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Breaking the Banks

by Richard M. Salsman

What underlies the grave financial difficulties facing our banking system—and what is the basic cure?

THE financial condition of the banking system in America has deteriorated significantly throughout most of this century—and the decline has accelerated in the past decade. The proximate cause of this trend is our statist system of central banking, a system in which the Federal Reserve manipulates money and credit and exploits the private banking system in order to draw resources from the economy and finance the welfare state. The *ultimate* cause, however, is philosophy—specifically, the altruist/collectivist philosophy, which makes both the welfare state possible and central banking necessary.

The current state of the banking system cries out for rational reform. In the commercial banking industry during the past decade, banks have failed in numbers unprecedented since the Great Depression, a period when one-third of all such banks failed. The rate of failure has risen precipitously since 1980 and every important measure of the financial stability of banks has been declining, despite generally favorable economic conditions. In the decades prior to 1980, commercial banks failed at a rate of less than ten per year. But in this decade bank failures have grown steadily from 10 in 1980 to 80 in 1984 to 150 in 1987 to 211 last year. The list of "problem banks," those still in operation but depleted of capital and effectively insolvent, rose from 217 in 1980 to over 1,400 today, representing more than 10 percent of the total banks in the country. Some of the biggest bank failures in U.S. history have occurred in recent years, including First Pennsylvania (1980), First Seattle (1982), Continental Illinois (1984), Texas Commerce (1986), First City Bancorp. (1987), First Republic (1988), MCorp (1989) and Bank of New England (1990).

In the savings and loan industry, this trend of financial dissipation is equally evident. A record number of such institutions—over 200—failed last year. The largest savings-and-loan in the country (American Savings and Loan) went broke in 1988, and nearly half of the ten largest such institutions are now insolvent. A recent study by the consulting firm Booz-Allen & Company estimates that more than a third of the 3,100 thrift institutions nationwide are also insolvent, yet still operating today. The government will not allow these institutions to close down because the deposit insurance fund of the Federal Savings and Loan Insurance Corp. (FSLIC), which contained over $6 billion in 1980, has been completely exhausted due to failures in this decade. Today, the FSLIC is estimated to be insolvent by more than $500 billion (or $2,000 per American).

Aside from the growing rate of bank failures, other crucial measures of the financial condition of banks—such as capital adequacy, liquidity, loan quality, profitability and management prudence—have all declined significantly since the establishment of central banking in the U.S. with the creation of the Federal Reserve system in 1913.

Capital adequacy, for example, identifies the extent to which assets exceed liabilities. It is a measure of the value of a bank. The lower the capital ratio (capital as a percentage of total loans and other assets) falls, the more likely insolvency becomes. For the entire banking system, that ratio has plummeted from 17 percent in 1913 to approximately 5 percent now. In other words, the margin for error in banking has been narrowing dangerously under central banking.

Even with adequate capital, banks must close if they do not have the liquidity to meet deposit withdrawals. Liquidity ratios, which measure the portion of cash and reserves held in banks in relation to deposit liabilities, have declined steadily over the same period from 23 percent to 10 percent. For many years the profitability of banks has been well below that of other industries, and has been fitfully declining over these same decades. With lower profits, banks lose an internal source of new capital, and have more difficulty attracting capital from the outside. Meanwhile, bank loan quality has deteriorated as credit standards have become more lax and bankers have grown less prudent in their lending practices. Evidence of this abounds today, from the proliferation of credit cards mailed to over-extended consumers, to the banks' lemming-like lending to over-leveraged companies, to the banks' virtual give-away of $400 billion in "loans" over the past decade to bankrupt socialist governments in Latin America. Operating under today's capital ratios, a bank becomes insolvent when only 5 percent of its loans and investments cannot be repaid.

While the frightening number of banks going broke is convincing many people of the gravity of the problem, few realize that it is *government* that is breaking the banks. Central banking under-

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mines the private banking system through repeated assaults on all the major components of bank stability. This is not simply an unintended consequence; it is rather inherent in the very *purpose* of central banking.

