the absence of branches, it did not test the ability of each bank to redeem its own notes (Dunbar 1917, p. 228); thus the system did not provide a check on expansion (Smith 1936, p. 132).

Each national bank was required to maintain with the U.S. Treasury a reserve equal to 5 percent of the bank's note issue (Dunbar 1917, p. 228). After 1874, however, the U.S. Treasury itself was the sole redeeming agency for all national bank notes, and it had to pay out "lawful money" for *all* bank notes presented, regardless of the size of the 5 percent reserve.

The large number of independent banks issuing homogeneous notes might be expected to cause an overissuance of notes, but not deposits. Checks were cleared through various clearinghouse settlements and were returned to the bank much faster than notes. Notes were a direct promise of the bank to pay the bearer, but checks did not obligate the bank to pay at all. Therefore, with banks paying out each other's notes, the notes did not return to the issuer in the manner of checks (Dunbar 1917, pp. 70–73). Nevertheless, in the United States, bank notes were often underissued because of an onerous restriction: Each national bank was required to deposit with the Comptroller of the Currency \$100 of special 2 percent government bonds for every \$90 of bank notes issued. National banks thus attempted to issue credit in the form of deposits rather than notes, frequently charging a higher interest rate to those borrowers who demanded their loan proceeds in notes. The underissuance of notes led to several liquidity crises peculiar to the United States. These panics forced banks to suspend cash payments because they could not exchange one liability for another—deposits for bank notes—but had to pay out legal tender cash in gold or greenbacks from their assets, thus depleting their reserves (Smith 1936, pp. 130, 134).

The value of government bonds, rather than the demand for bank notes, became the operative constraint on bank-note issuance. Reduction of the federal debt in the 1880s exacerbated the problem. The quantity of national bank notes fell from \$325 million in 1880 to a little over \$123 million at the end of 1890 (Dunbar 1917, p. 232). This sharp reduction in national bank notes stimulated interest in state bank notes: Between 1875 and 1892 there were 34 unsuccessful legislative attempts to repeal the 10 percent tax on state bank notes that had been imposed during the Civil War, in the hopes that such issues would satisfy the public's demand for currency (Dunbar 1904, p. 188).

The panics suffered by U.S. banks were avoided in Canada and England. Before the founding of the Bank of Canada in 1935, each bank was restricted in note-issuance to the amount of its paid-in capital, but it could exceed this amount by 15 percent in the crop-moving seasons. In England, banks were completely independent of the government; they had no required reserves or balance sheet

restrictions. They survived the gold crisis of 1931 with no failures, runs, or suspensions (Baster 1934, pp. 9, 12).

The Cost of Government Deposit Insurance

The establishment of the FDIC assured the perpetuation of a unit-bank system that had produced 15,000 failures between 1921 and 1933. Arguments over the desirability of deposit insurance had raged since the mid-19th century. Between 1866 and 1900, 18 deposit insurance bills were introduced in Congress, and another 45 were introduced between 1900 and 1910, but none was passed. In fact, Congress considered 150 deposit insurance bills before passage in 1933 (Golembe 1960, p. 188). Advocates favored deposit insurance as the best way to keep the money supply from contracting in a unit-bank system. Representative Henry Steagall, a co-sponsor of the 1933 act that created the FDIC, was a strong proponent of government insurance precisely because he wanted to preserve the unit-bank system; Senator Carter Glass, initially an opponent, was recruited as a co-sponsor with the understanding that the permanent plan would cover only member banks (Golembe 1960, p. 182). Similar positions were assumed by various Comptrollers of the Currency: Those who advocated branch banking, such as D. R. Crissinger and John W. Poole, opposed deposit insurance; those who wanted to preserve unit banks, such as John S. Williams, favored insurance (Kent 1963, pp. 44, 54).

Even economists who would retain deposit insurance recognize its serious shortcomings. Benston (1983, pp. 229–30) concedes that insurance relieves depositor fears but acknowledges that it increases bank risk taking: The benefits from successful risky investments accrue mainly to stockholders of the institution, while the losses from unsuccessful ventures are borne mainly by the FDIC. Benston further charges that the current system leads to overregulation by the FDIC. Because it charges a flat rate, rather than a risk-based premium, the FDIC stands to lose if a failure occurs but gains nothing from success. He deplores the monopoly position of the FDIC and suggests that various federal agencies, as well as private insurers, be allowed to compete for business, thereby permitting those banks willing to pay higher premiums to assume more risk. Greenbaum (1983, p. 67) considers deposit insurance a moral hazard because it increases risk taking and gives banks the incentive to reduce their capital. He also argues that deposit insurance allows federal agencies to maintain a large number of banks in the industry via the subsidy

of the flat-rate premium, preventing banks from achieving scale economies through nationwide branching.

