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A Rejoinder to "A response to critiques of 'full reserve banking'"

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1. Introduction

This paper is a rejoinder to Dyson, Hodgson and van Lerven (2016; thereafter DHVL), which is an attempted rebuttal of a range of critiques made of full reserve banking (FRB) in the recent symposium of this Journal (September 2016, vol. 40, no. 5) titled "'Cranks' and 'brave heretics': Rethinking money and banking after the Great Financial Crisis". The focus of attention of DHVL is Fontana and Sawyer (2016; thereafter F&S), though DHVL also comment on other symposium papers, especially Nersisyan and Wray (2016).

In their response, DHVL state a preference for the use of the term 'sovereign money', which differs from the original FRB proposals as follows:

> The original FRB proposals stipulated that the reserves held by banks should match the deposits held by their customers. Sovereign money takes this one step further by transferring the deposits themselves to the central bank, where they would be administered by banks as agents for the deposit holders (DHVL, p. 1353).

In major respects, 'sovereign money' proposals do not appear to differ significantly from 'positive money' proposals, and both are particular forms of FRB proposals as discussed in F&S. Therefore, the rest of this paper refers to 'positive/sovereign money' (thereafter P/SM) proposals.

DHVL has four main objectives, namely to show that in a P/SM system: (1) there are no additional constraints to fiscal policy compared to present arrangements; (2) the central bank can always provide credit for an expansion of production; (3) additional means of payment will come into existence very slowly, if at all, and under very specific set of circumstances; (4) financial instability will be *de-facto* abolished. This paper argues among other things that objectives (1) and (2) are problematic, and objectives (3) and (4) are chimeras.

The rest of the paper is organized as follows. Section 2 reconsiders some exaggerated, if not patently false, claims made by proponents of P/SM, including objective 4 above. Section 3 shows that (against objective 3 above) P/SM will not prevent the emergence of additional means of payment, and is likely to provide a powerful stimulus to it. Section 4 discusses the relationship between the creation of money and government expenditure in P/SM, showing among other things that objectives (1) and (2) are problematic, since they are both dependent on the inflationary stance of unelected central bankers. Section 5 explains the use of the monetary circuit theory, consolidated State accounts and the deflationary bias argument in F&S. Section 6 concludes.

2. Exaggerated, if not patently false, claims

In their rebuttal DHVL seem to ignore many of the problems of P/SM (and FRB alike) proposals highlighted by F&S, implicitly accepting and often reiterating controversial claims, which include:

1. Commercial banks have the right to acquire goods and services from the market without offering anything in return for it, i.e. commercial banks are endowed with a seigniorage privilege.

2. Inflation can be controlled by the rate of increase of the money supply, as in the standard though now discredited monetarist theory.
3. The demand for loans is of little or no consequence for the determination of the quantity of money in the economy.
4. The new supply of bank loans produces an equivalent increase in the amount of outstanding debt in the economy.

Against these controversial claims made by DHVL (see original quotes in F&S), drawing on the endogenous money theory, F&S has argued that:

1. No agents involved in the loans supply process, including commercial banks, have a seigniorage privilege.
2. Inflation is the outcome of a social conflict over the distribution of income, i.e. the result of complex power struggles between capital and labour, and among capitalists.
3. The quantity of money in the economy is determined by the interplay between the supply of and the demand for loans.
4. The reflux principle operates in modern economies such that much or all of newly created money is extinguished by the reimbursement of previously accumulated debt.

DHVL also highlight a methodological shortcoming of P/SM proposals, namely the tendency to emphasise problems, which either arise from the operations of, or appear to be associated with, the banking and financial sector, and then to imply that those problems are caused by the power of commercial banks to create money. It is then claimed that P/SM will abolish this power, and as a result those problems will disappear or be easily solved. Below there are a couple of examples of this controversial methodological approach and the issues which arise out of it.

In Dyson *et al.* (2014), we argue that this monetary system [in which banks create money] is a key driver or facilitator of financial instability, asset price bubbles, unaffordable housing and unsustainably high private sector debt. It also has negative implications for public sector finances and rising inequality and may exacerbate ecological problems (DHVL, p.1353).

The problems mentioned are obviously important, but a P/SM system would do nothing to address them. The ways in which loans are allocated by banks will continue. Therefore, P/SM would not in itself lead to more funds being channelled into 'green investments' and low carbon activities. It would not reduce or eliminate inequalities and inequities. It would not tame rising and unstable house prices, since the terms on which mortgage are provided and their effects on house prices would remain. It would also not bring financial stability, and if any is likely to exacerbate financial instabilities for a variety of reasons discussed at great length by F&S. For instance, F&S argue that investments generate the cash flows that validate the liabilities of firms and households, and hence they create the real sources of financial stability in capitalist economies. When investments are halted, the creation of income, employment and cash flows stop, and the economy is likely to experience insolvencies and bankruptcies, if not financial instability and deep and long-lasting recessions. Therefore, the creation of money by commercial banks is essential to accommodate the financing needs for investment of modern economies, generating the cash flows that prevent the occurrence of real and financial instabilities.