CENTRAL banking is a statist system of government-controlled money and credit characterized by four main features: 1) the government holds a monopoly on fiat money which is enforced by legal tender laws; 2) the government guarantees deposits; 3) the government acts as "lender of last resort" to mismanaged or failing banks; and 4) the government regulates management decisions on lending policy, branching, etc. All these attributes evolved over the years in order to help finance the growth of unlimited government—a goal incompatible with the existence of a private, independent banking system.

The state obtained its monopoly on money by forbidding banks to issue gold-convertible currency and forcing them to accept fiat money. Historically, this process began with the government's refusal to uphold gold-convertibility contracts between bankers and depositors. Writing in *Human Action*, Ludwig von Mises described how "the suspension of specie payments entirely changes the state of affairs. . . . The government enters the scene with its government-made legal tender laws. The bank loses its independent existence; it becomes a tool of government policies, a subordinate office of the treasury." The suspension of gold convertibility means that banks are in a position to lend to anyone—including the government—without limit. It is obvious why statists would find this appealing.

When the Federal Reserve was formed in 1913, it not only prohibited private banks from issuing their own (gold-convertible) currency, it also began taking control of the balance sheet from the owners and managers of the banks. Banks retained the power to issue deposit credits, but these deposits now had to be convertible into Federal Reserve currency. In 1917 the government forced banks to exchange a good part of their gold reserves for government securities, enabling Washington to absorb its World War I debts. (Banks that protested were criticized for their lack of "patriotism.")

Upon surrendering gold, their only objective anchor of value, the banks began issuing loans which would not have been made under free banking. And they became dangerously reliant on the central bank for their ultimate liquidity needs. This proved disastrous during the following decades. The Federal Reserve pursued wildly inflationary policies in the 1920s, causing the collapse of the stock market, the banking system and the entire economy in the Great Depression. For a decade the banks had come to expect an unending supply of cash from the government, lending it out in increasingly unproductive ventures—until the liquidity spigot was turned off and depositor withdrawals could no longer be met. Nearly 10,000 banks, one-third of the total, failed during the Depression. (The regulatory controls on branching made the disaster even worse. Many of the banks in the U.S. were legally restricted to one or two branches. Consequently, when faced with local loan defaults and large deposit withdrawals, an entire bank company had to fail. By contrast, Canada, which also suffered a depression, had no central bank at the time. There was only a handful of banking institutions in the country, but they had virtually unlimited branching powers and thus thousands of offices. Local branches would close, but their deposits were simply transferred to other branches. As a result, none of these Canadian banks failed.)

The Federal Reserve had removed banks' independent control over gold as a reserve—and then instituted an inflation-deflation policy which decimated bank profitability, capital adequacy and loan quality. Clearly, the real culprit was the central bank and its monopoly currency. But it was gold (despite the fact that it had been largely eliminated from the system) that bore the blame. So in 1934 the government confiscated the limited amount of gold still held by the banks and the general public, and went off the domestic gold standard entirely. Subjective, politically-based, fiat money was forced into the economy in place of objective, market-based, gold money. Neither the banks' financial health nor their freedom could long survive on such a statist monetary base.

Inexorably, the links between banking and real money kept vanishing. In 1934, for instance, the Federal Reserve still had to hold a certain proportion of gold reserves to back up its fiat currency. By 1968, that requirement was dropped completely. And by 1971, the system's last tenuous tie to the precious metal—the right of foreign banks to demand gold in exchange for U.S. currency—was severed. The central banking fiat dollar has lost 90 percent of its value since 1934; 60 percent of that drop has occurred since 1971. It is no coincidence that the financial decay of banks has accelerated in the decades following the final abandonment of gold and the heightened expansion of the welfare state.

Central banking exists in order to finance unlimited government. Defenders claim that its purpose is to "control the money supply," or "fight inflation," or "lower interest rates," or "smooth business cycles" or "fight unemployment." But an uncontrolled money supply, inflation, high interest rates, boom-and-bust business cycles and unemployment are the *results* of statism, not justifications for more of it. Central banking is an integral part of the welfare state, for it serves as the convenient tool of politicians committed to the redistribution of wealth. These politicians want the power to keep spending other people's money. To avoid the need to raise taxes overtly, they resort to deficit spending (government borrowing). But this produces higher interest rates. So, in an attempt to avoid this unpopular effect, the central bank creates money out of thin air to help the treasury pay for its spending schemes.

