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Surveys

100 percent reserve banking: A critical review of green perspectives

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ABSTRACT

100 percent reserve banking (C-PeRB) is an enduring proposal for monetary reform that has been taken up by some ecological economists. This paper identifies three groups of green arguments in favor of C-PeRB, and offers some criticism. First, the proposal could serve to constrain new investments by the availability of savings, thereby checking economic growth. However, this would strongly increase interest rate volatility. Second, it could potentially elevate environmental considerations in decisions about resource allocation by increasing the role of the democratic state as an economic actor. This line of argument faces problems that require further detailed exploration and historical perspective. Third, a transition to C-PeRB would allow debt levels to be drastically cut. This is technically possible, but politically a tall order. Whether the existing system of 'debt-based' bank money generates a significant growth imperative is unclear, and the importance of other driving forces behind perennial economic growth in modern societies – which C-PeRB does not address – remains an issue of contention. In general, the adoption of C-PeRB presupposes a tremendous reconfiguration of power relations between states and finance capital.

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1. Introduction

The financial crisis that began in 2007 has underlined the fact that ecological economics does not have much to say about monetary and financial reform. As recently suggested by Daly (2014: 127), "[m]oney and finance have rather naturally been pushed aside by ecological economists' focus on biophysical dimensions", the latter being the great blind spot of conventional economics that the field was born to uncover. Insofar as ecological economists have analyzed market-based policies, these have tended to be narrowly environmental in character, such as payments for ecosystem services or green taxation. A number of proposals for monetary and financial reform have indeed been advocated on environmental grounds (e.g. Douthwaite, 2012; Lawn, 2010; Loehr, 2012), but critical debate has been largely absent. This paper aims to foster such debate by reviewing and making some criticism of green arguments for the long-standing proposal of 100 percent reserve banking (here abbreviated C-PeRB). We begin by explaining the basics of C-PeRB and giving a brief historical overview of the proposal. Sections 2–4 discuss three groups of distinctively green arguments for C-PeRB. Section 5 describes the 'near-money' problem that has accompanied the proposal from its beginnings, and Section 6 concludes.

1.1. Outline and History of Proposals for 100 Percent Reserve Banking

The essence of C-PeRB – or synonymously, full-reserve banking – is that the state gains control over the quantity of money in the economy, i.e. the money supply. In today's capitalist economies, the lion's share of the money supply is bank money, created by commercial banks in the act of lending as a new deposit for the borrower and a new liability of the bank.[1] Conversely, bank money is extinguished as loans are repaid. Under C-PeRB, only the state – via the central bank or some other monetary authority – would have the ability to create (and destroy) money. There would be two basic types of private bank; deposit banks and lending banks (or investment trusts). Deposit banks would be obligated to hold cash, or reserves in their accounts with the central bank, to the full amount of their demand deposit liabilities to their customers.[2]

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[1] The extent to which commercial banks can create money at their discretion remains a matter of debate. Economic orthodoxy holds that banks are constrained by the central bank's provision of reserves via the 'money multiplier'. Post-Keynesian economists, however, argue that any interest-rate targeting central bank must supply banks with whatever reserves they wish to borrow at a given rate of interest. They subscribe to Keynes' view that "there is no limit to the amount of bank-money which the banks can safely create *provided that they move forward in step*" (Keynes, 1965: 26, italics in original), so that each bank can compensate clearing losses of reserves by gains.

[2] This implies that a deposit bank carries its monetary assets and liabilities on its balance sheet, although there must always be a one-to-one relation between them. Some present-day authors reject this design as "backward-looking, actually conserving the obsolete reserve system" with its distinction between commercial bank money and central bank money, and propose instead a system in which deposit banks would only be agents of the central bank, managing people's accounts *held at the central bank* (Huber and Robertson, 2000: 23). Rather than a full-reserve system, this is labeled a 'plain money' or 'sovereign money' system, in which there is "just one integrated quantity of money circulating among banks and non-banks alike" (Jackson, 2013). However, we will here treat the two models as equivalents, coinciding with Wolf's (2014a) judgment that the difference is not "at all important". Indeed, some early full-reservists described their own proposal as a plain money system rather than a two-circuit reserve system, prescribing the "[d]isplacement by notes and deposits of the [Federal] Reserve banks of all other forms of currency in circulation, thus giving us a completely homogeneous national circulating medium" (Simons, 1948: 63).