Below, there is another example of the methodological shortcoming of P/SM:

[w]e should avoid the trap of thinking of banks as providers of a public service who passively wait to meet the demand for credit from creditworthy businesses and households. Banks are profit-seeking businesses, and their main product is debt. They use incentive schemes and targets to encourage staff to 'sell' (lend) more, while using marketing and sales strategies to encourage households to 'buy' (borrow) more'. … Since banks do not face the negative externalities of their private money creation, they face powerful incentives to create 'suboptimally large' volumes of credit and money … (DHVL, p. 1352).

First, the initial sentence sets up a straw person: F&S do not envisage commercial banks as providers of a public service or as passive providers of loans. Second, the problems mentioned

are obviously important, but again P/SM would do little or nothing to address them. Banks would still be in the business of allocating loans, and P/SM would not stop their promotion. Therefore, P/SM would not close the door to fraud and unsafe banking procedures. It would not eliminate 'credit rationing' and 'credit discrimination'. Banks do not meet all demand for credit, which varies over the business cycle and across time (e.g. following financial liberalisation and deregulation), and differs across groups. Lastly, leaving aside the question of by what criteria an optimal volume of credit and money is to be judged, the idea that banks do not face the negative externalities of their private money creation is at variance with the realities of bank failures, bankruptcies and closures over past centuries.

3. Positive/Sovereign Money and the emergence of additional means of payment

F&S argue that the State is not able to determine what serves as the final means of payment in *all circumstances* and at *all times*. The State typically determines what it will accept in payment of taxes and fines, in this way establishing the official means of payment. However, what is a widely accepted means of payments is not limited to central bank money: additional means of payment emerge over time, ranging from private current account deposits with commercial banks through to the adoption of international currency (e.g. countries which have dollarized). F&S argue that in the context of P/SM the challenge is to establish and maintain a clear and rigid distinction between 'money' and 'near-money' (see, for a similar point, Goodhart and Jensen, 2015), and to ensure additional means of payment do not emerge.

In their rebuttal, DHVL make two points in this regard. First, DHVL complain that some critics of P/SM confuse money as a store of value with money as a means of payment. F&S, and endogenous money theorists more generally, have always argued that any financial asset which serves as money has to be a store of value in order to transfer purchasing power from the present

to a fundamentally uncertain future. However, not all stores of value are money: to operate as money they must be highly liquid, and able to be used as a means of payment to buy goods and services.

Secondly, DHVL maintain that new means of payment will emerge only slowly, if at all, and under very specific set of circumstances in a P/SM system:

> [c]reating a substitute for state money as a means of payment is easier said than done. … It took a number of decades for banks to gain sufficient public trust in order to make bank deposits a perfect substitute for central bank money, and even this was only possible due to the courtesy of state-provided liquidity guarantees from the central bank and credit guarantees via deposit insurance (DHVL, p. 1358).

There are several problems with those arguments. First, public trust in additional means of payment may require several decades to be established or may emerge relatively quickly. For instance, Kregel (2016) has assessed the possibility for alternative payment systems like Google Wallet (introduced in September 2011) and PayPal (founded in US in 1998, and operating in Europe from 2007) to compete with commercial banks as providers of means of payment. Currently, Google Wallet and PayPal link the bank accounts of sellers and buyers, therefore acting as intermediaries or brokers between the bank accounts of their customers. Kregel warns that PayPal has rapidly gained the trust of a large portfolios of customers, hence it may soon act as a creator or dealer of means of payment.

Second, additional means of payment do not need to be perfect substitutes for central bank money. Norms, conventions, and practice dictate the use of a means of payment for certain transactions and not for others. Even today there are transactions which are conducted in notes and coins, where the transfer of current/checking account deposits would not be accepted.

Furthermore, F&S argue that in a P/SM system commercial banks would incur the costs of managing bank accounts (as now), but without benefiting from the revenues associated with the power of creating money. This would lead to higher fees for bank customers. As a result,

there will be powerful incentives for banks and their customers to develop alternative accounts, i.e. 'near moneys', that could be directly or indirectly used for the payment of goods and services (e.g. 7-day notice account). It is presumably for this reason that proponents of P/SM have proposed that "[a]ny bank that did take customer's [sic] funds, promise repayment of the funds on demand and then lent the funds would be in breach of th[e] law" (Jackson and Dyson, 2012, Ch. 6, n. 1).

