

**Stephen Zarlenga and Robert Poteat**

## **“The Nature of Money in Modern Economy – Implications and Consequences”**

**Philip Molyneux**

*Bangor University, Wales, UK*

This insightful paper calls for a re-design of the monetary system to aid both economic development and social justice. The main proposal is to shift the Federal Reserve Bank into the Treasury – this seems a sensible and not too controversial action (to me as a non-American) at least. Probably, the shift to abolish fractional reserve banking is the most controversial – although it has been promoted by many others in the past but never came to fruition. This, the authors argue, will lead to improved economic and social justice and less inequality.

The elimination of a fractional reserve banking system is based on the view that financial crises are directly caused by banks' ability to create credit well beyond the direct control of the central bank and the protection afforded by the lender-of-last-resort facility. So the elimination of a fractional reserve banking system is considered a way that a safe money asset will be created, backed by the state, and therefore ending the need for costly (taxpayer funded) bank bail-outs. A number of proposals, as the authors note, have been made that offer types of full reserve banking systems. Recent important examples include the 1930s Chicago Plan (Benes and Kumhof 2013), the Positive Money proposals for monetary reform (Jackson and Dyson 2012), Kay's Narrow Banking plan (2009), and

Kotlikoff's Limited Purpose Banking (2010) and also very recently the 100% equity funded banks as proposed by Cochrane (2014).

If we look at the four main plans, they have specific features:

Chicago Plan – the suggestion here is to create two types of banks: money banks that have 100% reserve backed deposits, and credit investment trusts funded by treasury credit or savings. Money banks will not be allowed to create ‘near monies’, will be public and independent institutions. To be established, existing banks will have to have massive debt write-offs (a so-called debt jubilee) and this will result in a reduction in private and public sector indebtedness. The main challenge to establishing such a structure relates to the effects of the debt write-offs.

Positive Money – here private commercial banks will only be allowed if they can fund loans from savings or their own capital. All money accounts will be held at the central bank, so money will be defined as only accounts held at the central bank. A public independent institution will be set-up to determine the quantity of money, commercial banks of themselves will not be able to create credit.

Narrow Banking – commercial banks will be forced to hold ‘safe’ assets equal to the amount of deposits, and an independent public institution will limit the quantity of money as it will only be able to create ‘safe’ assets. The proposal is based on the notion of ‘safe’ assets and the transition of current balance sheet structures to this safe regime.

Limited Purpose Banking – all banks become mutual funds (either for cash, insurance and investment). Cash funds enable payments and investment funds facilitate credit extension. Only cash mutual funds constitute money. The challenge is to get banks to change to mutual funds, although such a transformation may have few risks. Whether depositors will be happy to place their funds in mutual fund structures is one challenge with this proposal, as well as the incentives for banks to monitor credit through such structures.

All the plans for full reserve banking have different definitions of money; mechanisms for controlling credit creation; transition schemes (how the new structures are implemented; benefits and costs. What they have in common is that banks will no longer be able to create money through credit creation. They will not be able to leverage up their balance sheets to the extent that credit has hardly any reserve backing. Such a structure enables tight control of the money supply, ensuring that poor performing banks fail without threatening the banking system or resulting in taxpayer bailouts. All plans for full reserve banking aim to remove the ability of banks to create money by separating money and credit. They create a public money system (backed by safe assets) that is distinct from a private money system where savings and loans are dictated by leverage (propensity to take on risk) and market forces. More specifically, the proposals remove current accounts from banks and place them in a public institution or in some form of separate special bank. Then, special independent institutions (established by the central bank or government) would have a mandate to control the quantity of money in circulation.

However, Dow et al. (2015) have noted that these proposals are all well-intentioned, but all plans for 100% reserve banking have serious shortcomings. First, they argue that even if the state could control

the money supply there would be little scope for asset maturity transformation or credit intermediation. They would likely resemble investment trusts where liabilities and assets had simple size, maturity, and other features. This would make the banks safer but would dramatically curtail credit expansion.

