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**MINSKY'S IRRECONCILABLE MASTERS GOVERNING
FINANCIAL REGULATION AND FINANCIAL STRUCTURE**

*OS MESTRES IRRECONCILIÁVEIS DE MINSKY GOVERNANDO REGULAÇÃO
FINANCEIRA E ESTRUTUA FINANCEIRA*

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Minsky's Irreconcilable Masters Governing Financial Regulation and Financial Structure

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The Two Masters

Confronted with the need to reform Glass-Steagall legislation in the US in the 1980s Hy Minsky highlighted an irresolvable contradiction that made the design of an ideal regulatory system capable of providing financial stability impossible. He spent the last years of his life trying to resolve this contradiction.

The contradiction arose from the need of financial regulation to serve two conflicting objectives: "Any capitalist banking and financial system needs to serve two masters: one master requires assurance that the financing needed for the capital development of the economy will be forthcoming the other master requires assurance that a safe and secure payments mechanism will be provided. ... It ... needs to be understood now that development financing involves taking risks, that projects would not perform up to the expectations of their promoters and financiers, and opens the way for fraud and unsafe banking procedures." Thus the "need is for a regulatory and supervising authority for the financial system that accepts that financing development opens the system to losses that have the potential for adversely affecting the safety and security of the economy's payment facilities. ... To allow for this possibility the regulators need to try to insulate the payments system from the consequences of such losses. The problem therefore is to provide for protecting the payments system from the consequences of the losses which may ensue from development financing." (Minsky, 1994:10-11)

Since the means of payment and savings vehicles are broadly defined as the liabilities of the financial system and the financing of productive investment involves the financial system acquisition of the productive assets of the system, making the former riskless would require the limitation of the holdings of financial institutions to risk-free assets. Thus, one regulatory proposal that reappears periodically to safeguard the payments



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system is to restrict the assets held by financial institutions issuing means of payment to risk-free government securities or 100% gold reserves. While such proposals serve the needs of one master, they leave the objective of financing inherently risky productive investment to private, unregulated institutions. As pointed out elsewhere (Kregel, 2012), this proposal implies that the rate of investment would be limited by private saving, and fail to insure stable growth of output and employment. In simple terms stability of the payments system would be produced at the price of increased instability in the overall economic system.

But, more importantly, these proposals mistake the essence of the role modern monetary systems in capitalist development that have been recognized at least since the 19th century. A fuller understanding of these developments provides insight into an alternative resolution to Minsky's regulatory contradiction.

Understanding the Operation of the Payments Systems and Financial Instability: Theory and Practice

As Minsky argued in his early work, any discussion of financial regulation presupposes the existence of a theoretical explanation of the operation of the economic and credit system in which instability is possible, otherwise regulation is redundant: "The risk characteristics of banking and the tasks of bank regulators are different in a world in which instability is a present danger than in a world in which markets are stable. If bank regulators are to do a better job than in the past, [regulation] needs to be based upon an understanding of how our financial structure becomes susceptible to financial crisis." "Standard economic theory leads to the proposition that markets are equilibrating. It is evident that disequilibrating forces exist in the essential financing practices of a capitalist economy. These disequilibrating forces center in the financial of positions in capital assets and investment in progress. In time, financial practices lead to an environment in which financial crises can occur." (Minsky, 196_) And this is the theoretical background to the narrow banking proposals: the operation of the private market will produce the financing institutions that ensure both stability and growth.

What Minsky called "standard" economic theory locates the source of financial instability in the difference between an economy using commodity money, such as gold or silver, and an economy using a money surrogate or substitute without physical existence, denoted as "fiat" money or a fiduciary issue such as "paper money" or deposits, in which the means of payment has no intrinsic value. Since there is no physical limitation on the production of these commodity money substitutes, instability is the result of the divergence of the fiduciary issue from its "real" money backing. This is represented by the ability of banks under fractional reserve systems to "create" money that is a multiple of its money or deposit base. Regulation is thus concerned to provide limitations on the issue of fiat money to conform to the underlying quantity of physical



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money. As noted, the proposals for 100% reserve-backing for fiduciary issues is the standard representation of this approach.