Banks are the most immediate victims of newly created money. Inflating the money supply means primarily inflating—i.e., devaluing—the balance sheet of the banking system, since bank demand deposits represent 85 percent of the total money supply (the remaining 15 percent is Federal Reserve currency in public hands). Having relied for years solely on the central bank for ultimate liquidity, the banks have held diminishing fractions of reserves against deposits. Today banks keep only $10 in cash reserve for every $100 on deposit, which is another way of saying that deposits grow by $100 for every $10 injected into the banks by the Federal Reserve. Since deposits are created when banks make loans, this system of fractional reserves allows for ever larger creations of loans and deposits for a given reserve injection. And because the source of this increase in reserves and deposits is really the politics of the welfare state and not the productivity of the economy, the

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balance sheet of the banking system (loans and deposits) becomes artificially inflated in magnitudes which dwarf its capital base. The proportion of capital to loans and deposits shrinks, and the risk of bank failures grows.

The central bank's inflationary policies also encourage banks to make poorer quality loans to less creditworthy borrowers. Banks make money by making interest-bearing loans, not by holding excess sums of cash reserves. To invest this ever-growing excess, they must relax their credit standards, reaching ever more marginally productive borrowers and increasing the chances of such loans going unpaid—especially if the borrower relies on future inflation instead of future production.

UNDER central banking the creation of new fiat money and the consequent credit expansions are increasingly based on the central bank's commitment to finance the *redistribution* of wealth. Under free banking, however, reserves are held in the form of gold and any credit expansions must be based on the *production* of wealth. It has been the massive budget deficits of this decade, not the creation of real goods, that have caused the central bank to nearly double the money supply, from $400 billion in 1980 to almost $800 billion today.

Adding to the risks in the system are government restrictions on lending policies and branching decisions. This leads banks to accumulate undiversified loan portfolios and deposit sources. Government encourages banks to put all their eggs in one basket by concentrating their risks in only a few industries or sectors of the economy. Profitability becomes more precarious when banks are legally tied to certain pockets of the economy undergoing a recession. Many bank failures in the past decade have occurred in Illinois and Texas, the two states with the strictest anti-branching laws in the country. Illinois banks have been hurt by problems in the farming sector and Texas banks have been undermined by a concentration of loans in oil and real estate ventures. Large New York City banks have some of the lowest capital ratios and worst loan problems in the country because they are the first to receive monetary injections from the Federal Reserve, and because branching restrictions (and inducements from such central banking agencies as the World Bank and the International Monetary Fund) encouraged them to make ruinous loans to socialist countries.

The corrosion of the private banking system takes the form of a vicious, downward spiral. Banks make money when their cost of raising money (interest they pay on deposits) is lower than that of the companies to which they lend (interest they earn on a loan). In the past, banks were "pillars of the community" upon which all industry rested. But no longer. Due to government intervention, the condition of many banks is now inferior to that of the companies which are their potential borrowers. The most creditworthy companies now frequently bypass the banking system and borrow directly in the securities markets, leaving the banks to lend to the dregs of industry. As the banks worsen financially, their costs of deposits and capital rise, leading them to seek out less creditworthy companies willing to pay higher rates on loans. In the process, banks make loans of ever-poorer quality, causing their financial health to spiral ever downward.

It is a mistake to believe that government deposit insurance is an answer to this basic instability. Deposit insurance, a patchwork scheme concocted in the Great Depression after the Federal Reserve destroyed a third of the banking system, serves only to further *undermine* the viability of the banks. In fact it is not insurance at all and would be unobtainable on a free market. First, it forces the prudent, healthy banks to pay the same premiums into the fund as the incompetent and dishonest banks do. The rates paid bear no relation to the riskiness of a bank's lending practices. This is a program which penalizes success and rewards failure, for it is the inefficient banks that draw money out of the fund—when they achieve insolvency. The remaining, successful banks are then forced to pay even greater sums to replenish the fund. This is nothing but government-sponsored cannibalism.

