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In Defense of Bank Failures

by H.A. Scott Trask

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The American people have not seen widespread bank runs since 1933. In that object at least, the Federal Deposit Insurance Corporation has succeeded. But at what cost? To insure deposits is to invite bad banking—and worse; it is to foster reckless speculation and unsound investments, help make inflation permanent instead of intermittent, obstruct the curative powers of economic contractions, and divorce freedom from responsibility.

Federal deposit insurance is part of two wider trends in government policy in the twentieth century. One was what James Grant terms the "socialization of credit risk," that is removing the risk attendant on credit dealings from the contracting parties and fastening it upon society as a whole, who were now forced to make up any losses. Governments also guaranteed mortgage loans, college loans, farm loans, and even loans to foreign governments.

If it is an economic and political law that "no vast subsidy goes unexploited," the excesses of the American economy in the 1980s and 90s offered plenty of corroboration. According to Grant,

The institution of the federal banking 'safety net,' intended to protect innocent depositors from the consequences of bad banking, had the unintended consequence of promoting bad banking. In the United States, but also in Japan, most of the Nordic countries, Britain, and Australia, scenes of competitive bank wrecking and fabulous real estate inflation were played out in the 1980s.

Another example is the notorious Savings and Loan debacle of the late 1980s, which ended up costing the taxpayers \$250 billion of their income. Between 1989 and 1992, the federal government bailed out hundreds of insolvent savings and loans that had lent too freely financing the construction of office parks, shopping malls, apartment complexes, and golf courses during the southwestern real estate boom of the mid-1980s.

When the crash of 1987 rocked the markets, the S&Ls tottered and fell. While many blamed lax regulation and political cronyism for the crisis, they neglected the more important role played by federal deposit guarantees as well as the doctrine that banks and financial institutions should not be allowed to fail.

The crisis illustrated a sobering lesson. In a market already distorted by extensive government regulations, high taxes, and pervasive subsidies, partial deregulation and



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modest tax cuts often do more harm than good. When they backfire, they discredit the cause of freedom and open the door to even greater regulations, taxes, and subsidies.

By 1980 the savings and loan industry was ailing. Chronic inflation was dissuading people from keeping large deposits (at low interest) with them, and the thrift's returns from fixed-rate mortgages negotiated at the low rates prevailing during the 1960s were marginal. Congress provided relief. They permitted the thrifts to enter the commercial real estate loans market, at the same time raising the maximum deposit covered by federal insurance from \$40,000 to \$100,000.

Looking back in history, the Banking Act of 1933 created the Federal Deposit Insurance Corporation to put an end to the ubiquitous bank run, which had bedeviled fractional-reserve bankers from the beginning of the republic.

But the first experiment had been made 104 years before with the founding of the New York Safety Fund. Every bank in the state had to pay into an insurance pool, which would be used to reimburse depositors and note-holders of insolvent institutions. The act was assailed by hard-money and free market writers as inflationary and unjust. Albert Gallatin, Jefferson's former treasury secretary and now president of the National Bank of New York, wrote that the act "must have the tendency to encourage excessive issues of paper, which could not be sustained if resting only on the credit of the bank by which they are made."

In other words, depositors would no longer exercise the same care in selecting or watching over the policies of their bank; for by legislative fiat, all banks, reckless or prudent, had been placed on the same plane of credit. He also pointed out that it did "not accord with the principles of government founded on the equal rights of all," as it rendered "institutions properly managed, responsible for the conduct of others at a great distance over which they have no control."

Isaac Bronson, president of the Bank of Bridgeport (Conn.), predicted that the fund would neither prevent a general bank suspension nor prove adequate in case of a collective failure. These warnings were borne out. The Safety Fund did not deter the banks of New York from suspending payments during the panic of 1837, it did not prevent widespread bank failures, nor was it sufficient to indemnify all those who lost their deposits or the value of their notes during the contraction of 1839–43.

Banking during the early American republic (1789–1861) was decentralized and uncoordinated with quasi-national banks existing during part of that time. Each state chartered its own banks, which had a privileged legal status but were otherwise private. The money supply was composed of bank notes and deposits, convertible into specie, and gold and silver coin. From 1789–1834, the country was on a de facto silver standard, from 1834–1861 a gold standard.