Finally, the discussion above has indicated that additional means of payment could spontaneously emerge without state-provided liquidity guarantees from the central bank and credit guarantees via deposit insurance. In this regard, P/SM advocates the abolition of deposit insurance schemes, not recognising that deposit insurance extends well beyond current account deposits, which are deemed to be money. In a P/SM system the risk of insolvency for banks and financial institutions would remain, and some protection of savers would still be required.

In summary, a P/SM system will not prevent the spontaneous emergence of additional means of payment, and is likely to provide a powerful stimulus to it.

4. Positive/Sovereign Money, monetary policy, and fiscal policy

Much of DHVL is a eulogy of the beneficial effects of replacing private money creation with public money creation, with the alleged result, among other things, that the newly created liquidity will be now directed to boost fiscal spending in the real sector, rather than private speculation in the property and financial assets markets. In order to achieve this, DHVL resurrect two discredited monetarist propositions, namely that in a P/SM system (1) the central bank would control the money supply, and (2) commercial banks are (or can be made) simply intermediaries between savings accounts and investment accounts.

The sovereign money approach is based on the view that money creation can be conducted more effectively and appropriately by the state than by commercial banks. … [p]rivate money creation is eliminated and exclusively replaced by public money creation. … With banks no longer able to create money, the task of creating new money consistent with a sustainable rate of change in economic activity would fall to the central bank. … Consequently, in a sovereign money system, monetary policy would work by financing a fiscal stimulus, boosting spending and aggregate demand (DHVL, pp. 1353-1354).

There are several problems here. First, any fiscal spending that can be (initially) financed by a P/SM system, could also be financed under the current system, if that is desired by the government. DHVL seems to acknowledge this argument, though they fail to recognise the implication of it.

As a matter of policy, the central bank does not provide overdraft facilities to the Treasury; therefore, the Treasury's account can only be debited if it has a positive balance. In other words, the Treasury's account must be credited before it can be debited: the Treasury must collect taxes or issue bonds before it can spend (DHVL, p. 1355).

The following footnote is immediately added at the end of the last sentence:

[i]n practice, it is only necessary for the government to have used money creation to 'prime' the central bank money monetary circuit. Once the initial stock of reserves is in the system, the Treasury can become a 'money user', taxing or issuing bonds so that those reserves return to its account and then recirculating them back into the economy via government spending, without any resulting net money creation at all (DHVL, p. 1355, no. 1).

DHVL argue that the Treasury must collect liquidity from the market, by issuing bonds and collecting taxes, before it can boost fiscal spending. But then, they immediately realise (in a footnote!) that it is technically impossible for the Treasury to collect liquidity, if money has not yet been created and injected in the market. Therefore, DHVL are obliged to acknowledge that initially there must have been a process of money creation in the economy, which was completely unconstrained and unrelated to pre-existing resources. A legitimate question then arises: if the government has the power to create money once, in order to promote - in their words - the central bank money monetary circuit, why then the government could not use the same power in future?

Second, the replacement of private money creation with public money creation would not lead *per se* to an increase in the government budget deficit. Governments adopt budget deficit

targets for a range of economic and political reasons. The crucial question here is whether there is any reason to believe that the decision on the appropriate scale of the government budget deficit would be, for similar economic conditions, different under P/SM compared to present circumstances. If there is to be a larger budget deficit, that has to be accompanied by a set of conditions, namely (i) a corresponding increase in the difference between private savings and investment plus borrowing from overseas, and (ii) the financial instruments (i.e. bonds and central bank money) issued by State have then to be held as part of (domestic and foreign) savings. These conditions are independent from the existence or not of a P/SM system.

Finally, while replacing private money creation with public money creation will not boost fiscal spending, a P/SM system would add an additional constraint on the power of the government to increase aggregate demand and economic activity, namely that the central bank does not deem the corresponding creation of money to be inflationary.

> At the simplest level of analysis, if inflation is below the target, for instance the MPC [Monetary Policy Committee] could increase the money supply, while if inflation was above the target, the MPC would decrease the money supply (Dyson *et al.*, 2011, p. 11).

In a P/SM system the central bank is supposed to change the money supply in line with the inflation target, with any newly created money to be channelled by the Treasury to some combination of increased government spending, reduced taxes, direct grants to citizens and indirect lending to businesses (DHVL, pp. 1354-1355). Taking this argument at its face value, it means that monetary policy would have three goals: an inflation target, a fiscal policy target, and a sustainable income target. These is no reason to think that these three targets are in general mutually consistent.

For instance, when the central bank believes that an expansion of the money supply would be inflationary, it will not finance government spending; and *vice versa*, when the change in the money supply is deemed to be deflationary, the central bank will demand that the government spends more. Therefore, the distinctive limit which is placed in P/SM on the money creation

process, namely that commercial banks do not have the power to create money and the central bank changes the money supply to hit the inflation target, feeds back on the willingness of the central bank to finance fiscal policy (and a sustainable rate of change in economic activity), and hence on the budget decisions of the Treasury.