Money and Credit: The eternal conundrum

There is a long-standing alternative theoretical tradition amongst banking experts and economists of the cycle, largely forgotten after the empiricism of the monetarist counter revolution, emphasizing the importance of the structure of the financial system in creating the stability of the payments system. This view informed the creation of the Federal Reserve, as well as the New Deal regulations known as Glass-Steagall. It is based on the detailed analysis of the balance sheets of economic agents and incorporates much of what is now most commonly known as stock-flow consistency. Its differences from the “standard” view is aptly described by Mitchell Innes: (1914:159) “a sale and a purchase is the exchange of a commodity for a credit and not for a piece of metal or any other tangible property. In that theory lies the essence of the whole science of money.” It derives from the recognition that payments settlements by means of credit entries on balance sheets was a financial innovation that displaces the use of commodity based monies because of its increased efficiency.

The Balance Sheet – Clearing House Approach to the Credit System

According to Colwell (1859:188-9) “Credit, in no one of its meanings, is the same thing as the credit system; the latter implies the former, but the former does not include the latter. Credit refers chiefly to the confidence which dealers repose in each other, and the consequent postponement of payment upon transactions of sale. ... The credit system is that by which not only personal confidence exists between parties, inducing them to sell and deliver goods, and defer the payment, but by which the payment is eventually effected, without resort to coin, bullion, or any similar equivalent: it is that by which commodities or services are made to pay for commodities or services: it is a system by which men apply their credits to the extinguishment of their debts. ... This is in direct contrast with the cash or money system, in which every article is either paid for in the precious metals at the time of delivery, or at some time afterwards. These two systems work side by side.” This approach is thus based on the recognition of the independence of the money and credit system, rather than attempts to make them conform.

In contrast to the Quantity theory it argues that if payments can be effectuated without the presence of physical monetary units, the value of the commodities exchanged cannot be determined by the relation between commodities and the intrinsic value of the means of exchange, but instead are expressed by means of an historically determined unit of account: “the credit system could not exist for a day, but by the aid of a money of account” (ibid., 191) “By the agency of money of account all prices and valuations are fixed, expressed verbally, stated in writing, entered in books of account ...: all values or



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amounts involved are thus stated and preserved for adjustment or future payment. For every article sold upon time a debt and a credit of exactly equal amount are created; there is a debtor and a creditor – the one having to pay the exact sum which the other is to receive. If the debtor can purchase that credit, he becomes both the debtor and the creditor, and both debt and credit are extinguished, being merged in the same person. The same extinguishment occurs when some third part assumes the place of the debtor, and also purchases the credit; both debt and credit meet in the same person and are merged. ...What is thus true of every case of debt and credit . . . is true of the whole class of debtors and creditors.” (ibid.192)

To effectuate this, “A class of men is formed, who make it their business to deal in these securities , or evidences of debt. If a banker or broker purchases the two notes given by the merchant and his customer, it is obvious that both receive the means from him to pay the notes of which he has become holder and owner. The Process of payment between them will be very simple, if the banker merely give each of the two parties credit on his books for the proceeds of the notes purchased of them. Their respective checks on these credits pay off the whole indebtedness, ...” (ibid.:9)

Colwell thus concludes that “The credit system does not, then really furnish a substitute for money, so much as a model of dispensing with it.” (ibid. 193) Indeed, in this point of view the credit system is a financial innovation that creative destructs the use of money by economizing and replacing it as a means of payment in the commercial transactions of the economy: “in all stages of commerce, we find there has been a constant effort to dispense entirely with the use of precious metals.” ibid: 157).

