

## Why We Need Free Banking

*Recent disclosures of the magnitude of the costs of the S&L bailout, now a half-trillion dollars and counting, reveal it to be by far the largest financial scandal in human history. Many analysts attribute the debacle to "a recklessly deregulated industry." They urge that Government regulators tighten the reins on banks and repeal the legislation "that turned the S&L's loose." Long before the current crisis erupted, however, we observed that the regulatory mechanism itself poses the greatest threat to sound banking. Contrary to popular belief, it would appear that Government intervention historically has been a destabilizing influence on banking practice. In this respect, the recent crisis may largely reflect the cumulative distortions that artificial barriers to market discipline have permitted. If past experience is any guide, a more useful approach to preventing a recurrence of such losses would be to restore free banking.<sup>1</sup>*

During the past decade, "deregulation" has been a frequently cited source of the banking and S&L industries' troubles. The proposition that the partial unfettering of such enterprise has fostered its undoing would, however, seem to fly in the face of the undeniable: *i.e.*, that the commercial banking and savings and loan industries in the United States remain the most regulated sectors in the economy. Simply put, about the only regulatory relief banks have received in the past decade has been a greater freedom to pay higher interest rates on deposits (a cost, not a profit), and to open a few additional branches. Savings and loan associations also have been allowed to raise the costs of their deposits and to try to recapture such costs by diversifying their loan portfolios beyond home mortgages.

For the most part, the authorities granted those limited freedoms not as part of any agenda to get the Government out of banking, but rather as *ad hoc* measures that were believed necessary to save institutions about to collapse under the onus of specific Federal regulations. For example, ceilings on interest rates were lifted only *after* they had led to massive disintermediation. Branching restrictions were relaxed only when hundreds of banks collapsed in unit branching states such as Illinois and Texas. Interstate mergers and acquisitions have been permitted only rarely, and for similar reasons, as "salvage operations," and then with only the faintest recognition of what sound banking requires.

In short, rather than "freeing" the banks and S&Ls to plunder, deregulation — such as it is — has been a piecemeal process whose overall effect seems to have been to "bail out" the regulators who had no funds to resolve institutional failures in their jurisdictions. The practices that deregulation has mainly fostered — additional branching, interstate banking, the creation of new interest-bearing accounts, and diversification of portfolios — are sound banking practices, not destructive ones.

At the same time, numerous regulations and government prerogatives persist that, in effect, codify bad management: the government's money monopoly forces monetary inflation onto bank balance sheets; government deposit insurance underwrites banks that take wild risks and taxes banks that take prudent ones; "regulatory accounting principles" mask insolvencies and so perpetuate fraud; and the Federal Reserve's discount window provides the deep pockets to keep "zombie" institutions going when nothing else can or, more importantly, should.

Moreover, the notion that deregulation *per se* has encouraged fraud seems bizarre. Without question, frauds have been drawn to the financial industry (as they have to all other industries) in the past — and undoubtedly they will continue to be in the future. However, there is nothing inherent in banking or in those who make it their profession that would invite fraud. Embezzlement is difficult to commit and few studies have shown that, *ceteris paribus*, it could be expected to be any more widespread in banking than in other industries.

Rather, to the extent that banking fraud *has* been practiced, it has been government regulation, not the lack thereof, that may have promoted and sanctioned it. It ought not come as any great surprise that a government that guarantees the liabilities of an entire industry invites the incompetent and the fraudulent. A liability is a promise to deliver some value. If a regime is set up that tends to remove the responsibility for delivering (indeed, makes it impossible to deliver) on that promise, those who are the least prone to keeping their promises would seem likely to be attracted to it.

### *Extending Government's Line of Credit*

In a related matter, probably one of the largest deceptions fostered in recent years is the notion that highly regulated banking is designed to serve the public interest. Although their supporters nearly always justify regulatory regimes as necessary to curb the excesses of both lenders and borrowers, the history of banking regulation in the United States strongly suggests that the greatest beneficiary of regulated banking has been not the public, but Government itself. Indeed, the major effects of banking regulation appear to have been 1) to provide governments with an assured source of funding; and 2) at the same time to destabilize the banking industry.