Probably more important is that full reserve banking would constrain credit and this would likely inhibit economic growth. Even worse, it may create the unregulated provision of money in the private sector – just like the shadow banking system we see today – that could also lead to greater instability. Dow et al. (2015) also give the example of the British bank, Kaupthing, Singer and Friedlander (KSF), which had a 95% liquidity requirement but still could not prevent the collapse and that of its Icelandic parent, Kaupthing. So one can point to an array of cases where full reserve banking will not necessarily bring about banking sector stability. Also, moves from where we are today to a new banking system could also create such a shock that the transformation in itself could be problematic. So although I like these quirky 100% reserve banking, in practice, I am not sure that they really deliver on creating a banking system where taxpayers are not on the hook if things go wrong.

Overall, I very much enjoyed reading the paper as it made you think about a host of monetary and economic issues and brought together economic/philosophical and policy issues that really matter.

Although I am skeptical as to the 100% reserve banking proposal, other issues that could be elaborated on in the paper relate to the following:

- Problems with German and other European currencies can be related/linked to widespread bank collapses in 1929-32 – although no such failures occurred in the UK.
- I would have liked to have seen more discussion on control over the monetary base. Banks have to hold reserves at the central bank; this is stipulated by law – so government determined. This influences the amount of credit/deposits that can be created. So although the discussion tries to make bank/state dichotomy, both can be culpable of being money creators.

- It is good to see the authors point out issues surrounding the understanding of the ‘nature of money’ and a lack of understanding of the nature of money creation – regulators and others had an idea of what money is but had *no idea/limited idea* how the shadow banking/securitization phenomena could cause a quasi-Ponzi style credit creation system – namely where credit growth was not limited to deposit growth.
- Confusion of credit with money. Of course, politicians knew – they encouraged lending to low income sub-prime households in the US (both Bush and Clinton), that boosted bank and non-bank securitization. That meant that lending was not linked to deposit growth (which is typically linked to GDP growth). Politicians are always partially to blame for excessive monetary phenomena because they (in the modern world at least) oversee and make policy!
- The authors’ mention of ‘back to men on the street’ reminds me of what Henry Ford said – in substance –“It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning” (paraphrased by Charles Binderup, 19 March 1937 in the US House of Representatives, Congressional Record – House 81:2528).
- I agree that greater social injustice and inequality has been created by the current monetary system, but this can be more formally expressed with reference to well-regarded recent work like Piketty and so on.
- There is discussion of ‘criminal bankers’ in places but the authors let government, regulators and politicians off the hook. They were also complicit in fueling the global financial crisis and credit boom.
- Finally, the NEED Act is an interesting and radical reform proposal. Push the Fed into the Treasury (OK no big deal) and eliminate fractional reserve banking (very big deal and I am not convinced it will work!!). The US does not have the monetary strength to maintain a strong currency given its spiraling budget and other deficits, and this NEED Act proposal could (quite easily) shock the system into a (German) hyperinflation problem. The risks are too great and it is not certain that full reserve banking will eliminate risks. So overall nice work, but we will need to look for alternative policy proposals if we want a safer banking system.

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**Philip Molyneux** is currently the Dean of the College of Business, Law, Education and Social Sciences and Professor of Banking and Finance at Bangor University, UK. His main areas of research are on the structure and efficiency of banking markets and he has published widely in this area. Recent publications appear in the Review of Finance, Journal of Money, Credit and Banking and the Journal of Banking and Finance. He has also co-authored a variety of texts in banking areas including an Introduction to Banking (2nd Edition, FT Prentice Hall), Introduction to Global Financial Markets (8th Edition, Palgrave Macmillan) and the Oxford Handbook of Banking (2nd Edition, Oxford University Press). In the past has acted as a consultant to: New York Federal Reserve Bank, World Bank, European Commission, UK Treasury; Citibank Private Bank, Barclays Wealth, McKinsey & co, Credit Suisse and various other international banks and consulting firms.

E-mail: [p.molyneux@bangor.ac.uk](mailto:p.molyneux@bangor.ac.uk)