“We have already remarked that the trade or business depending on payments proceeds as if they were made – the making and arranging of payment becoming a separate occupation. That this may be done with more efficiency, the whole indebtedness becomes, in fact, a fund for this purpose. At all times there is a large amount, in the aggregate, of debts, incurred for goods sold; but this aggregate, however great, agrees precisely with the amount of credits. ...when large sums come to be concentrated in the banks, it becomes an efficient manageable fund for the extinction of debts. . The whole amount of the credits may in this way, become available as a medium of payment As all the debts which originate in the credit system are but the counterpart of the credits, the credits become an article of great demand. ... The debtors are, in fact, the holders of the articles of most general consumption; for, that they might be such holders, they contracted the debts. They are, then, not only under stringent necessity of obtaining credits to pay their debts, but that have the best means of obtaining them; having for sale, purposely selected, the commodities of daily consumption with the use of which people cannot dispense. . The credits, whatever be the shape they take, whether that of negotiable paper, bank-notes, or bank deposits, become a general

instrument of purchase, not because they are money, or representatives of money, but because they are the chief medium of paying debts.”(ibid. 194-5)

For Colwell “Banks become, in this way, substantially book-keepers for their customers.” (ibid, 9) “The books of the banks furnish, thus, a mode of adjustment by which the customers are enabled to apply their credits to the payment of their debts,” (ibid.: 10) since “No currency can be more suited to pay a man with than that which he has issued himself.” (ibid: 8)

Colwell argues that such a payments system is inherently stable for while “individuals might have trouble, owing to particular circumstance, in meeting payments; but a whole class or body of men could not, unless from other causes, because the fund for payment could never be short, and interest upon credits could never go to a high rate.”

What are the other causes? Since these are short-term self-liquidating, or even pre-liquidating, positions there is virtually no chance of being able to extinguish a debt through the acquisition of a credit. Instead, instability in the credit system is the result of the fact that “The blending credits and money, and treating them mainly as identical, have been a fruitful source of error and mischief... This fatal policy has been the parent of more commercial revulsions than all other causes combined. ... Any diversion of credits from the legitimate purpose of paying such debts is hazardous.... Under our present system of credit, a great amount of credits and securities are annually diverted from their legitimate purposes, and employed as money. ... The great temptation to this diversion of credits arises from the fact that, by our present system, they are required to be convertible at will into gold or silver. In point of fact they are not so convertible, and they cannot possibly be, as they amount at all times to a sum from ten to twenty times greater than any possible amount of gold and silver which would be available for such purposes. ... neither the necessities of business, nor the demands of convenience, require to be convertible on demand... This requirement, as it operates, is one of the most mischievous blunders in modern times”” (ibid. 197-9)

In Minsky’s terms cash inflows must equal cash outflows in the credit system, and as Colwell notes, could well take place without any interconnection with the use or creation of money as physical means of payment. While there have been various institutional constructs and forms of payment, the concept is easiest to see in terms of a clearing house system. As long as all settlement takes place within the system, there can only be individual divergences between debts and credits, but not for the system as a whole. The divergences can be handled by means of internal clearing house credits, as was indeed the case in the United States before the creation of the Federal Reserve. The difficulty for the credit system arises when financial system institutions are required to redeem their liabilities for a credit created outside the system. which leads to the

possibility of temporal disruption in the natural identity of debts and credits, and the need for financial institutions to hold external physical means of payment as reserves.

Thus, the credit system based on the clearing house principle is stable in that debts and credit always balance, while a credit system with sight liabilities issued to make payments is inherently unstable since it requires institutions to hold reserves of money; it is only stable if banks hold 100 per cent reserves in money assets. But this means there is no creation of credit, and no accommodation of the production of output by the business sector. The source of the problem for Colwell is thus the confusion of bank liabilities as a means of term settlement with sight means of payment through physical assets. Thus where the standard theory sees an excessive multiple expansion of credit on the basis of physical commodity money or reserves, this approach sees an inappropriate use of credit. The regulatory implications are also diametrically opposed. Instead of making credit conform to money, debts should not be payable on demand as money.