The banking laws passed during the early phases of free banking during the nineteenth century (1838-1862) — the era of "wildcat banking" often cited by advocates of more regulation as evidence of the dangers of free banking — are a case in point. The most consequential of these involved provisions that required currency-issuing banks to pledge state bonds as collateral, a form of asset regulation.<sup>2</sup> In order to begin operations, banks had to purchase state bonds in the open market, usually those of the state in which they were char-

<sup>2</sup> This scheme was advanced in Britain by David Ricardo in his *Proposals for an Economical and Secure Currency*, published in 1816. The evolution of this idea and its incorporation in U.S. banking laws is carefully documented by Fritz Redlich in *The Molding of American Banking*, Johnson Reprint Corp., New York, 1968, pp. 191-196.

<sup>1</sup> This article is drawn largely from Richard M. Salsman's comprehensive study, *Breaking the Banks: Central Banking Problems and Free Banking Solutions*, forthcoming in our *Economic Education Bulletin* series.

CAPITAL ADEQUACY OF U.S. BANKS

1836-1862*			1913-1929*			1971-1988†					
Year	Capital	Assets	Ratio	Year	Capital	Assets	Ratio	Year	Capital	Assets	Ratio
1836	\$ 252	\$ 622	40.5%	1913	\$4,443	\$26,103	17.0%	1971	\$ 44.4	\$ 598.9	7.4%
1838	318	682	46.7	1914	4,503	27,349	16.5	1972	49.4	660.3	7.4
1840	358	658	54.4	1915	4,643	28,363	16.4	1973	54.2	746.3	7.3
1842	260	472	55.1	1916	4,718	32,697	14.4	1974	60.1	852.0	7.1
1844	211	427	49.4	1917	4,988	37,540	13.3	1975	64.8	896.6	7.2
1846	197	456	43.2	1918	5,133	41,097	12.4	1976	72.0	957.0	7.5
1848	205	512	40.0	1919	5,409	47,603	11.4	1977	81.8	1,074.2	7.6
1850	217	532	40.8	1920	6,019	53,094	11.3	1978	89.9	1,215.0	7.4
1852	237	620	38.2	1921	6,385	49,633	12.9	1979	98.9	1,272.7	7.8
1854	301	795	37.9	1922	6,599	50,368	13.1	1980	109.8	1,384.9	7.9
1856	344	880	39.1	1923	6,818	54,144	12.6	1981	126.7	1,543.7	8.2
1858	395	849	46.5	1924	7,073	57,420	12.4	1982	133.0	1,704.0	7.8
1860	422	1,000	42.2	1925	7,384	62,232	11.9	1983	137.0	1,865.2	7.3
1862	418	1,012	41.3	1926	7,841	65,079	12.0	1983	137.0	1,865.2	7.3
				1927	8,301	67,893	12.2	1984	140.2	2,135.6	6.6
1863	\$ 412	\$ 1,209	34.1%	1928	8,954	71,121	12.6	1985	151.3	2,303.0	6.5
1866	560	1,673	33.5	1929	9,750	72,315	13.5	1986	170.9	2,498.1	6.8
1869	616	1,736	35.5					1987	170.6	2,719.6	6.2
1872	748	2,145	34.9					1988	188.8	2,931.6	6.4
1875	847	3,205	26.4					1989**	181.6	3,238.6	5.6
1878	826	3,081	26.8								
1881	864	3,869	22.3	1930	\$10,372	\$74,290	14.0%				
1884	1,036	4,221	24.5	1931	9,872	70,070	14.1				
1887	1,259	5,193	24.2	1932	8,525	57,295	14.9				
1890	1,558	6,358	24.5	1933	7,388	51,359	14.4				
1893	1,781	7,192	24.8								
1896	1,746	7,554	23.1								
1899	1,907	10,679	17.9	1934	\$ 7,865	\$ 55,915	14.1%				
1902	2,473	14,026	17.6	1939	8,236	73,193	11.3				
1905	3,066	17,511	17.5	1945	10,126	162,169	6.2				
1908	3,627	19,946	18.2	1950	13,577	179,165	7.6				
1911	4,133	24,026	17.2	1955	17,663	229,626	7.7				
1914	4,503	27,349	16.5	1960	23,857	282,872	8.4				
				1965	34,124	412,493	8.3				
				1968	38,351	479,590	8.0				