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Hence, their role would be limited to the payment system, offering transaction and safekeeping services. Typically, deposit banks would finance their activities by charging a fee for managing deposits. Lending banks would be what banks are often wrongly believed to be today, namely pure intermediaries between savers and borrowers. Crucially, a deposit in a lending bank would not be available to the depositor on demand but actually lent out, i.e. it would not be a liquid monetary asset for the depositor. C-PeRB proposals vary in their specifications about lending banks, e.g. regarding reserve and capital requirements and presumed sources of funding (private loans, government loans, or equity investment). The central bank would conduct monetary policy through quantity control of the money stock, rather than (as today primarily) by setting the price (i.e. interest rate) at which it lends reserves to banks through the 'discount window'.

Frederick Soddy (1933: 197–9), a chemistry Nobel laureate, is usually credited with having first raised the C-PeRB idea in the 20th century (but see Bromberg, 1939; and Mints, 1945 on the pre-20th century history of the idea). Soddy aimed to set out a monetary system based on the physical principles that he believed to underlie wealth; the laws of thermodynamics. By requiring banks to hold "pound for pound" of reserves against demand liabilities, a "disinterested bureau of statisticians" could control the money stock to make money an invariable standard analogous to the scales of measurement of the physical world (Soddy, 1934: 211, 169). For Soddy, this "scientific monetary system" was all that was needed to inaugurate the egalitarian age of plenty (Soddy, 1931: 22), characterized by economic *laissez faire* (Soddy, 1934: 3), that the progress of natural science had made possible. Soddy was a "monetary crank" (Clark, 2008), attributing "the whole hell's brew which the scientific civilisation has become" to the "banking tricks" of fractional reserve banking that robbed the nation of its "virtual wealth" (Soddy, 1933: 10; Soddy, 1934: 215, 89).[3] Soddy's original proposal was favorably reviewed by Frank Knight (1927), who in March 1933, together with colleagues at the University of Chicago economics department, would write a memorandum to the US Secretary of Agriculture, known as the first *Chicago plan* for banking reform (Knight, 1933).[4] The essential feature of the Chicago plan is a system of C-PeRB together with a legislated rule for monetary policy (as opposed to central bank discretionary powers). The plan was presented as a free-market alternative to the danger of bank nationalization (Phillips, 1995: 53), in line with Soddy's (1934: 211) advice to "[a]void as the plague schemes for nationalizing banks" (this motive remains in Daly, 2013). Among the few receivers of the memorandum was the eminent economist Irving Fisher, who took up the cause after some hesitation (Allen, 1993), and soon became its most conspicuous advocate.[5] Along similarly *laissez faire* lines, Fisher argued that C-PeRB – by protecting the payment system from the risks involved in bank lending – "would render unnecessary many, if not most, of the present vexatious regulations of banking" (Fisher, 1946, sec. 11; see also Douglas et al., 1939: 31; Simons, 1948: 332–3 n19). The other advantages most commonly claimed by its Depression-era advocates were that it would eliminate runs on deposit banks and eliminate great inflations and deflations, thereby greatly mitigating booms and depressions (Fisher, 1945: 11–4).