A similar explication of the credit system is given by Mitchell Innes (1914:152), referred to above,: “Shortly, the Credit Theory is this: that a sale and purchase is the exchange of a commodity for a credit. From this main theory springs the sub-theory that the value of credit or money does not depend on the value of any metal or metals, but on the right which the creditor acquires to ‘payment,’ that is to say, to satisfaction for the credit, and on the obligation of the debtor to ‘pay’ his debt, and conversely on the right of the debtor to release himself from his debt by the tender of an equivalent debt owed by the creditor, and the obligation of the creditor to accept this tender in satisfaction of this credit. Such is the fundamental theory, but in practice it is not necessary for a debtor to acquire credits on the same persons to whom he is debtor. We are all both buyers and sellers, so that we are all at the same time both debtors and creditors of each other, and by the wonderfully efficient machinery of the banks to which we sell our credits, and which thus become the clearing houses of commerce, the debts and credits of the whole community are centralized and set off against each other. In practice, therefore, any good credit will pay any debt. Again in theory we create a debt every time we buy and acquire a credit every time we sell, but in practice this theory is also modified, at least in advanced commercial communities. When we are successful in business, we accumulate credits on a banker and we can then buy without creating new debts, by merely transferring to our sellers part of our accumulated credits. Or again, if we have no accumulated credits at the moment when we wish to make a purchase, we can, instead of becoming the debtors of the person from whom we buy, arrange with our bankers to ‘borrow’ a credit on his books, and can transfer this borrowed credit to our seller, on undertaking to hand over to the banker the same amount of credit (or something over) which we acquire when we, in our turn, become sellers.”



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Mitchell summarises his approach as follows: “A credit cancels a debt; this is the primitive law of commerce. By sale a credit is acquired, by purchase a debt is created. Purchases, therefore, are paid for by sales. The object of commerce is the acquisition of credits. A banker is one who centralizes the debts of mankind and cancels them against one another. Banks are the clearing house of commerce. ... The value of credit does not depend on the existence of gold behind it, but on the solvency of the debtor.” (Ibid: 168)

A similar view of the operation credit system was present in the creation of the US Federal Reserve, based on the so-called “real bills” doctrine supported by H. Parker Willis, a Professor of Banking who served as executive director of the National Monetary Commission and an influential adviser to Carter Glass who drafted the proposals for, and was the first Secretary of, the US Federal Reserve System. In satisfying the need for a more elastic currency to avoid financial instability similar to the 1907 banking crisis, banks were viewed as the central clearing house, with the creation of deposit credits limited to self-liquidating commercial loans. The imposition by the Fed of the par clearance of checks on deposits ensured that all credits were available to meet liabilities. “The function of banking ... appears as the largest factor in carrying on the actual exchange work ... of business It appears not as a means of ‘lending money,’ but rather as a means of ‘creating’ or providing it.” (Willis, et. al: 46) “[I]n the usual instance, the bank merely lends to [the borrower], agreeing to honor his draft or check, in which case it simply marks up on its books the amount of the loan. It stands ready to meet this obligation in any form in which the borrower may call for it, but it expects to be able to pay, in the majority of cases, by offsetting the check to be drawn by the borrower by another that it expects to be deposited with it.” (ibid., 52) As in Colwell¹, the explanation of instability was created by “Banks which create liabilities against credit which does not exist, this type of credit being known as illiquid credit.” “Loans to investors to purchase securities in order to resell them at a profit are probably the most illiquid loans, for repayment depends upon the existence at some future time of more than the present number of investors, anxious to purchase the securities out of income than out of the proceeds of new bank loans. If these investors are certain to exist in the future, why do they not exist in the present? Banks frequently make such loans with the knowledge that they can be liquidated only from the proceeds of new loans either to the original security purchases of those to whom he sells. In such cases they are acting single handed, expecting to maintain their own liquidity at the expense of the liquidity of less cautious banks.”(Whitney: 186) This led to the erroneous principle of “shiftability as the basis for liquidity” which “assumes that any loans are as safe as liquid loans, if they can be shifted to other banks. The principle is safe as applied to an individual bank, provided other banks are willing to take over the shiftable

¹ Robey, an assistant professor of banking at Columbia under Willis, was a co-author of a money and banking text with Willis and Chapman (1934) and author of a summary (1938) of Colwell’s book.

loans, but not to banks as a whole.” (ibid. 187) Innes (1910) had already noted that the US financial system was excessively dependent on lending against securities traded on the stock exchange.