Second, the reserves of the deposit insurance funds are woefully small in relation to the risk they are insuring against, a policy which would face criminal prosecution if adopted by any private insurer. The reserve fund of the Federal Deposit Insurance Corporation (FDIC) is only $12 billion (and falling)—or less than one percent of the total bank deposits it is supposed to insure. The failure of any large bank can easily deplete the fund, as evidenced by the insufficient capital of the "insurer" of the savings-and-loans, the FSLIC. In fact, the adequacy of the deposit insurance funds really depends on the government's power to tax and to print money. Finally, deposit insurance promotes imprudent lending because it promotes bank immunity from the effects of such decisions, namely loan losses and deposit withdrawals. Deposit insurance regulators have recently begun purchasing unpayable loans from banks in return for cash. The banks continue their unsound policies, but now with government officials often becoming members of their loan committees.

Government deposit insurance is not intended as much to protect the small depositor as it is to forestall runs on the banks. Its ultimate purpose is to guarantee the inflated supply of money the central bank has created—most of which consists of bank demand deposits. The Federal Reserve wants to keep its shaky structure of fractional reserve banking from toppling. *This* is why government deposit insurance was instituted in 1934—in the aftermath of massive bank failures, the consequent destruction of billions in deposits, and deflation—and *this* is why it has been vigorously preserved and expanded in more recent decades.

Although central banking is the basic source of trouble in the banking industry, this fact is ignored by conventional analysts. But they know that *some* explanation is required, and so they place the blame on "deregulation" or on dishonest bankers. These are worse than lies because they are half-truths. The first charge stems from the chronic efforts of statists to blame capitalism for the disasters wrought by their own interventions. While there has been a modicum of decontrol in recent years, banking remains the most regulated industry in the U.S. economy. The value of the banks' basic product still rises or falls according to bureaucratic whim. The government continues to hold a monopoly on currency, to force inflation through the banking system, to regulate lending, to promote imprudent risk-taking, to punish success and to compensate failure. If less-than-totalitarian control results in disaster, the cause

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lies not in the few crumbs of freedom dispensed, but in the overriding enslavement that renders such crumbs virtually meaningless.

The same evasion applies to the charge that the trouble stems from dishonest bankers. This is not to say that fraudulent banking does not take place. But why would its frequency be on the rise? Why would it be more prevalent than in any other industry? Has the nature of banking, or of those who enter the profession, changed for the worse, and if so, why now?

The answer is that the system of central banking *institutionalizes* unsound and dishonest banking. Inflation is the most significant manifestation of this institutionalized fraud. And deposit insurance is a device to mask it. Then there is the deliberate policy of government regulators to conceal the rotten financial condition of banks through irregular accounting practices designed to camouflage poor loans or poor capital positions. The regulators refuse to make public the names on their "problem banks" list. The government has even warned banks against using the terms "most secure," "strongest" or "best managed" in their advertising because, though accurate, "the relative strengths and weaknesses of an institution have no bearing on deposit insurance protection."

If government declares its readiness to make good on all bank liabilities—i.e., on private promises to pay bank debts—then the people least willing to deliver on their promises will be the ones most attracted to the system. Our government, which stole our gold within two decades of establishing central banking, and which every day since has stolen our wealth by forcing on us its depreciating paper money, has in the process given a license to steal to those in the banking system low enough to accept the offer and exercise it. When such bankers "freely" do so, it is "freedom" (or "deregulation") which takes the blame and which serves to justify still more interventions.

CONTROLS breed further controls. And so the "solution" proposed by a variety of reformers is to accelerate the nationalization of the private banking system. The basic pattern mimics that in all statist interventions: government first makes it impossible for the efficient and the productive to succeed, while it promotes the rise of the incompetent and the unethical. As the industry weakens and threatens to collapse, the government calls for additional interventions on the grounds that survival of the industry is crucial and that justice demands a crackdown on the unscrupulous forces that have "taken advantage" of the system.