As might be expected from anyone familiar with Gresham's Law, bank paper of equivalent denomination drove hard money out of circulation. For instance, if the banks issued dollar notes, silver dollars ceased to circulate, and no one paid with a gold eagle if a ten dollar note was at hand. Paper notes circulated at various rates of discount depending on the reputation of the issuing bank and the distance from the place of redemption. Presentation of them for payment in specie was infrequent and during some periods was regarded as a kind of social crime.

During periods of bank inflation, specie was hoarded or shipped abroad. Competition between the banks served only to increase the inflation. Banks had an unwritten agreement *not* to demand balances be paid in hard money. Free competition in paper money was quite inflationary. Gallatin had little use for free banking arguments: "The proposition that a paper currency may be issued by all, without any legislative restrictions, appears to be founded on an erroneous application of the principles of free

trade. Free competition . . . causes a reduction in the cost, or an improvement in the quality of the commodity. But issuing a paper currency increases the price of goods" by debasing the currency.

Bank runs followed inexorably upon periods of bank inflation. William Graham Sumner provided an able summary:

There was no limit to bank note issue, except the utmost which each bank could keep afloat. The specie reserve was made as small as the banker dared to risk. This specie became the vital nerve of the entire economic system of the country. . . . When things seemed prosperous and the exchanges were favorable, the banker put out his circulation. When one did it, the others did it, and the consequence was general inflation. Presently the issue became excessive. The exchanges turned and a little specie was shipped. Thereupon, the vital nerve being touched, a shock went through the entire system. Discounts were refused; loans could only be obtained through brokers at extravagant rates; the circulation was contracted very suddenly; the commercial system was arrested; then industry stopped; production was reduced; wages were lowered; and finally the farmers, so far as they were debtors, were reached. This severe remedy operated as a cure, and all were ready to begin again.

These periods of alternating expansions and contractions were usually short and mild, but they could be quite severe. The panics of 1819 and 1837/39 were followed by runs on the banks for specie, a contraction of credit, widespread bankruptcies and foreclosures, and numerous bank failures. While deploring the cycle and its consequences, hard-money writers of the period pointed to their inevitability under a paper money system based on fractional reserves. They also pointed out that if bank paper were backed fully by specie, and no loans were made beyond the actual paid in capital of the banks, there would be no inflations, no bank runs, and no crises.

However, as long as Americans remained wedded to the paper system, the bank run and bank collapse served an essential function. They stopped the inflation of money and credit. They thereby started a process of regenerative liquidation that re-directed labor and capital out of overdone areas (such as cotton lands and canal construction) into the areas where they were most needed (and would produce the highest return). They also forced a reduction in excessive consumption and indebtedness and purged the system of its worst banks. The years following the worst busts (1820s, 1840/50s) were characterized by low inflation, stable prices, high reserves, circulating metal, increasing purchasing power, and rising per capita income.

During the middle years of the republic (1865–1912), the Republicans saddled the country with the National Banking System. While Murray Rothbard has correctly diagnosed its built-in inflationary mechanisms and pyramidal structure of credit creation, one would be a fool not to feel nostalgia for its heyday (apart from the years before specie payments were resumed in 1879). The country was on the gold standard, and national bank notes were convertible into gold (at any national bank or the treasury). The banks were under legal constraints as well. They had to maintain a 25 percent reserve for all deposits. They could make no loans on the security of real estate. Every note issued had to be backed by a federal bond on deposit with the treasury. Furthermore, in the event of insolvency, stockholders were liable for the full face value of their stock to reimburse depositors. Nevertheless, it remained a fractional-reserve system, and the inflation (though moderate by our standards) was sufficient to contribute to panics in 1884, 1893, and 1907.

Bank runs continued, but with a different character. In the antebellum period, people rushed to the banks to redeem their notes for specie; now, it was mainly depositors who wanted to withdraw national bank notes, which they considered to be as good as gold (almost anyway). As national banks could and did fail, depositors had to keep on their guard. Their best reliance was on the character of the management of any given

bank. New Yorkers had two rock solid institutions to depend on: National City Bank and Chemical Bank. Neither paid interest on deposits (other national banks offered 2 percent), but they offered something else that had real value before the age of government insurance—*security*.