But, as the Federal Reserve moved away from this credit principle it came under increasing criticism from Willis’ students: “The automatic elasticity provided for in the Federal Reserve Act, as originally enacted into law, is present in a system which recognizes only commercial credit. Willingness of the Reserve banks to advance funds by other means than the rediscount or purchase of commercial credit instruments has left the ultimate determination of who shall be entitled to bank deposits by borrowing in the hands of the member banks. Consequently, the automatic action of the elasticity provided for in the Federal Reserve Act disappeared.” (ibid: 216) For this reason Willis and his students joined Franklin Roosevelt in arguing against deposit insurance as the form of insuring a safe payments system: “No plan of protection has had much success” and “the wise selection of credit risks is, after all, the ultimate source of safety – far transcending in its effects and importance any system of artificial protection, designed to take care of the interest of the depositor.” Willis, et. al, (1934:66-7) Instead of insurance the recommendation was either direct supervision of composition of bank assets to prevent acquisition of illiquid loans, and thus provide for the “enforcement of safety for the deposits of banks.” “Under a policy of commercial banking, instead of investment banking as at present practiced, banks would be smaller institutions than at present. The volume of bank deposits would be curtailed, but the active parts would remain. The inactive part of bank deposits [that is created by “illiquid” loans for hoarding or speculation] would seek an outlet in outside investment markets, where it could be converted into purchasing power until other investors are willing to purchase the underlying securities.” (Whitney, op. cit.: 217)

The same view of the operation of the credit system is reflected in Minsky’s description of the financial system: “Banking is not money lending; to lend, a money lender must have money. The fundamental banking activity is accepting, that is, guaranteeing that some party is creditworthy. A bank, by accepting a debt instrument, agrees to make specified payments if the debtor will not or cannot. Such an accepted or endorsed note can then be sold in the open market. A bank loan is equivalent to a bank's buying a note that it has accepted.” (1986: 258) But, for this system to function it requires that the bank debtors have access to bank deposits to liquidate the loan. Thus: “In our system payments banks make for customers become deposits, usually at some other bank. If the payments for a customer were made because of a loan agreement, the customer now owes the bank money; he now has to operate in the economy or in financial markets so that he is able to fulfill his obligations to the bank at the due dates. Demand deposits have exchange value because a multitude of debtors to banks have outstanding debts that call for the payment of demand deposits to banks. These debtors will work and sell

goods or financial instruments to get demand deposits. The exchange value of deposits is determined by the demands of debtors for deposits needed to fulfill their commitments. Bank loans, while ostensibly money-today for money-later contracts, are really an exchange of debits from a bank's books today for credits to a bank's books later. (ibid. 258)

Despite financial innovation in the provision of the clearing of credits and debts, “As the 21st century approaches, the only reason why banks are special is that they operate the "ultimate" payment system within economies (the proximate payment mechanism is now often a credit card). There are now alternatives to banks for all but the provision of the ultimate payment mechanism function. Because banks operate the ultimate payments mechanism, those liabilities of banks which serve as the "medium of exchange" also serve as the standard in which domestic public and private debts are denominated.” (Minsky, 1995).

The Banking Principle, the Balance Sheet, the Clearing House and Lifting Constraints

It is this approach that Keynes refers to as the “banking principle” in his proposals for an international clearing union, noting that it provides automatic creditor financing of debtor positions. It is also the principle that is recognized by early Austrian trade cycle theorists such as Mises, Hahn, Hayek and Schumpeter and English cycle theorists such as Hawtrey, Lavington, Hawtrey and Keynes when both schools note that the existence banks allows investment to take place independently of private savings.