Short and O'Driscoll (1983, pp. 12–13) recommend that private insurers be allowed to offer an alternative to the FDIC, even if the latter were retained as a dominant supplier. But Diamond and Dybvig (1983, p. 413) argue that private insurers could only operate on the fringe, since they would have to rely on their reserves and not on taxing power. However, England and Palffy (1982, pp. 13–14) contend that private insurers would be more selective in choosing their risks and could monitor banks more closely, while avoiding the publicity that now accompanies the FDIC “problem list.” Government agencies cannot operate in secret, but publicizing federal aid to a struggling bank can precipitate the very run that the aid was intended to prevent. This was demonstrated in 1932 and 1933, when political pressure forced the Reconstruction Finance Corporation to disclose its loans to banks that were illiquid, and failures often followed within 60 days of the reporting (Sullivan 1936, p. 49).

Often omitted from discussions of government or private deposit insurance is the fact that the announced purpose of the FDIC was to protect depositors and *not* banks (Jamison 1933, p. 451). Of course, the actual purpose—admitted by former Senator Robert Owen in 1932 in testimony before Congress—was to maintain the money supply in a unit-bank system. Indeed, this “monetary-policy” motivation was evident before the Civil War, when six states set up guarantee or insurance funds for the protection of state bank notes. In almost all cases, the states avoided closing the banks by selling bonds to redeem the notes, and thereby preventing decreases in the money supply (FDIC 1953, pp. 49–51). But even if depositor protection were the objective, banks with unlimited branches would be much stronger and safer and would not need insurance. Some banks might subscribe to, say, \$10,000 of private insurance per account as a marketing strategy to allay depositor fears, but there would be no implied total bank bailout like that apparently enjoyed by modern large institutions. Therefore, bank capital and reserves would have to rise above current levels. With nationwide branching, the correspondent system would not be needed; interbank deposits could not be used as an excuse for a government rescue.

Another major flaw in the current deposit insurance scheme is the implied subsidy from large to small banks. The gross premium is one-twelfth of 1 percent of all deposits, not merely insured deposits, and the larger banks have more of the larger accounts that are not fully covered. Part of this problem could have been alleviated by having the banks, rather than government agencies, audit each other,

since they are insuring one another. This idea was proposed by some economists 70 years ago, when eight states set up deposit guarantee systems (Danner 1914, p. 220). Evidence also exists that under the bank note guarantee plans before the Civil War, the three states that allowed the banks to choose the auditors (Iowa, Indiana, and Ohio) enjoyed better bank supervision than the states in which auditors were political appointees (New York, Vermont, and Michigan). In the former case, the cost of laxity fell directly on the banks (FDIC 1953, p. 59).

Proponents of government deposit insurance argue that deposits are often hard to convert to cash when a bank's assets have to be sold at a loss. This necessitates, they contend, either government insurance or a central bank serving as lender of last resort (Diamond and Dybvig 1983, pp. 401–2). Actually this argument applies to the current situation wherein all currency is “outside money” to a bank, and central banks increase the money supply when they lend to commercial banks. But in a free banking system, currency is “inside money” to banks just as deposits are, so they can be exchanged for one another at the whim of the public without affecting the money supply.

Prior to the passage of the Federal Reserve Act, banks did resort to the issuance of a free-market currency—the clearinghouse loan certificate—that worked quite well in emergencies, even though it was illegal. After 1908 the Aldrich-Vreeland Act authorized the issuance of national bank notes on the basis of commercial loans rather than government bonds. Since both of these issues worked much like free banking, it is worthwhile to discuss them in more detail.

The Clearinghouse Loan Certificate

Between 1857 and 1907 commercial banks, first in New York and later in other reserve cities, resorted to the use of clearinghouse loan certificates (CLOCs) as a means of settling liquidity crises, during which cash payments were suspended. Their use was an example of a free-market solution to crises caused by legal restrictions on the issuance of currency, anti-branching regulations, and the forced holding of idle reserves. The clearinghouse worked like an ad hoc central bank, issuing an illegal currency at which the government winked. With the inducement of a 6 percent interest rate, the stronger banks willingly acquired the CLOCs that deficient banks issued on the basis of 75 percent of the face value of collateral security. In 1873 and 1893 certified checks drawn with no funds on deposit and cashiers checks payable only through the clearinghouse were used in

place of currency or as settlement media. After 1873 the concept of the CLOC spread to many parts of the country. Large denominations served as reserves, and small denominations were used as currency substitutes. In Chicago CLOC denominations were as low as \$1 and in Atlanta 25 cents (Timberlake 1984, pp. 4–6). The only loss on these certificates over the 50-year period was \$170,000 in Philadelphia in 1890. Interest rates constrained the use of CLOCs just as the gold standard limited the monetary base.

Although CLOCs did not prevent the failure of weak banks, they did prevent a fractional reserve collapse as in the 1930s. In 1908 the Aldrich-Vreeland Act authorized the issuance of regular national bank notes, without the backing of the special government bonds, thereby rendering CLOCs obsolete for national banks but not for state banks. While CLOCs worked very well, they were considered “hucksterish” and were associated with cash suspensions. In addition, popular sentiment felt that the government, not private banks, should issue currency (Timberlake 1984, pp. 13–14).