Harvard economist Lauchlin Currie (1968 [1934a]: ch. XV) had independently argued for C-PeRB in early 1934. By July, he was employed by the US Treasury *explicitly* to elaborate this proposal (Sandilands, 1990: 57), submitting it in September 1934 to Treasury Secretary Morgenthau (Currie, 1968 [1934b]). As a New Dealer – and unlike the Chicago economists – Currie's intention "was to render activist monetary policy a more useful component of a generally interventionist policy regime" (Laidler, 1993: 1070). Currie went on to draft the administration version of the Banking Act of 1935, which included the legal right of the Federal Reserve Board to raise reserve requirements by anything up to 100% if it so wished.[6] However, by the work of Senator Glass, this right was excluded from the enacted version. Phillips (1995: ch. 10) argues that the exclusion was due to administration blunders affecting Glass and resistance from the banking community based on misconceptions about C-PeRB as a plan to end private banking. Nevertheless, campaigning for C-PeRB went on, especially by Fisher — right until his death in 1947 (Allen, 1993). Various bills prescribing C-PeRB were introduced in the US Congress between 1934 and 1945, but without success. The Banking Act of 1935, which provided permanent federal deposit insurance as the de facto alternative to C-PeRB, would remain the basic banking legislation until the late 20th century. C-PeRB lived on for some time in academia, notably advocated by Milton Friedman (1960: 65–76), but progressively lost attention. In the midst of the US savings and loan crisis of the late 1980s and early 1990s, it enjoyed a revival as 'narrow banking' (Litan, 1987), seen as a solution to the moral hazard problems associated with federal deposit insurance (Phillips, 1995: 180) (narrow banking proposals accept a wider range of assets counting as reserves). C-PeRB has been given yet another lease of life in the aftermath of the financial crisis of the late 2000s; in the policy debate (Benes and Kumhof, 2013; Kotlikoff, 2010; Wolf, 2014b, 2014c) and by the Positive Money movement originating in the UK (Jackson and Dyson, 2013). In September 2011, Dennis Kucinich introduced a bill (HR2990) in the US Congress including C-PeRB, but it failed to pass.

Advocacy of C-PeRB by ecological economists – or more broadly, greens – appears to have begun with Daly's (1980) recovery from oblivion of Soddy's economic thought. Rather than attempting to sketch the historical trajectory of this idea within the international green movement, the following three sections will discuss the distinctively environmentalist case for C-PeRB, as advanced in the English-language literature.[7]

2. Controlling Scale by Limiting Private Investments to the Availability of Savings

Herman Daly is commonly associated with the vision of a steady-state (i.e. physically non-growing) economy (SSE) organized around three basic economic goals: sustainable scale of the macroeconomy within the biosphere; just distribution; and efficient allocation (Daly, 1992). Daly advocates C-PeRB as a policy that could help achieve a sustainable scale, because, "[a]ssuming initially a fixed relationship between GNP and throughput, a steady-state economy requires a constant real money supply" (Daly and Farley, 2011: 335). In Daly's version of C-PeRB, the nominal money supply would also be constant, since the Treasury (not the Fed) would control it so as to maintain a constant price index.[8] This system "would restrict borrowing for new investment to existing savings, greatly reducing speculative growth ventures", so

[3] As Daly (1980: 471) observes, "Soddy is admittedly unconvincing in his frequent attribution of war and all other evils to fractional reserve banking". We may add, conversely, that Soddy never went to great lengths to substantiate his extraordinary claims about C-PeRB. Indeed, it is not for his monetary reform proposal – which is not mentioned – that Martinez-Alier (1987: ch. 9) includes Soddy in the pre-history of ecological economics, but for his discussion of the physical principles underlying wealth, and how these are contradicted by conventional economics.

[4] See Phillips (1995) for an excellent history of Depression-era C-PeRB proposals.

[5] Daly (1980) notes Soddy's apparently magnanimous acknowledgement of Fisher's campaigning in a 1943 pamphlet. However, in the widely forgotten *Economic Forum*, Soddy had previously accused Fisher of having "put forward as his own" the proposal (Soddy cit. in Dimand, 1991: 24). It was pointed out in response that Fisher (1945: 204 n2, 221–3) had in fact already cited Soddy and listed three of his works.

[6] It is therefore not entirely correct to say of the 1930s full-reservists that "their ideas on money were simply classed separately from the rest of their economics, treated as a peccadillo, and were ignored" (Daly and Farley, 2011: 296).

[7] I am unaware of the existence of other major environmentalist arguments for C-PeRB presented in other languages.

[8] Daly allows for some, presumably very limited, GDP growth in an SSE: "Once we have achieved sustainable throughput, technological advance may still allow growth in the real value of market goods and services" (Daly and Farley, 2011: 335).

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