There is an important corollary of this “credits liquidate debts” approach to financial organization. It applies to all liabilities, whether public or private. As highlighted by Innes (ibid, 168) “The issue of money is not an exclusive privilege of government, but merely one of its functions” ... “every merchant who pays for a purchase with his bill, and every banker who issues his notes or authorizes drafts to be drawn on him, issues money just as surely as does a government which issues drafts on the Treasury, or which puts its stamp on a piece of metal or a sheet of paper” (ibid: 152). But in the case of government, unlike the implicit aggregate equality of debts and credits, when it uses its debts to make acquisitions, the transaction appears to be a unilateral imposition, requiring public acceptance. But this is not the case, as Innes argues, following Knapp: “Whenever a tax is imposed, each taxpayer becomes responsible for the redemption of a small part of the debt which the government has contracted by its issues of money, whether coins, certificates, notes, drafts on the treasury, or by whatever name this money is called. This debt takes the form of ... the redemption of government debt by taxation – is the basic law of coinage and of any issue of government ‘money’ in what ever form.” (ibid: 161) This position is recalled in modern post Keynesian theory by Lerner in his 1947 paper on “Money as a Creature of the State:” “The modern state can

make anything it chooses generally acceptable as money ... apart from any connection ... with gold ... if the state is willing to accept the proposed money in payment of taxes and other obligations.” (Lerner: 313)

The basic credit-debt theory carries over in Minsky’s approach: As Minsky notes, anyone can issue a promise to pay, the problem is to get it accepted. Minsky (1970, note 8) answers the question as follows: “For fiat money to be generally acceptable and valuable there must be a set of payments units must make for which this money will do. Taxes are such payments, thus fiat money really should not be introduced without a government with taxes and expenditures. Symmetrically money as a liability of a fractional reserve bank acquires value in the market because there exist units, the debtors to the banks, which have payments to make for which this credit money will be acceptable. The acceptability and value of money depend on the existence of payments denominated in that money: thus fiat money without a government that taxes and spends, and credit money without debtors under constraint to meet payments commitments are quite meaningless concepts.”

It is important to note that modern monetary theorists are simply following in this line by noting that just as banks allow investment to diverge from saving, the government issue of currency backed by taxation means that government investment and expenditures in general cannot be limited by government saving in the form of taxation and/or borrowing from the public. It is odd that while economists have generally accepted that the financial clearing system lifts the constraint on private expenditure, they have much more difficulty with the same argument applied to public expenditure.

But, as noted above, the policy responses are very different across those who view credit as a substitute for physical commodity money or currency and those who view it as a complement. For the former, policy should remove this power to lift expenditure constraints, while for the latter, policy should control this power to accomplish policy goals such as growth of employment and output.

Giving 100 % Banking a Look

Minsky reprises this idea in his 1986 book (Minsky: 1986:258, note 10) “In an economy where government debt is a major asset on the books of the deposit-issuing banks, the fact that taxes need to be paid gives value to the money of the economy.” The substitution of government debt for commercial credits on bank balance sheets (a move away from what Colwell would have considered a stable credit structure and Willis would have considered an increase in the “frozen” assets) led Minsky to suggest that given “the limited success of deposit insurance in the late 1980s it is worth considering the 100% money proposal ... Fundamentally 100% money position holds that two functions of the banking and the financial structure, the supply and processing of



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instruments used in the payments mechanism and participating in the financing in the capital development of the economy, are separable. The operation of the payments mechanism is now undergoing rapid changes due to the electronic revolutions and the expanding use of credit cards” (1994/5: 5).

In the 100 % banking proposal government debt goes from being the “major asset” to being the only asset on banks’ balance sheets! Since government debt can always be redeemed for government liabilities which households will demand to meet taxes, the sight deposit liabilities issued by the banks become a surrogate for government securities and should be just as risk free. Thus, 100 % banking could provide a safe and secure payments system, it implies that the government would be supporting a secure private payments system that it could just as easily provide itself.

Indeed, this was implied in any earlier proposal for reform of deposit insurance: “Whenever bank failures are due to idiosyncratic behavior, actuarial estimates of the probability of payoffs are possible... But “a system-wide decline in asset values cannot be contained by a guarantee or bailout of some restricted class of deposits or institutions. If instabilities that can generate large, system-wide losses of output, employment, and asset values are to be contained, more than deposit insurance is needed” (Minsky and Campbell 1987, 255-6). His conclusion was that the government should provide full support for bank liabilities and to set in place a well-funded, institutional structure to fulfill this obligation. (ibid: 253) Again, this is the equivalent to having the government provide the payments system.

