

Abolish the Fed:  
The Case for Liberty in Money and Banking

Lawrence H. White  
University of Missouri, St. Louis, lwhite@umsl.edu

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**About the title:** Professor Klein asked me to put “Abolish the Fed” in the title. He wanted to make the policy implications of my talk crystal-clear.

The Federal Reserve System has nationalized some useful services that once were private (for example, issuing currency, clearing checks, and processing wire transfers). I favor **re-privatizing** those services, and **eliminating** the rest of what the Fed does (namely enforcing legal restrictions on banks and conducting a monetary policy). Thus I favor abolishing the Fed, and replacing it with laissez-faire banking.

**The set of legal restrictions that I oppose includes:**

1. “Legal tender” laws that make contracts in alternative monies less enforceable than contracts in government-issued money.
2. Restrictions on entry into banking and the issue of money.
3. The nationalization of the clearing and settlement system that is at the heart of our payments system.
4. The nationalization of the holding of the banking system’s reserves.

**Without the Fed, what would replace monetary policy?** Commercial banks would return to issuing all types of money, currency as well as checking deposits. A gold or silver standard would regulate the quantity of money, without the need for Alan Greenspan’s wisdom.

To focus on the case for eliminating the legal restrictions, I will have to treat the case against monetary policy very briefly.

One use for monetary policy is to **pay for some government expenses** by creating money out of thin air. (Money and Banking textbooks describe the process.) Some defenders of the status quo consider this a great convenience to the government. In practice, however, rich countries’ governments rely on other taxes for financing their spending. Money-printing typically supplies only a trivial amount of their revenue (1-2% of the US federal budget).

In poor countries, money-printing sometimes finances a much bigger share (10-20%). There **the very convenience of printing money makes it a great danger**. The injection of new money dilutes the value of the money citizens already hold, stripping resources from society to feed the government's appetite for spending. Where the appetite is enormous, high inflation (sometimes hyperinflation) ensues.

Another use for monetary policy is to try to **stabilize macroeconomic conditions** (smooth out interest rates, output, employment, or inflation). Economists have debated long and hard over whether stabilization policy has actually worked in practice. To cut to the chase, I think the evidence is fairly clear that it has not. The reason is not that the Fed is particularly incompetent – other central banks haven't succeeded either. The problem is that to stabilize the economy, the Fed would have to know more than is humanly possible for it to know.

### **My argument for laissez-faire banking in a nutshell:**

1. No good theoretical case exists to show why government should provide money. The leading “market failure” arguments do not hold water.
2. There is good historical evidence – as well as good theory – showing that private money or “free banking” works well.
3. Government provision of money is beset, both in theory and in practice, with serious problems.
4. It would be possible, as well as desirable, to re-establish market provision of money.

I will focus on items 1 and 2, the theory and history of laissez-faire in money.

## **THEORY: CRITIQUE OF “MARKET FAILURE” CLAIMS**

**The claim that money exhibits “market failure” is unfounded.**

**Money in its core sense – a commonly accepted medium of exchange – is a private good**, not a “public good”. The long history of private mints and banks shows that markets don't fail to provide high-quality money.

**Why have governments typically monopolized the minting of coins?** Not to improve their quality, judging by the historical record. (From ancient to relatively recent times, government mints were notorious for debasements. Now they've eliminated the gold and silver content entirely.) Instead, to exploit the profit potential.

The monetary standard is a “**network good**”, but this does not imply that too few people converge to the same standard. Carl Menger's theory of the origin of money explains how a free market supports the spontaneous formation of a universal money network.

The view that the market is prone to converge on the *wrong commodity* as the monetary standard misinterprets the convergence process. In choosing among media of exchange, I

want to be paid in the medium that my later trading partners will be happiest to take from me (based on properties like its durability, divisibility, portability, uniformity, stability of value). We each thus internalize other people's preferences for these properties, which promotes the **spontaneous emergence of a superior commodity standard**.

The view that an unbacked paper standard (fiat money) is better than a commodity standard is based on a serious overestimate of the **resource costs of a commodity standard**, and wishful thinking about the management of a paper standard.