The government now stands officially ready to bail out—i.e., take over—any major bank on the brink of failure. To finance this, Congress wants to impose new taxes to replenish the deposit-insurance funds (several hundred billion dollars will probably be required for the savings and loan industry alone). It has already passed a resolution requiring the Federal Reserve to print money for bailouts when the funds fall short. And bank regulators are now placing even tighter controls on the lending policies of the remaining banks. Their remedy for the problems of insolvencies and inadequate capital—problems at root caused by government interventions—is to intensify the government's control over such decisions as who is to receive loans, in what amounts, for what purposes, under what terms, etc.

This nationalization of the lending and investment process of the private banking system is a necessary consequence of central banking. It was justified decades ago by Keynes (and ever since by his followers). In his book *The General Theory of Employment, Money and Interest* (1936), Keynes wrote:

"The State will have to exercise a guiding influence on the propensity to consume, partly through its scheme of taxation, partly by fixing the rate of interest. . . but it seems unlikely that the influence of banking policy on the rate of interest will be sufficient by itself to determine an optimum rate of investment. I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment. . . . No obvious case is made out for a system of State Socialism which would embrace most of the economic life of the community. It is not ownership of the instruments of production which it is important for the state to assume."

Keynes claimed then, and his followers allege today, that he is not promoting socialism because he would leave business in private hands, while "socializing" only money and credit decisions. But to control money and credit is to control the industry whose lifeblood consists of money and credit. Keynes' ideas lead inescapably to the situation in which banking is dominated by the state and is "private" in name only—i.e., to a fascist form of socialism.

Those who are looking for a once-and-for-all collapse of the banking system, after which some fundamental reform might be instituted, are not likely to see it happen. The government may be killing the private banking system but it is doing so by slow poison, not a gunshot to the head. There will continue to be periodic banking crises brought on by central banking interventions, and the statists' preferred solution will continue to be the piecemeal takeover of the private banking system. The takeover will sometimes be in ownership, sometimes in direct management control, more often a combination of the two. So it is more accurate to say that while particular banks are collapsing like dominoes into the waiting arms of the state, the overall banking system is dying a slow death. But it is a lengthy process, imperceptible to those who do not grasp the principle of a free economy. And unless the advocates of genuine free banking are given a hearing and unless their reforms are adopted, there will be no way to reverse this fatal trend.

The nationalization of the private banking system will proceed as long as the diminishing remnants of laissez-faire banking are blamed for the deterioration of the industry. And even if reformers recognize in some way the detrimental influence of central banking, they are unlikely to adopt appropriate reforms unless they are aware of the alternative case for free banking. Further, even if they are aware of the free banking alternative, they need to know how to make the transition to it from the central banking system of today. All three of these factors are critical to the adoption of free banking.

Fortunately, the fastest growing segment in economic research today is the study of free banking—both in its theory and its practice. A large and growing body of free banking evidence is available for policy-makers and others who care to study it.

Scholarly investigation of the history and theory of free banking accelerated after the publication of *The Denationalization of Money* in 1976 by the Austrian economist and student of Ludwig von Mises, Friederich Hayek. There are many flaws in Hayek's treat-

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ment of free banking and the best grounding for free banking research remains the work of von Mises, especially his *Theory of Money and Credit* (1912) and *Human Action* (1949). Still, Hayek does challenge the long-unquestioned allegiance to central banking. That fact, combined with his rise in academic respectability following his winning of the Nobel Prize in economics in 1974, has encouraged young scholars to build on his work. The most notable recent books on free banking have been Hugh Rockoff's *The Free Banking Era: A Re-Examination* (1978), Lawrence White's *Free Banking in Britain* (1984) and George Selgin's *The Theory of Free Banking* (1988). Rockoff is at Rutgers University. Selgin was White's student in the Austrian economics program at New York University. Selgin and White are now both at the University of Georgia with another powerful scholar of free banking, Richard Timberlake. About a dozen other free-banking scholars are scattered throughout universities in the U.S., and their works appear in many leading publications. Arthur Rolnick and Warren Weber are advocates of free banking—as well as top economists at the Federal Reserve Bank of Minneapolis. Free banking has also been the topic of many favorable articles in *Forbes*, today's pre-eminent business magazine.