A More Detailed Description of 100 % Narrow Banking

Minsky(1995a: 19-20) provided a more detailed proposal via a bank holding company structure containing a narrow bank and a Colwell style clearing house subsidiary for business lending funded by short-term Certificates of Deposit protected by a government insurance fund for 80 percent of the face value of the liabilities. The government guarantee of deposits would be transferred to its short-term financing of business, with the deposit certificates carrying a guarantee. The insurance would take the place of reserves against these liabilities to encourage households to hold them rather than the 100 % government backed deposits. Indeed, it is now common to encourage governments to engage in public-private partnerships to support specific investment projects, with the government carrying contingent liability for returns. Minsky’s proposal would provide a similar mechanism that could be used to direct funding toward productive business investments rather than financial speculation. In addition, the holding company would have another subsidiary for investment banking. Insurance subsidiaries can carry out the underwriting and sales of insurance products. The merchant banking operation will be financed by own capital as well as commercial paper and certificates of deposit. Because of the high risk these activities will be



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financed to a larger extent than the other functions by capital: special liabilities of this subsidiary may well carry some equity kicker. The creation of large denomination “participation deposits” to finance merchant banking activities which carries some of the pains even as it shares in the gains from merchant banking activities.

The most important implication of this proposal, as Minsky seems to have admitted, was that it bowed to the master of safe payments at the expense of the financing of risky investment (see Kregel2014). This is because in such a segregated system there would be neither a deposit–credit multiplier, nor leverage, nor private creation of liquidity which was at the heart of the Schumpeterian innovation process and the benefits of creative destruction. Indeed, as Fisher had noted in his original proposal, “new loan funds would come out of savings, but no longer out of thin air” (Fisher, 1935: 91). He pointed out in that this would not mean that financing would cease, only that it would be limited to the rollover or repayment of existing credits. In essence, the approach would institutionalize the “loanable funds” theory in which saving determines investment. A similar observation was made by Neil Wallace, who characterized “the narrow banking proposal as one requiring the banking system to be liquid without any reliance on liabilities subordinate to deposits,” and concluded that this implied that “the narrow banking proposal eliminates the banking system” (Wallace 1996, 7–8).

These narrow bank proposals would thus require a credit system to provide “substitute for bank lending” in a capitalist system, since they eliminate the creation of liquidity normally associated with the role of the banking system in accepting the illiquid liabilities of the business sector used for financing day-to-day operations. The question is whether the capitalist system could function on this basis (Kregel 2012).

In simple terms the 100 % narrow bank proposals seek to take away the power of the banking system to lift the constraint on private expenditure, imposing the constraint of private investment. But the analysis of government expenditure as a corollary suggested above provide an indication of how additional liquidity could be created to provide increased financing for business investment in a narrow bank world. If the government financed investment expenditure via a fiscal deficit then the constraint on spending would be lifted. The bonds issued to cover the deficit would be deposited in the narrow bank subsidiary against credits that could be transferred to private individuals in payment for goods and services or to purchase certificates of deposit or securitized assets, providing for an increase in available investment financing. Instead of being governed by the decisions of banks to extend credit, or the private sector to increase saving, investment finance would then be determined by the position of the government budget and the direction of investment as determined by the extent of the insurance of the liabilities of different types of investment funds. Indeed, such a government policy

would be necessary, for in its absence the inherently deflationary tendency would create an additional financial instability.

How to Preserve Policy in a Narrow Bank System

Alternatively, the central bank could engage in the direct financing of public or private sector investment expenditures. The stability of the financial system would then be buttressed by the application of what Abba Lerner called “functional finance.” The size of the deficit creating the additional government means of payment required for financing investment exceeding past saving and allow for positive growth. In the absence of a government sector deficit to support incomes, liabilities used to finance investment could not be validated in a narrow bank holding company structure. But, even more important, it would be impossible in such a system for banks to act as the Schumpeterian handmaiden to innovation and creative destruction by providing entrepreneurs the purchasing power necessary for them to appropriate the assets required for their innovative investments. In the absence of private sector “liquidity” creation, the central bank would have to provide financing for private sector investment trust liabilities, or a national development bank could finance innovation through the issue of debt monetized by the central bank. Were Minsky alive today, he would probably agree that the current institutional and political structures are not equipped to recognize the role of fiscal deficits in the successful operation of a narrow banking system intended to obviate the need for financial regulation.