\* Dollars in millions.

† Dollars in billions.

\*\* December 31, 1989.

Sources: *Historical Statistics of the United States Through 1970*, Series X580-87 and *Federal Reserve Bulletin*, Table 1.25 (for June 30 or nearest available date), 1971-90.

tered, and deliver them to state banking authorities to be held as collateral. These bonds were supposed to be held for the benefit of depositors who would be receiving currency from the new bank in exchange for specie deposits. If a bank failed, the bonds were to be liquidated and the proceeds used to repay depositors.

In fact, this rarely happened. Many states simply permitted suspensions of convertibility without liquidating bonds. The bond collateral provisions were supposed to protect noteholders from losses, but their principal effect was to provide states with a guaranteed source of credit. Many banks were financially stronger than the states that were “guaranteeing” their notes, especially states located on the frontier.

These bond collateral provisions damaged the finances of the banks in a number of ways. They restricted the portfolio composition of banks and forced them to hold state securities that often had been issued for projects of dubious economic value. In addition, since the available supply of state bonds (instead of the needs of production and trade) governed bank note issuance, the laws created an inelastic currency.

### Regulation Promoted Wildcat Banking

Finally, such bond-collateral provisions actually encouraged “wildcat banking” in the financially weak states on the frontier. The laws were written to permit bank notes to be issued against the par value instead of the market value of state bonds. But the market value of bonds issued by financially weak states often were much lower than par. The unscrupulous took advantage of this situation by purchasing bonds in the market at the low price and delivering them to the state auditors in turn for the right to issue bank notes against the higher face amount of the bonds. According to one historian, “if the legal price [of the bonds] exceeded the market price by more than the costs of printing the approved volume of banks notes plus the discounts those notes would bear, it paid entrepreneurs to set up banks which held no reserves in specie, since the banks would be profitable even if they collapsed after the notes were put in circulation.”<sup>3</sup>

The quick profits that could be gained, and that look attractive to the “fly-by-night” operators of any era, represented the

difference between the value of state bonds acquired (at a low market price) and the value of bonds used as a basis for note issuance with the state banking auditors (at a higher face amount). For such a bank to go into “business,” it had merely to issue, as quickly as possible, all of its newly approved notes in exchange for real values (usually specie). Meanwhile, recipients of the notes (depositors of specie) had no idea they were backed by bonds with market values far below the face amount of the bank notes. They were told not to worry, for the state government was preserving the value of the bank notes.

In practice, the opposite was occurring. The “bankers” would flee with the specie. Not surprisingly, the loophole was exploited most in those states that had poor financial records and hence, with bonds trading at discount in the market. These states were not eager to close the loophole for one obvious reason: to do so would mean that they would lose an important financing source. In effect, the bond collateral provision, promoted as a way to protect unsuspecting depositors from frauds carried out by financially unsound or dishonest banks, led to wildcat banks and the defrauding of depositors by financially unsound and dishonest state governments.

### Extending Government's Line of Credit Further

Although it is beyond the scope of this discussion to consider in detail all of the ways in which subsequent government intervention in the banking industry has further eroded its financial stability, it should be noted that the effective results — *i.e.*, providing Government with a line of credit and subverting market discipline — have remained the same, only on a much grander scale.