**The leading argument today against unregulated banking:**

- a. An unregulated banking system is inherently prone to runs and (due to "contagion") panics.
- b. Runs and panics have harmful spillover effects.
- c. Appropriate regulations can reduce runs and panics, at a cost less than the benefit of doing so.

bank run: many customers simultaneously seek to withdraw deposits (and, in the 19<sup>th</sup> century, redeem banknotes), out of concern that the bank will default if they wait

banking panic: many banks experience runs in the same period

Some regulations that the above argument has been cited in support of:

lender of last resort

deposit insurance

restrictions on: capital ratios, entry, deposit interest rates, reserve ratios, asset portfolios, activities

*Runs on individual banks are harmful to . . .*

- 1) bank shareholders: losses from hasty asset liquidation ("fire sale")
- 2) bank borrowers: interrupts bank-borrower relationship
- 3) depositors: risk of loss

*Panics are even more harmful to those parties because*

- 1) sudden and unexpected contraction of the money supply disrupts the economy
- 2) fewer deposits means less intermediation, smaller supply of bank loans

**But runs are not always bad.** A run on an **insolvent** bank has the good consequence of forcing the bank to close (now, before it wastes any more of the depositors' wealth).

The *threat* of runs compels depositors to **monitor** how risky banks are, which helps keep the banks from taking undue risks.

How can ordinary depositors know how risky a bank is? Read the reports of experts.

The S&L fiasco of the 1980s showed what can happen when nobody runs and regulators fail to close insolvent banks: \$150 billion in wealth squandered.

The potential problem with depositor runs arises when a (mistaken) run forces a **solvent** bank to close.

What *triggers* a run? Two leading theories.

### **The “sunspot” theory:**

Because a bank run can itself turn a bank insolvent through “fire sale” losses (run → hasty “fire sale” of illiquid assets → reduced value of assets → **insolvency**), a run can be **self-justifying**. If others are running, you'd better run too, because there won't be enough to go around (the “me first” problem). Then **any** event can trigger a run, even if **intrinsically irrelevant** (like the appearance of spots on the sun). *Whatever* makes depositors *anticipate* a run, will in fact cause them to run, validating the anticipation. According to this theory, **runs were triggered by depositors fearing that others would run, which could happen anytime, anywhere.**

Though logically coherent, the “sunspot” theory doesn't explain actual patterns of runs:

- 1) Runs were **not random events**, or linked to irrelevant events. They typically occurred at onset of recessions.
- 2) Runs **weren't a problem in all banking systems**. They occurred in the countries where the banks often failed (19<sup>th</sup> century US, England), but not where the banks seldom failed (Canada, Scotland). The sunspot theory doesn't help us understand this pattern.

### **The “bad news” theory**

A better theory of what triggers runs is the **“bad news” theory: runs occurred when depositors received bad news indicating that a bank might be already insolvent**. Depositors would run on a bank that people suspected of being already insolvent because its assets were already not enough to pay them all back.

The “bad news” theory explains why runs occurred at the onset of recessions, and why countries with stronger banks (less prone to insolvency from bad loans) experienced fewer runs.

“Sunspot” theorists say that the financial crisis in southeast Asia 1997-98 was an unjustified investor panic. Bad-news theorists say it was triggered by revelations about bad government policies.

Diamond and Dybvig formalized the sunspot theory in 1983, but the core idea is old. Consider this passage from Thomas Jefferson (1813):

“It is said that our paper [currency] is as good as silver, because we may have silver for it at the bank where it issues. This is not true. One, two, or three persons might have it; but a general application would soon exhaust their vaults ... Nothing is necessary to effect it but a general alarm; and that may take place whenever the public shall begin to reflect on, and perceive the impossibility that the banks should repay this sum.”

D&D argue for deposit insurance as a costless way to hold the bank at the good no-run equilibrium. It is costless, in their theory, because runs are the only cause of bank failures and the assurance of depositor protection eliminates runs. So the deposit insurance agency never has to make a payout.

Is laissez-faire banking really as vulnerable to runs and panics as the “sunspot” view suggests? If so, how on earth did banking survive before the FDIC?

### **When is a deposit run-prone?**

*It depends on the contract.* Run-prone implies a greater expected payoff to arriving sooner rather than later to redeem. Which implies that the claim on the bank is:

- (1) a **debt claim** (claim to a fixed amount of dollars, regardless of the bank’s situation);
- (2) **unconditionally redeemable** on demand, with a first-come, first-served rule for meeting redemption requests; and
- (3) **subject to likely default** (less than 100% payoff) on the last redemption claim serviced, due to bank insolvency.

**To make a deposit non-run-prone: change any one of those three conditions.**

That is, instead, make the claim any one of the following:

- (1) an **equity claim**, like a MMMF share. Total claims can’t exceed portfolio value (no insolvency). Too late to run when bad news arrives (no me-first problem). No reward for rushing to be first to redeem. Or,
- (2) **conditionally redeemable** (the bank can delay redemption if necessary), like “option-clause” banknotes or deposits with a “notice of withdrawal” clause. Banks didn’t delay except in banking panics, when delay is good for everyone. Conditionality avoids potential fire-sale losses. It is agreeable to depositors *ex ante* because it stops others from emptying the bank. Or,
- (3) **secure against bank insolvency**. Solvency assurances include:
  - a) *adequate capital*
  - b) *safe asset portfolio*
  - c) extended (double, triple, or even unlimited) liability
  - d) certification by independent examiner (e.g. a clearinghouse association)

**When is “contagion” rational?** When one bank’s default provides info relevant to the probability that a second bank is about to default. Under the bad-news theory, this occurs when the two banks have similar and poorly diversified asset portfolios. Government restrictions on portfolio and geographic diversification have thus been part of the problem, not a solution.