Given that Thus much as Colwell had indicated that the money and credit system could be considered as separable, but with government liabilities replacing physical commodity money. In his reflections on reform of the US financing system in the 1980s and 1990s Minsky noted the affinity of this result to the 100 per cent reserve narrow bank proposals.

The alternative understanding of the operation of the credit system presented above thus allows for a diverse solution to Minsky’s contradiction. Limiting the banking system to commercial and transaction credits via a clearing system provides the counter proposal to the narrow bank proposal, but without the constraint of savings on the expansion of liquidity to finance investment. As Minsky noted, new communications technology offers the possibility of creating an electronic clearing house, whether via electronic payment cards, or smart phone payment/transfer applications that would eliminate the need for sight conversion whether the clearing is operated by the private sector or by the government through a national giro system of payments. This would provide the safe and secure means of payment and secure investment of savings.

This leaves the other master, the financing of risky investment. Since the issue of government debt as means of payment is not limited by any financing constraint, but is



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validated at any chosen level by the imposition of taxation, it is the government provision of means of payment that should provide the financing of investment independent of private saving. Since in a modern monetary system government created liabilities that serve as means of payment, as opposed to credit, in Innes' conception of government credit, can always be created to offset an imbalance in the private system of credit.

Thus, the alternative to the narrow banking proposals put forward by the Chicago School and more recently would be to accept the Willis School "qualitative limitation" of bank assets (see Dunkman, 1933) to preserve liquidity, without the necessity of using government debt or gold for bank reserves. This would provide stability in the organization of commercial transactions. The financing of investment would be maintained by means of government financing in private investment banking institutions, a proposal very close to Keynes's idea of the "socialization" of investment. This would be achieved by means of government budgets being divided into balanced current accounts and capital account deficits to produce the funding required to achieve the desired rate of aggregate investment to produce the desired rate of growth, or for expenditures on employer of last resort programs to produce the desired level of employment.

In this way, the financial structure would be designed in order to induce financial stability, and regulation would primarily involve the qualitative assessment of commercial bank assets. This would imply a public-private division of labour in the design of the financial system. Private banks would provide for the provision of credit to finance short-term transaction and production level financing. This would allow the provision of the safe and secure payments system and secure savings outlets. Private commercial banks would be excluded from financing longer-term capital investments which would be undertaken by a government institution funded by the government capital account budget deficit. It would not borrow private savings from the capital markets so that the losses that are the natural result of the financing of innovative productive investment would be borne by the collective, not by individual financial institutions or by private individual holding means of payment issued by those institutions as under the present system. The private sector would maintain the control over the selection and financing of innovative, but risky capital investment projects, but the losses would be covered by the government (which is not different from current practice, but now the collective would get both the benefit and the loss).

Are we going in the Right Direction to Create a Financial Structure that Serves the Two Masters?

It is clear that the US financial system, especially after the introduction of the Financial Services Modernisation Act has moved in the wrong direction in allowing the



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comingling of these two different aspects of credit provision, and indeed in having provided an incentive to the creation of “illiquid” assets backed by means of payment. Dodd-Frank legislation has implicitly accepted this financing structure, but seeks to provide limits on the activities that have led to instability in the past.

On the other hand developing countries, who have been encouraged to adopt the US model would do well to investigate the alternative approach to stability via the design of their domestic financial structure. Among emergent market economies, Brazil seems to have, either by design or by chance, stumbled on the ideal financial structure in support of financial stability. A private sector composed of financial institutions primarily limited to a Colwell type intermediation of debts and credits, and a government investment bank, independent of private financial market borrowing, with government financial support to carry out the risky financing of the productive structure. This provides a solution to the Minsky conundrum of providing a safe and secure financial system of payments and household savings while at the same time being able to finance risky productive investment and absorb losses without compromising the domestic payment system.

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