What is the theory behind free banking? As these scholars have discovered, the system of money and credit is not immune from the general laws of economics. The banking industry is not different in principle from other industries—i.e., freedom leads to the most efficient, most stable and most productive system possible. However—these scholars have found—the history of freer systems of money and banking has been grossly misrepresented, with insufficient appreciation either of the virtues of free banking or of the distortive effects of government intervention.

Despite differences in particulars, Mises, Hayek, White, Selgin and others generally characterize free banking as a laissez-faire system of privately-owned and operated banks which compete to provide the highest quality service in the provision of money and credit. To prosper in such a system, banks must place a premium on integrity and reputation. Banks must discipline themselves, or face bankruptcy (with no federal bailouts available to them). Gold is the objectively based and commonly accepted money of the economy and constitutes the reserves of the sound banks. As the anchor of the free banking system, gold regulates a bank's lending practices and note-issuing policies, it limits swings in the business cycle, and it determines prices. Bank notes and demand deposits are issued within strict boundaries because banks are always subject to gold convertibility, whether from depositors at the window or from competitors at the clearinghouse. Reserves may be fractional, and, as long as banks make their reserve policies known, there is no fraud and no cause for government concern. However, under free banking, high-reserve banks will attract greater confidence and more deposit business.

Ludwig von Mises, describing the legal framework of free banking, writes that the government's only job is "to place the banking business under the general rules of commercial and civil laws compelling every individual and every firm to fulfill all obligations in full compliance with the terms of the contract" (*Human Action*, p.443). This means that there are no legal tender laws. The government establishes no franchises or monopolies in money or banking, and it neither bails out banks nor restricts their legitimate operations. But it also does not condone banks that break contracts. That is, since there are no legal tender laws, people are motivated to accept the currency of the best banks, and the opposite of Gresham's Law holds—good money drives out bad. Retail businesses and banks agree to accept various currencies of numerous banks to ensure their place in an integrated economy. But notes of unsound banks are quickly ostracized and the failure to redeem in gold is swiftly prosecuted in courts of law. Checking accounts are an important component of the money supply and are used primarily for larger items and payment by mail. Gold and other specie coins circulate publicly along with convertible free bank notes and demand deposits.

Similarly, under free banking, branching and lending decisions are left entirely up to the banks, without legislative interference, allowing free reign to the principles of risk diversification. This is the best form of "deposit insurance" available. Loan requests are scrutinized for the reputation and productivity of the borrower and the legitimacy of his venture. Banks may fail, as none are omniscient, but free banking minimizes the likelihood that the incompetent or dishonest banks will survive, and it certainly does not allow such banks to exploit the able and honest banks, as they do under central banking.

AND what has been the *practice* of free banking in the U.S.? The history of free banking and the gold standard (1836-62) is a favorable one—to the extent it has been allowed to operate. It is responsible for a highly impressive degree of bank stabililty. Studies by Rockoff, Rolnick and Weber have shown that bank failures during the free banking era were minimal compared with today's, and that the ones which did occur were caused primarily by state interventions, such as restrictions on branching. Another manifestation of government-induced bankruptcies was the group of brazenly fraudulent banks that arose in order to take advantage of state regulations requiring that state bonds replace specie reserves in backing bank notes. States passed the regulations to increase demand for their bonds, but in the process they promoted and sanctioned excessive note issue and the expropriation of gold from unsuspecting depositors.

Despite the growing interventions during the national banking era (1862-1912), the banks were much stronger then, since gold was still money and there was no central bank. In the seventy-five years *prior* to the establishment of the Federal Reserve in 1913, the purchasing power of money never deteriorated (whereas in the seventy-five *since*, it has lost 90 percent of its value). Before 1913, there was no widespread inflation. Business cycles were contained and there were no profuse breakdowns in the banking system or prolonged depressions, as have occurred under central banking. Banking practices were prudent because of the discipline of market forces such as the potential for deposit withdrawals or loan losses. When these occurred they were borne directly by individual banks which adjusted their policies accordingly, instead of being foisted upon unrelated parties. As a result, the capital ratio of the free banking system was 40 percent and it never declined; whereas it has fallen continuously under central banking, under 5 percent today. Bank liquidity ratios were in excess of 40 percent, four times the figure under today's central banking system. The ratios were so

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high because reserves were decentralized—i.e., controlled by bankers, not politicians. Under free banking, over-expansions brought down just a single bank, or a few. Under central banking, over-expansions, and subsequent contractions, erode the health of the whole system. And the *quality* of free banking reserves was also greater, consisting primarily of gold, not an unlimited supply of government bonds and monopoly notes.