The National Bank Act of 1863 introduced Federal intervention in the banking industry. Under this regime, banks continued to be responsible for holding their own reserves, including specie and specie-backed notes and deposits of other banks. In this respect, there still was free banking, with no central banking monopoly of reserves. The National Bank Act, however, regulated bank note issues by mandating that

<sup>3</sup> See Hugh Rockoff, “American Free Banking Before the Civil War: A Re-Examination,” *Journal of Economic History*, March 1972, p. 418.

they be uniform in appearance and that they be backed by collateral consisting of U.S. Treasury securities. As with state bond collateral requirements, this was primarily a way for government to create demand for a significant volume of securities it issued to finance the Civil War. As with state banking regulations, the National Bank Act's collateral requirement regulated bank portfolio compositions, created an inelastic currency and hurt banks that held bonds that traded at a discount or that were likely to be defaulted. The costs of such intervention were similar to those that had occurred at the state level.

### ***Central Banking Fosters Unsoundness***

Despite these early regulatory impediments to sound banking, and based on the available evidence on such measures as capital adequacy (a primary indicator of the financial soundness of an institution), in the aggregate the balance sheet of the banking industry during this allegedly hazardous era of "free banking" would be the envy of virtually any bank today. Plainly, the aggregate safety of U.S. banks then compared very favorably to that following the introduction of central banking in 1913, when the Federal Reserve was created.

As shown in the accompanying tables, the aggregate capital ratio of banks at the end of 1862 was higher than it had been in 1836, when the "free banking" era began. No other era in banking history has witnessed an actual improvement in the financial condition of the industry; and this performance stands in sharp contrast to the deterioration that has occurred under highly regulated central banking (see data in chart for the periods after 1913), when capital ratios dropped drastically from their free banking levels.

Moreover, it should be noted that the deterioration in these ratios under the Federal Reserve's regulatory regime has proceeded steadily. The deterioration shown during the past decade was *not* an exceptional result of "deregulation," but a continuation of the trend established under the Fed's central banking regime. The available data (not shown) on liquidity, asset quality, and profitability show similar trends.

### ***Backwards Thinking***

In sum, there is considerable irony in the conventional arguments used to "explain" the deterioration of the banking industry: *i.e.*, they have the relationship between government regulation and banking safety backwards. Today, pervasive government intervention has undermined the safety of virtually all banks and S&Ls — yet the charge that deregulation is the problem persists. Government has created a chaotic monetary environment and has fashioned a regime that rewards imprudence — yet the charge that banker mismanagement is to blame has gained credence. Government steals and hoards gold, cheating creditors and money holders via chronic inflating, and covers up bad banking with deceptive "regulatory accounting" — yet the view that bankers are fraudulent and dishonest is widespread.

Contrary to such views, experience suggests that free banking minimizes mismanagement and fraud. When they do occur, those harmed can turn to the courts for redress. But under regulated central banking, mismanagement and fraud are basic components of government policy. They are promoted in the banking system and institutionalized by the regulatory framework. In effect if not by design, central banking harms an extensive number of people who can turn to no one, certainly not to Government, for justice. In this sense, the Federal Reserve and the other agencies that administer the banking laws have become the 20th-century equivalent of "wildcat banking," but on a scale unimagined by the pikers of a century ago. That is why we need free banking, and the sooner the better.

## **COMMUNISM'S COLLAPSE WON'T FAZE THE MARXISTS IN ACADEME\***

Although the unattractive qualities and massive failures of existing socialist (communist) systems have been known for decades, their recent, spectacular collapse has removed the last shred of doubt about their unpopularity and illegitimacy. These developments should have a substantial impact on the influence of Marxism in American higher education. I don't think they will, however — at least not for a while.