It is also worth noting that DHVL (p. 1355) argue that "[m]uch of F&S's critique applies to the scenario in which governments are prohibited from issuing bonds, so that budget deficits must be entirely financed by money creation by the central bank". F&S were not, as DHVL suggest, following Friedman's proposals, nor were they talking of governments being prohibited from issuing bonds. It was rather that there is only a possible direct relationship between the change in the money supply and government expenditure if there is no bond issue. Similarly, DHVL (p. 1356) argue that "[s]ince many of F&S's further criticisms on fiscal policy rest on the incorrect assumption that bond issuance would necessarily be lower by the amount of money creation, we will not address them here". A careful reading of the paper would show that the arguments advanced by F&S do not rest on bond issuance being necessarily lower by the amount of money creation.

In summary, in a P/SM system the inflationary stance of unelected central bankers is an additional constraint to both fiscal policy vis-à-vis today, and the possibility of pursuing a sustainable rate of change in production.

5. Monetary circuit theory, consolidated State accounts and the deflationary bias in Positive/Sovereign Money

The circuitist approach places considerable emphasis on the distinction between 'initial finance' and 'final finance', which F&S have applied to the relationships between the Treasury and the central bank. In this context 'initial finance' relates to the power of the Treasury to

finance its expenditure by drawing down its account at the central bank. 'Final finance' refers to the ways in which the Treasury funds its expenditure, through a combination of tax revenues and sale of bonds: for the consolidated accounts of the State (Treasury and central bank) sector, expenditure is funded by tax revenues, sale of bonds (net to the private sector) and change in central bank money held by the private sector.

DHVL (p.1354) argue that 'this depiction of events assumes that the balance sheets of the Treasury and central bank can be consolidated so that any balances in the Treasury's account at the central bank are 'cancelled out' and effectively disappear. … However this consolidation is unhelpful, as it ignores the operational constraints on the Treasury's policy space'. F & S maintain that there are occasions when it aids analysis to consider the government and its agencies separately, e.g. when considering the operational decisions of an agency and how well or otherwise those decisions conform to declared government objectives. There are other occasions when it is useful to consolidate government and its agencies, e.g. in the assessment of the overall balance sheets of the State sector. When considering the initial financing of the Treasury, it is relevant to consider the central bank and the Treasury separately, as a commercial bank and its customers would be treated separately. When the asset/liability position of the State sector is being considered, then using a consolidated balance sheet is generally helpful. It should also be borne in mind that the liabilities of the State sector are the assets of the private sector, and those assets are held as part of the asset portfolio of the private sector.

DHVL (p. 1352) also complain that F&S use the outdated monetary circuit theory, which has at its heart the creation of money by banks to creditworthy entrepreneur, when actually "in most cases today, the circuit starts with a bank creating money to a provide a mortgage to a borrower … potentially allowing them to bid up the price of housing and land". It is indeed the case that the circuitist analysis has traditionally focused on commercial banks providing loans

to finance production, though the extension of circuitist analysis to accommodate consumer borrowing and financial assets has been undertaken by, for example, Sawyer and Veronese Passarella (2016).

Finally, DHVL (p. 1357) complain that F&S (p. 1339) build their deflationary bias argument on the alleged hypothesis that in P/SM the money supply is fixed, in the sense of being constant. A careful reading of the paper would show that F&S use the word 'fix' in the sense that the central bank determines the supply of money (under P/SM), i.e. 'fix' the size of the newly created money, in line with its monetary policy target. F&S ground the inherently deflationary bias of P/SM on much more solid grounds. Notwithstanding the controversial, anti-Keynesian hypothesis that in P/SM savings determine investment (see Daly, 2013, p. 1 as quoted in F&S), investment is constrained in the upward direction by the availability of prior savings. In the downward direction, a fall in entrepreneurial spirits would lead to a fall in savings, investment and so on, with cumulative negative effects on economic activity.

6. Concluding comments

DHVL argue that criticisms raised against P/SM are unfair and invalid. They are based on misunderstandings and analytical errors. They claim F&S is a case in point. Whereas acknowledging all the good and noble intentions that motivate the work done, F&S argue that advocates of P/SM are 'more cranks than brave heretics'. DHVL challenge F&S and other critics by aiming to show that in a P/SM system: (1) there are no additional constraints to fiscal policy vis-à-vis today; (2) the central bank can always finance a sustainable rate of change in production; (3) new means of payment will come into existence very slowly, if at all, and under very specific circumstances; (4) financial instability will be *de-facto* abolished. This paper has shown (among other things) that objectives (1) and (2) are problematic, since they are both

dependent on the inflationary stance of unelected central bankers, and objectives (3) and (4) are nothing but chimeras.

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