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MONETARY REFORMS MAY NOT PREVENT BOOMS AND BUSTS; BUT THEY HAVE A GROWING CONSTITUENCY

One of the legal powers of central banks is the power to print paper currency (or generate its digital equivalent) without restriction. Central bankers describe this expansion of the money supply as “quantitative easing.” With this “new money” the central bank is able to invest in government securities, earning interest income, without removing any money from circulation. Proponents of monetary reform rightfully question the laws that grant to a central bank this extraordinary power. Appropriately regulated (to prevent inflation), the public good would be better served by transferring the issuance of legal tender currency to national governments. Supplementing tax revenue and fees for services, the direct spending by government would be debt free.

The public good would be further served by the chartering of publicly-owned banks charged with providing funding for infrastructure, for small businesses, for housing affordable to lower income households, and other public assets (e.g., schools and libraries). In this way, money becomes a social good rather than means to leverage rent-seeking and passive and speculative investment activities.

Some proponents of banking reform call for “full reserve” banking, requiring a bank to hold cash equal to total short-term deposits. Such a change would dramatically change the business model for depository institutions. By removing the ability of the bank to use deposited funds to make loans to others, earning interest income, banks would need to cover their costs and earn a return to shareholders by charging even higher fees for any service performed. A bank could still be a lender, drawing on funds raised by the sale of shares of stock or by the issuance of debt where repayment comes from a specific income stream rather than the bank’s general assets. A less draconian reform is embraced by at least some members of the economics discipline: Here Sheila Dow, Guorun Johnsen and Alberto Montagnoli in *A Critique of Full Reserve Banking*, Sheffield Economic Research Paper Series. The University of Sheffield, March 2015:

“While a return to a traditional separation of retail banking (regulated and supported by the central bank) from investment banking (regulated differently but not supported) would contribute to financial stability, it is argued that the full reserve proposals go too far.”

The authors of this paper describe how most economists and reformers understand the role of the individual commercial bank in the expansion of the money supply:

“In the current economic system money is created by commercial banks in the process of credit creation and money is destroyed when a loan is repaid. Using the accounting rule of double-entry bookkeeping, every time a bank grants a loan the amount immediately becomes both an asset and a liability for the bank itself. These items are both in the name of the borrower (the bank’s customer).”

The above description is widely accepted by critics of the existing rules for banks. Contrary to this interpretation, I suggest there is much more to the story.

When a group of investors decides to establish a bank, the first step is to contribute cash in return for shares of stock. The cash raised from investors is the bank’s initial start-up capital. In the United States, this will require between $12 to $20 million depending on the state. Once the bank opens an office (or a website), it is able to offer its services to the public. Capital above required minimum reserve requirements is available to make loans. The bank begins to accept deposits of cash (or its digital equivalent), 90% of which can also be offered to borrowers. The bank can also issue bonds to raise additional cash.

U.S. banks are required to adhere to capital requirements adopted by the Basel Committee on Banking Supervision. These rules apply to all insured depository institutions. The main source of capital is the net valued common equity (net, that is, of goodwill and other intangible assets). These rules are detailed and complex. One of the most controversial aspects of the regulations is the marking of assets to current market value, which involves accounting for a gain or loss in value despite the fact that the asset remains on the books.

As I see it, the problem with the way the above (and other) economists describe the outcome of a bank loan is that, in most instances, the proceeds of the loan are immediately distributed to one or more third parties. This is almost always the case when a loan is made to finance the purchase of land or land improved with one or more buildings. Proceeds are distributed at closing to any mortgagee holding a lien with an outstanding balance, to the mortgage broker, to the property appraiser, to the realtor, to the title insurance carrier, to the closing attorney, to the recorder of deeds and to the taxing authorities. Whatever is left goes to the seller.

Is money created when a loan is made, as asserted above? This is a fundamental question. If true, would any bank ever become insolvent? A bank would not need to draw on cash reserves, issue new shares of stock, borrow from other banks, or issue bonds to raise cash.

As it is, banks must hold some portion of funds deposited as a reserve against demands for cash by depositors. In addition, banks are required to hold reserves based on statistically-calculated losses on categories of its lending. And, of course, when the bank takes on imprudent risks or is insufficiently capitalized to weather a severe economic downturn, the bank may be declared insolvent and forced to close its operations.

As important as these issues are, they pale in comparison to the unjust private appropriation of rents from land as well as other land-like assets.