## **HISTORY**

### **Historical evidence on panics**

Banking panics were a problem in the US during the National Banking era (1863-1913) and the Great Depression. Few other countries have had similar experiences. Scotland, Canada, Sweden, and Switzerland, for example, had stable and competitive financial systems. There were occasional bank failures and rare runs on individual banks suspected of pre-run insolvency, but neither led contagiously to widespread runs or system-wide panic. Sweden had no private bank failures in a hundred years of free banking. Canada had no bank failures even during the Great Depression. Thus panics are not inherent to banking.

### **Why was the US system unusually fragile?**

**Answer: Legal restrictions destabilized the system.** *Laws against branch banking* reduced diversification of assets and deposit sources, and hampered allocation of reserves. *Collateral requirement on banknotes* unintentionally prevented banks from meeting peak demands for currency. Seasonal demands for currency became scrambles for cash that occasionally escalated into panics.

**Private clearinghouse associations** in US cities – clubs of member banks – developed techniques for supervising member banks, for assuring depositors of their banks' solvency, and even for acting as lenders of last resort. These private institutions in the pre-Fed era performed better than the Fed did once it nationalized their functions. Nationalizing depositor protection and lender-of-last-resort services is evidently unnecessary and inadvisable.

Contrary to the Diamond-Dybvig model, **deposit insurance has proven costly**. Real-world bank failures (with or without deposit insurance) are typically due to bad loan decisions, not runs. Deposit insurance is accordingly not costless: taxpayers have had to foot the bill for making depositors whole.

## **THE POSITIVE THEORY OF FREE BANKING**

How are the quantity and value of money (the price level) determined under free banking? In a nutshell, the underlying **commodity standard** (gold or silver, historically) and **interbank competition** combine to compel banks to limit their money-creation and to hold adequate reserves.

Bank-issued money (banknotes and account balances historically, perhaps digital card balances in the future) is, by contract, **redeemable** for something (e.g. silver or gold). It is cheap for a bank to print up notes, or create deposit balances, and to lend them into circulation. But the bank can maintain a larger loan portfolio only if additional money *stays* in circulation. The bank must cultivate a demand to *hold* its currency, rather than redeem it or deposit it elsewhere. The volume of currency a bank wants to issue is limited by the rising marginal cost of keeping currency in circulation.

Costly ways for a bank to cultivate a larger demand to hold its currency or deposit balances:

- (1) enhance spendability by recruiting more retailers to accept the brand;
- (2) make redemption easier by opening more branch offices, hiring more tellers, staying open more hours;
- (3) advertise;
- (4) reduce risk by anti-counterfeiting measures;
- (5) make its notes or checks more physically attractive

What happens if a bank accidentally overissues?

**The “law of adverse clearings”** takes hold. The volume of notes or deposits returns to equilibrium as the public adjusts toward its desired portfolio of assets. Mr. Smith will normally deposit any excess currency or checks into another bank. The other bank returns the items to the issuing bank through the clearinghouse, demanding redemption. Settling the “adverse clearings” means that the over-issuing bank loses reserves. The reserve loss tells the bank that reissuing the currency once again would lead to further hemorrhaging of reserves, so it should accept the reduction in its circulation. It must also sell some assets to bring its level of reserves back up.

A similar process of reserve loss, the **“price-specie-flow mechanism”**, restrains over-issue even if all the banks in the clearinghouse system over-issue in concert. Reserves are eventually lost to the rest of the world. The danger of system-wide overissue is greatest, and the correction slowest, when a single issuer has a 100% share of the circulation. Hence the “free banking school” in the 19<sup>th</sup> century made a strong case against central banking: it is dangerous to restrict note-issue to a single institution. Free banking better disciplines money creation.

## CONCLUSION

The case for central banking is founded on myths: the myth that money is a public good, the myth that free banking is inherently unstable, the myth that government knows best.

Why do so many economists fail to challenge these myths, and thus fail to call for the abolition of the Fed? The answer *may* have something to do with the fact that the Fed funds, directly or indirectly, most of the monetary research by American economists. But that is a topic for another lecture.