To understand the situation, we must grasp the role played by Marxism in American intellectual life. Its entrenchment in academe is a legacy of the 1960's. The radical activists of the time were susceptible to Marxism because it provided plausibility and coherence to their critiques of American society and could be adapted to a multitude of purposes. Marxism *seemed* capable of accounting for virtually everything that disturbed them: poverty, racism, sexism, environmental degradation, U.S. foreign policy, bad television programs, junk food — you name it.

Marxism has been congenial to many American academics because it seemed to provide a scientific foundation for their denunciation of the evils of American society — not because they had empirical evidence that the political movements it inspired have succeeded in creating social systems superior to those in the West.

Indeed, throughout this century many Marxist intellectuals have proved to be peculiarly blind in their judgments of communist regimes abroad. They have found it difficult to resist the temptation to give the benefit of the doubt to every foreign political system that has claimed socialist credentials and legitimated itself through some version of Marxism. Eagerly scanning the horizon for an authentic and humane incarnation of Marxism, these intellectuals have sought to match Marxist ideals with socialist practices — first in the Soviet Union, then in China, Cuba, and assorted third-world countries, and finally in Nicaragua. Whenever a particular system has been discredited, they have looked for and found another one. Rarely have Western Marxists engaged in any prolonged analysis of why they were ready to believe that a succession of exceedingly inhumane political systems were providing collective fulfillment and moral uplift, or why they suspended their critical faculties and granted — at least temporarily — redemptive qualities to a succession of repressive governments.

Since the 1960's, Marxism has become an almost purely academic preoccupation, as it became difficult to find existing incarnations of the theory and plausible plans for its domestic application. Pleasantly insulated from the world outside academe, Western Marxists have been able to devote themselves to theory, untroubled by practice except insofar as their day-to-day criticisms of American society, culture, and capitalism have been enriched by Marxist concepts and vocabulary. Marxism has entered and established itself in academe as a stick with which to beat Western pluralist-capitalist systems and their cultures, not as a theory vindicated by its application, by results. Our Marxist academics knew little about existing socialist societies and were not in the least anxious to learn more or to criticize them; they were afraid that such criticism might put them in the unsavory company of "cold warriors" or "red bashers."

Above all, American Marxist academics have had little appetite for raising the question, Is it not possible that something is wrong with a theory that so stubbornly resists appli-

\* This article by Paul Hollander, professor of sociology at the University of Massachusetts at Amherst and a native of Hungary, first appeared in *The Chronicle of Higher Education*. We are grateful to that publication for permission to reprint it.

cation and becomes so easily distorted when attempts are made to put it into practice?

As of late, however, even American Marxists have been forced by world events to face that question. Four major strategies have emerged among leftist intellectuals to deal with the implications of the developments in Eastern Europe (and in Nicaragua and Mongolia).

The first is the familiar insistence that the regimes now collapsing had nothing whatsoever to do with true Marxism, other than debasing it. This argument, however, still leaves us with questions: Why did the social, economic, and political practices that Marxism inspired regularly turn into totalitarian police states with spectacularly mismanaged economies? Why did both the masses and the intellectuals in the countries where Marxism was put into practice come to hold it in part responsible for the unsavory realities it legitimated? (Their attitudes are conveyed by the venerable East European joke: An old peasant goes to the local Party Secretary and asks for his opinion about whether or not Marxism is a science. The Secretary assures him that indeed it is. To which the peasant responds: "If so, I wish they had tried it out first on animals.")

On closer inspection, the argument that Marxism as a theory has nothing to do with the political realities it inspired becomes questionable. The gap between theory and practice has been far from total, after all. Marxist political systems *did* realize some of the key ideas of Marxism, most importantly by putting in place the nationalization and public ownership of the means of production. But these actions did not lead to the results Marx and his followers had anticipated: Neither production nor work satisfaction increased; socialist systems did not become more democratic, egalitarian, participatory, or caring; the central planning that replaced "the anarchy of the marketplace" failed to make the economies of socialist states more rational.