Most banks in a freer era of nineteenth-century America were operated with prudence and integrity. They provided money and credit of the highest quality known in our history and played an integral role in the rapid development of agriculture, trade and industry. That era's widening division of labor, growth of specialization and burgeoning productive abundance relied heavily on an objective system of money and credit. Free banking—and *only* free banking— was able to provide it. (As an interesting footnote, Lawrence White's *Free Banking in Britain* uncovers an even purer form of free banking in Scotland from 1728 to 1845 and recounts an even more favorable experience.)

Demonstrating the virtues of free banking in theory and practice is a necessary but not sufficient condition for bringing it into existence in today's context. We need a rational plan to make the *transition* from central banking to free banking. Dr. George Reisman has outlined the important principles crucial to such a plan. In his *Gold: The Solution to Our Monetary Dilemma* (see *TIA*, Volume I, Number 22), he indicates how this can be done while averting both a 1929-style deflationary collapse and a 1923-style German hyperinflation. These twin risks have been the main impediments cited by economists to any serious consideration of the gold standard or free banking. Omitting all the details, the bare essence of the plan is that government would return gold to the banking system and to private hands (in proportion to their respective holdings of the money supply), end its money monopoly, and discontinue the central bank. In my opinion the Reisman plan is the only genuine reform which would truly restore sound money and private banking simultaneously.

Building on the Reisman plan, I believe the transition from central banking to free banking—from fiat money to gold money— can be achieved most effectively through the banking system. The balance sheet of the Federal Reserve would literally be transferred to the private banking system, so that banks would receive the assets (gold and government securities) and assume the liabilities (Federal Reserve notes) of the Federal Reserve. Banks would then assume responsibility for redeeming Federal Reserve notes in the hands of the public. Banks would serve as agents for the Federal Reserve before it is dissolved, taking in its notes and returning them to the central bank canceled. Eventually, all bank notes would be issued privately. The distribution of all gold to the banking system would be done on the condition that it serve as the reserves of private bank notes and demand deposits. Existing demand deposits would remain unchanged. But now gold would constitute the reserves of the banking system, with all private bank notes and demand deposits circulating as money and convertible into gold. Gold and other specie coins would also circulate as money, to the extent that the public withdrew them from their accounts in the banking system.

This plan would significantly bolster the financial condition of the banking system. Bank liquidity would once again consist of an indestructible, objective value—gold reserves— and would be decentralized and independently managed. Reserves would be a high proportion of demand deposits and private bank notes, reducing fractional-reserve banking and the boom-and-bust pattern it fosters. Capital ratios would be in excess of 20 percent and not be subject to deterioration, thus insuring long-range stability. Not only does this plan point the way to eliminating inflation, deflation and boom-and-bust cycles, it also enables us permanently to strengthen our banking system and remove from it the weaknesses which have been institutionalized by central banking. The proper solution to the problem of banking system instability is to phase out central banking in all its forms and to institute free banking on a gold reserve base, with bank notes, demand deposits and gold all circulating as money.

A PHILOSOPHY that promotes unlimited government is the same philosophy that inevitably promotes central banking. A limited government does not need a central bank. The deterioration in the money and banking system ultimately reflects the ideology of the welfare state—namely, the doctrines of altruism and collectivism. The prospects for a revolution in favor of free banking depend, therefore, on the prospects for a revolution in philosophy—against altruism and collectivism and in defense of the ethics of rational self-interest and individual rights.

In the meantime, it is important to understand why central banking is responsible for the decline in the financial condition of the private banking system, to know that free banking with gold as money *has* worked in the past, and to see that plans for the transition from central banking to free banking can be implemented— whenever philosophy allows and demands it.