'"Positive Money: Progressive solution or Trojan Horse?" By Christian Etzrodt: A critical response'

by

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Abstract: Etzrodt (2023) claims to offer an evaluation of the 'Positive Money' banking sector reform as set out in Jackson and Dyson (2012). A considerable part of the paper is a critique of Fontana and Sawyer (2016, 2017). This paper discusses what Etzrodt labels "the important economic issues" (the mechanism that brings financial instability in the Positive Money proposal, and the role of the shadow banking system in modern economies), and the "biggest problem" (the theoretical incompetence and lack of impartiality of Post Keynesian macroeconomists to assess the PM proposal) in Fontana and Sawyer. This paper has argued that Etzrodt misrepresents Fontana and Sawyer, and his critique is misplaced.

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“Positive Money: Progressive solution or Trojan Horse?” By Christian Etzrodt: A critical response

1. Introduction

The title of Etzrodt (2023) suggests that it provides an evaluation of the ‘Positive Money’ banking sector reform (PM hereafter) as set out in Jackson and Dyson (2012). However, a considerable part of Etzrodt (2023; Etzrodt hereafter) is a long criticism of Fontana and Sawyer (2016, 2017; F&S hereafter).[1] Those two papers offered a critical analysis of a range of proposals under the generic heading of full reserve banking (FRB hereafter), also called 100% reserve banking, of which the PM (or sovereign money) proposal of Jackson and Dyson (2012) was only one version of it. This paper offers a response to the range of criticisms, which Etzrodt levels against F&S.

2. Critiques and rebuttals

Etzrodt is made of four main sections *plus* Introduction (Section 1) and Conclusions (Section 6). Section 2 presents the reform proposal of Jackson and Dyson (2012). The lengthy Section 3 deals with the Post Keynesian analyses of PM, mainly that undertaken by F&S. Four minor issues, and two major points of criticisms of F&S are raised, with the former being described by the author as rhetorical or semantical arguments. Since Etzrodt concludes that he somewhat agrees with F&S on these “minor issues”, namely (i) monetarism, (ii) bank loans and the money supply, (iii) debt-free money, and (iv) seigniorage, and given space constraint, these issues would not be discussed further.[2] This paper will instead focuses on the two major points of criticisms of F&S, what Etzrodt labels “the important economic issues” and the “biggest problem”. Section 4 of Etzrodt deals with logical inconsistencies and the serious risks posed by the PM proposal. In accordance with F&S, though through different arguments, it argues that PM would actually pose more risks than the current system to the stability and sustainability of modern economies. Section 5 is a comparison of the previous Sections, namely the PM proposal put forward by Jackson and Dyson (2012), and the criticisms of it by F&S and Etzrodt (see e.g. Table 1).

2.1 “The important economic issues”

Etzrodt claims that one of the main weaknesses of F&S is how the PM proposal will lead to financial instability. According to Etzrodt, PM will bring financial instability because there will be moral hazard, with banks being more reckless, and causing an oversupply of credit, while

F&S maintains that PM would produce financial instability due to a deflationary bias, leading to a lack of credit.

> "Jackson and Dyson claim that their reform would increase the financial stability of the economy. Fontana and Sawyer, however, argue that the opposite would be the case, because the shadow banking sector would grow and the reform proposal would create *an inherent deflationary bias*. … I come therefore to the same conclusion as Fontana and Sawyer that the reform proposal leads to more instability, although I reach this conclusion based on a completely different argument." (Etzrodt, p. 1211 and p. 1212; italics added).

> "The major difference is that Fontana and Sawyer claim that the positive money proposal would lead to a lack of credit supply, whereas I conclude that … it would lead to an oversupply of cheap money." (Etzrodt, p. 1221)

Lainà has recently presented a stock–flow consistent (SFC) model of a generic FRB system similar to the type discussed by F&S. Lainà (2019, pp. 1238-1241) acknowledges that under various circumstances (e.g. increase in households' liquidity preference for cash or demand deposits, increase in firms demand for loans, tightening of the monetary or fiscal policy stance, long-term growth), FRB is likely to lead to credit crunches, i.e. a lack of credit. This vindicates the argument put forward by F&S that the PM proposal has an inherent deflationary bias.[3]

When discussing the disputed mechanisms that bring financial instability in PM, Etzrodt makes the additional claim that F&S have misrepresented the role of the shadow banking system (SBS, hereafter) in modern economies.

> "The underlying reason for this divergence [between F&S and Etzrodt] is a fundamentally different understanding of how the shadow banking sector operates." (Etzrodt, 2023, p. 1221).

> "They [F&S] claim that the reform would dry up the credit supply, because the private banks would be constrained by needing to collect deposits before they could offer loans (*Fontana and Sawyer, 2016, pp. 1339–40*). As a result, the shadow banks would replace the official banking sector (Fontana and Sawyer, 2016, *pp. 1338–9*), in order to fill the gap of credit demand with near-moneys (Fontana and Sawyer, 2016, *p. 1347*), which is

> supposedly possible independent of the credit supply of private banks." (Etzrodt, 2023, p. 1221; italics added).