Marx's animosity toward religion found institutional expression in the anti-religious policies of all state socialist systems. Communist regimes were also loyal to Marx's contempt for peasants and their attachment to private property, especially land. The streak of personal intolerance that characterized Marx found expression in widely institutionalized political intolerance.

The second tactic of American academics attempting to neutralize the impact of the collapse of communist systems is to express relief that the systems' demise will remove a taint from the good name of Marxism. No longer, they say, will the theory be associated with failed experiments; from now on, Marxism will be pure and unencumbered by unsavory realities. Supporters of this approach try to distance themselves not only from the political systems now totally discredited, but sometimes also from even what is distinctive about Marxism. They are proclaiming attachment to an increasingly watered-down version of Marxism, turning it into a theory of good intentions that supports every conceivable human right, freedom, humane value, and aspiration.

The third way to save the faith has been to make the astonishing claim that the people in the Soviet-bloc countries have been sworn enemies of capitalism and closet socialists all along, eager to embrace an authentic version of Marxism, as understood by Western intellectuals. Some Marxist scholars take heart by discerning similarities between the demeanors of demonstrators in Prague or Moscow last year and those of protesters in Berkeley in 1964 or Paris in 1968. Alas, the two sets of demonstrators (beyond a preference for wearing sneakers) have little in common, especially their political beliefs.

While all the evidence is not yet in, one thing is clear: The vast majority of those who lived under communist rule have little use for any variety of leftism or Marxism, and have

little doubt that Marxist theories had *something* to do with their misfortunes. In recent elections in East Germany and Hungary, voters showed their displeasure with left-wing ideas and movements by booting out even the harmless, mildly leftist social democrats, preferring right-of-center parties. Inhabitants of what used to be Karl-Marx-Stadt in East Germany recently voted overwhelmingly in favor of returning their city to its original name, Chemnitz. When the first opportunity presented itself in Czechoslovakia and in Hungary recently, students and their teachers got rid of departments of Marxism-Leninism at the universities — and not in order to replace them by neo-Marxist programs of study. East European intellectuals are also aware of the historical connection between capitalism and political pluralism, and the historical incompatibility of political pluralism and the denial of private ownership of the means of production.

The fourth strategy employed by American Marxist intellectuals is to aver that even if systems inspired by Marxism have turned out to be profoundly flawed, so has capitalism, especially in its American incarnation. To be sure, the defects of communist systems do not automatically cancel out those of our own. But what, if anything, does Marxism have to offer to understand and repair the defects of contemporary Western societies?

Marxism is a set of ideas conceived in the middle of the 19th century, inspired by revulsion at the horrors of early industrialization, by German romanticism, and by the belief in progress and rational human nature prevalent at the time. It created an often-sinister idealism, which bred intolerance and vast concentrations of power, as well as indifference to the means used in the pursuit of glorious ends. Marxist theory has failed to provide humane shortcuts to modernization, has proved incapable of making societies more free and productive, has overemphasized economic matters at the expense of political and social-psychological issues, and has operated with an oversimplified and incomplete model of human nature. Surely it does not have much to offer us today.

Leszek Kolakowski, the Polish philosopher and historian of Marxist theory, has offered the best summary of the attractions of Marxism in his *Main Currents of Marxism*:

"Marxism has been the greatest fantasy of our century. It was a dream offering the prospect of a society of perfect unity, in which all human aspirations would be fulfilled and all values reconciled.... The influence that Marxism has achieved, far from being the result or proof of its scientific character, is almost entirely due to its prophetic, fantastic, and irrational elements.... Almost all the prophecies of Marx and his followers have already proved false, but this does not disturb the spiritual certainty of the faithful."

That is why, in the words of the sociologist Peter Berger, Marxism has been "falsification proof" and the dismal experience of existing socialist systems made little dent in the faith of its devotees. That is why the current total loss of legitimacy is not likely to make a dent either.

**Erratum:** *Research Reports* for May 7, 1990, p. 44, fn. 4: Edward C. King should be Edward C. Krug. We regret the error.

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