National City (the forerunner to City Bank) kept a 60 percent reserve (gold and national bank currency) to deposits, possessed an equity capital of 16 percent of assets, and lent only on sound collateral equivalent to 120 percent of the loan. Chemical was also solid. During the panic of 1857, it was one of the only banks in the country to continue paying out gold coin. Both banks would gain depositors during crisis years. Prior to the panic of 1893, the president of National City would take prospective customers to the cellar and show him an abundant stock of gold bars. During the panic year of 1907, Chemical's deposits increased from \$20 million to \$29 million.

Progressives regarded the panic of 1907 as a holdover from an earlier barbaric age. Such things should not happen. With the proper planning and regulation, they would not happen again. One thing they decided was needed was government insurance for private bank deposits. In 1908, Oklahoma was the first of many states to pass a deposit insurance act. The Noble State Bank challenged the compulsory contribution feature in federal court as a violation of the Constitution's prohibition of taking property without compensation.

Progressive jurist and Union army veteran Oliver Wendell Holmes ruled that the general good represented by the safety and soundness of banks overruled private property considerations, an opinion combining bad economics with bad law. Despite judicial backing, the scheme failed. In 1910, the state insurance fund was exhausted after just one bank failure. Clearly, it would never suffice during a general crisis. Progressives decided a federal guarantee must be had. In 1913, they attempted to create a deposit-insurance fund for the new Federal Reserve banks. Once it was passed, they would try to extend it to the National banks.

Senator John W. Weeks (Mass.) denounced the legislation as "a form of socialism" and pointed to the injustice of assessing sound banks to bail out competing institutions whose insolvency may have resulted from riskier but higher-interest bearing loans and investments. He asked, "Why should I lose my business because somebody was offering an extravagant inducement for taking it away, and then be assessed because that somebody lost his money when he did not use any judgment in depositing it in another bank?" His fellow senator's response was classic compassionate fascism: "We consider the interest of depositors above the interests of any bank."

The Federal Reserve Act of 1913 was the progressive answer to the hundred year quest to find a way to abolish the down side of the business cycle. After studying how, for a hundred years, flagging economies had followed with unerring regularity upon periods of rapid growth, progressive economists decided that the problem was an inelastic currency and the absence of a central bank. If only the banking system had the means of continual and incessant money creation, there need be no more panics, crises, runs, or serious downturns. They made the egregious mistake of thinking the precipitating cause of previous panics and depressions (credit contraction) was *the only cause*, and that the cure for inflation was *more inflation*.

Roosevelt compounded the interventionist errors of Hoover by more of the same and worse, including the Federal Deposit Insurance component of the 1933 Banking Act. There was not much opposition, but at least there was one holdout—John M. (One Hundred Percent) Nichols president of the First National Bank of Illinois. Nichols' bank stood firm while other banks were barricading their doors. Every dollar on deposit was backed by a Federal Reserve note or a marketable and liquid security. During the bank panic of 1933, he actually invited his depositors to withdraw their money. He even refused to pay into the FDIC insurance fund (the only one of 6,000 bankers to do

so).

Government deposit insurance was only one of many policies adopted during the 20th century designed to suppress economic and business failures. On the theory that certain banks were "too big to fail," the United States government transferred \$2.5 billion to save the Bank of New England in the early 1990s. That was as nothing compared to what would come later.

Beginning with the Latin American debt crisis of 1982–86, the government undertook to bail out, either directly or through augmented payments to the International Monetary Fund, American banks and investors who had lent large sums to insolvent Third World governments and firms. As if to confirm the validity of the theory of "moral hazard," the Mexican bailout of 1994 (\$40 billion) was followed closely by the IMF "rescue" of the collapsing currencies of East Asia—South Korea, Thailand, Malaysia, and Indonesia (\$120 billion). And so it goes.

To paraphrase the poet Robinson Jeffers a half century ago: We cannot have all the security and safeguards and freedom also.

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