This criticism is grounded on some misunderstanding. First, it is not clear how F&S could derive a result on pp. 1338-1339 with an argument developed on pp. 1339-1340, which in turn rests on a point made on p. 1347. Secondly, and more importantly, F&S do not discuss the role of the SBS in creating near-money when criticising the financial instability feature of the PM proposal (F&S, Section 3), but rather when questioning the possibility of a rigid separation between transaction accounts and investment accounts, a prominent feature of PM (F&S, Section 4).

F&S maintain that the transaction accounts in PM, comparable to existing current accounts but with a 100% reserve requirement, are costly to operate. Therefore, there are incentives for commercial banks, traditional financial intermediaries and the shadow banking system to create near-moneys, i.e. profitable deposits accounts which are transferable at short notice. As a result, one of the main goals of PM, namely the direct control over the money supply, would soon slip away from the monetary authorities.

F&S are largely silent on the functioning of the SBS in modern economies, mainly for reasons of space. Etzrodt's criticism allows to remedy this omission. Sawyer (2013, 2016) and more recently Canelli *et al.* (2021) have discussed at great length the SBS. The main point of these papers is that the SBS has increased the channels through which commercial banks inject new liquidity into the economic system, while at the same time it has also amplified the ways already existing liquidity circulates into the system. Etzrodt seems to have a different view of the SBS.

> "[T]he impact of the shadow banks on the economy is directly related to the credit supply of private banks through securitisation. … Securitisation allows private banks to circumvent reserve regulations and to increase the number of times *the same money* can be used through the shadow banking sector." (Etzrodt, 2023, p. 1221; italics added).

The authors of this paper maintain that though the non-bank financial institutions which constitute the SBS do not create money (like commercial banks do), in their role of creditworthy borrowers these institutions do help commercial banks in establishing new channels of creation of money. In short, the SBS has had a major impact on both the channels of creation of money as well as the channels of circulation of already existing money (Etzrodt's "*same money*" above). Etzrodt seems to acknowledge the latter, but not the former.

2.2 "The biggest problem"

Etzrodt claims that the biggest problem of F&S is that they adopt the Post Keynesian macroeconomics theory, and related hypothesis of an endogenous supply of money, to critically assess the PM proposal, where the supply of money is exogenous:

> "Fontana and Sawyer (2016, p. 1346) emphasise the importance of a theory-based analysis of current or potential financial systems. … Post-Keynesianism is a theory that describes an economy with endogenous money creation. But Jackson and Sawyer [sic] are proposing economic reform with exogenous money creation. Therefore, I have serious doubts about the ability of a post-Keynesian theory to predict the effects of such a reform since it was simply not designed for the analysis of economic processes in an exogenous money system." (Etzrodt, 2023, p. 1213-1214).

F&S draw on Post Keynesian macroeconomic theory to explain the nature and origin of money in the current economic system. In this theory, money is an endogenous phenomenon, owing to its debit/credit nature, and – among other things - the need for a final means of payment that has to be provided by a third party (traditionally commercial banks in capitalist economies) on the demand of macroeconomic agents (traditionally firms to pay workers). F&S then use the same macroeconomic theory to explore the nature and origin of money in PM, highlighting the limitations of the proposal.

"Exogenous money" above refers to the view that in PM monetary authorities set the amount of money in circulation. However, in this exogenous money system it is still necessary to analyse how and when money is created, how does that creation relates to government and private expenditures, and what are the relationships between investment and saving, and government expenditure and tax revenue. Post Keynesian macroeconomic theory is well placed to investigate these issues.

Etzrodt also claims that an additional major weakness of F&S is the lack of impartiality, i.e. F&S and Post Keynesians more generally, have a conflict of interest in assessing a banking sector reform that would make their expertise redundant.

> "…[p]ost-Keynesians are not an impartial spectator in this debate, but an interested party. If Jackson and Dyson's banking reform would be executed, post-Keynesians

> would lose their expertise, because all their accumulated knowledge about an endogenous money economy would become useless.” (Etzrodt, 2023, p. 1214).

The criticism above amount to say that since Post Keynesian economists have written extensively about rising inequality in modern economies, they would not want a more equal society for fear of becoming unemployable in future.[4] In the exogenous money system devised by PM, money still need to be created to meet the financing needs of the private and government sectors. The money supply process would therefore retain many of the features of the current system, albeit in a changed institutional setting.

3. Conclusions

This paper has discussed what Etzrodt labels “the important economic issues”, and the “biggest problem” in F&S. The former refer to both the disputed mechanisms that brings financial instability in PM, and the role of the shadow banking system in modern economies. The latter describes the theoretical incompetence and lack of impartiality of Post Keynesian macroeconomists, and F&S more specifically, to assess the PM proposal. This paper has argued that Etzrodt misrepresents F&S, and his critique is misplaced.

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[1] Etzrodt (2023) is also critical of Nersisyan and Wray (2016, 2017). Etzrodt misspelled Giuseppe Fontana as Guiseppe.

[2] A note commenting on these four ‘minor issues’ is available on request from the authors.

[3] The authors are grateful to a referee for bringing to their attention this point. It should also be noted that Lainà’s analysis relates to a zero growth economy, and hence the need for financing increases in investment does not arise.

[4] The authors are grateful to a referee for suggesting this parallel.