Aldrich-Vreeland Act Currency

The Aldrich-Vreeland Act, passed in May 1908, permitted any 10 or more banks with an aggregate capital of at least \$5 million to form national currency associations for the issuance of new bank notes, which could be backed by commercial paper or other securities, not merely government bonds. The restrictions on issuance, however, were so burdensome that no Aldrich-Vreeland Act currency (AVAC) was issued for six years, even though 21 associations were actually formed. A prerequisite for issuing AVAC was the existence of outstanding bank notes backed by U.S. bonds in amounts of at least 40 percent of capital stock; AVAC could not exceed 75 percent of the cash value of securities backing it. In addition, a tax of 5 percent per year was imposed on AVAC for the first month it was outstanding, and this tax increased by 1 percent per year every month until a maximum of 10 percent per year was reached (Comptroller 1908, pp. 73, 75).

However, the Federal Reserve Act of 23 December 1913 amended the 1908 law by decreasing the tax on AVAC to 3 percent per year for the first three months, after which the tax increased 0.5 percent per year every month to a maximum of 6 percent per year. Another amendment was passed in August 1914 that permitted the Secretary of the Treasury to waive the prerequisite of U.S. bond-backed currency outstanding equal to 40 percent of capital. The 1914 amendment also allowed issuance of AVAC to equal 125 percent of aggre-

gate capital and annulled a provision that limited the total issue to \$500 million (Comptroller 1914, pp. 12–13).

At the outbreak of World War I in August 1914, England was demanding payment of loans in gold and established a special bank in Ottawa, Canada, to receive shipment. This caused another liquidity crisis in the United States, as banks saw their reserves depleted not only by the loss of gold but also by the public's increased demand to withdraw currency (Sprague 1915, p. 517). Instead of relying on CLOCs, as in past crises, banks for the first time issued AVAC.

The new currency prevented the suspensions of cash payments that were characteristic of the panics in 1873, 1893, and 1907. Applications to issue AVAC began the first week of August 1914; only 1,363 of the 2,197 banks in the 45 currency associations actually took out the new bank notes. The aggregate amount taken out by all banks was \$386.4 million, but the most out at any one time was \$368.6 million, 95 percent of the aggregate (Comptroller 1915, pp. 92, 99). By the first week of January 1915, 60 percent had been retired. The entire amount was retired by the end of June 1915, except for \$200,000 in a failed bank. Less than one-fourth of the possible amount was ever issued; the New York City banks issued \$144.9 million, or 37.5 percent of the total. The government collected \$2,977,066 on the AVAC. Approximately 57 percent was backed by commercial paper, 28 percent by miscellaneous securities, 14 percent by state and local government bonds, and 0.5 percent by warehouse receipts. New York banks were the first to apply for issue and the first to retire, completing it on 25 January 1915 (Comptroller 1915, pp. 91–92, 101).

During this crisis, the banking system acted more like a model free banking system than at any previous time in history. Currency was issued in exchange for deposits when the public demanded it, and it was extinguished when demand subsided. Banks were able to conserve their gold certificates and greenbacks as reserves by paying out the bank notes for use as hand-to-hand currency. Because of the peculiarity of the U.S. banking system, however, some of these bank notes served as reserves for state-chartered banks, even though they were not reserve money for national banks (Sprague 1915, p. 523).

The Aldrich-Vreeland Act worked far better than the Fed did in the early 1930s. Nevertheless, Aldrich-Vreeland did not create a truly free banking system. The latter would include a much smaller number of large banks with extensive branches, paying out only their own distinctive bank notes, which would not be subject to a tax. Each bank would be able to observe a separate demand for its own money, which it could supply in an amount that would keep its price stable

in terms of competing bank notes. The supply of money would be microeconomically determined.

Conclusion

This paper proposes complete deregulation of the banking system as the surest way to an improved monetary system. The short-comings of the past were not caused by too few government regulations, but by too many. Yet each crisis brought more government intervention, because the public apparently believed that there was something inherently unstable about banking. Too little was heard about the handicaps imposed on banks by these restrictions, although some economists did advocate unlimited branching.

If the existing stock of Federal Reserve notes were frozen and replaced only as they wore out (Friedman 1984, p. 49), they could serve as a reserve, like the frozen supply of greenbacks in the 19th century. Banks could issue their own notes, guaranteed redeemable in either Federal Reserve notes or such metals as gold or silver. The Fed then could buy back its stock from member banks and allow all financial institutions to close their reserve accounts and pay off their loans at the discount window. The Fed then could hand over its securities to the Treasury, cancelling them, and cease to exist.

Government deposit insurance could be phased out over a five-year period, perhaps retaining \$10,000 per account for a few years longer until private companies decide whether they want to provide insurance and the public decides if it wants such coverage. Banks and other financial institutions should immediately be allowed to branch where they choose and to hold the types of assets, including reserves, they feel are best. The demarcation between banking and other businesses would necessarily be obliterated.

In a laissez-faire monetary regime, each bank would be in a much better position to keep its money supply (bank notes and deposits) equal to the demand than would a central bank because, with individual banks, the demand for money is much more observable. As such, an era of free banking and competing currencies would tend to stabilize the level of prices and reduce the uncertainty inherent in the current monetary regime.

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