Kregel, Jan

Research Report
Minsky and the narrow banking proposal: No solution for financial reform

Public Policy Brief, No. 125

Provided in Cooperation with:
Levy Economics Institute of Bard College


This Version is available at:
http://hdl.handle.net/10419/121994

Terms of use:
Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.
MINSKY AND THE NARROW BANKING PROPOSAL: NO SOLUTION FOR FINANCIAL REFORM

JAN KREGEL
The Levy Economics Institute of Bard College, founded in 1986, is an autonomous research organization. It is nonpartisan, open to the examination of diverse points of view, and dedicated to public service.

The Institute is publishing this research with the conviction that it is a constructive and positive contribution to discussions and debates on relevant policy issues. Neither the Institute's Board of Governors nor its advisers necessarily endorse any proposal made by the authors.

The Institute believes in the potential for the study of economics to improve the human condition. Through scholarship and research it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

The present research agenda includes such issues as financial instability, poverty, employment, gender, problems associated with the distribution of income and wealth, and international trade and competitiveness. In all its endeavors, the Institute places heavy emphasis on the values of personal freedom and justice.

Editor: Michael Stephens
Text Editor: Barbara Ross

The Public Policy Brief Series is a publication of the Levy Economics Institute of Bard College, Bithwood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000.
For information about the Levy Institute, call 845-758-7700 or 202-887-8464 (in Washington, D.C.), e-mail info@levy.org, or visit www.levyinstitute.org.

The Public Policy Brief Series is produced by the Bard Publications Office.

Copyright © 2012 by the Levy Economics Institute. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or any information-retrieval system, without permission in writing from the publisher.

ISSN 1063 5297
ISBN 978-1-936192-25-0
Preface

Before the law has even been fully implemented, the inadequacies of the regulatory approach underlying the Dodd-Frank Act are becoming more and more apparent. Financial scandal by financial scandal, the realization is hardening that there is a pressing need to search for more robust regulatory alternatives. There are even increasing calls to break up the huge, multifunction financial institutions that dominate the sector in the United States. But this is only half a solution, at best. As Senior Scholar Jan Kregel makes clear in this policy brief, the most fundamental questions about a future financial structure remain unanswered by these proposals to break up the big banks. In the absence of effective antitrust legislation, it is far from a sure thing that we would not simply witness a fresh process of conglomeration through merger and acquisition. But even if breaking up the biggest financial institutions were to stick, this proposal does not tell us anything about the structure of the smaller institutions that would remain after such a breakup. If these smaller institutions are allowed to continue engaging in the same complex and risky activities that were at the center of the last financial mess, then we will have made little progress.

The real challenge for financial reform is to develop a vision for a financial structure that would simplify the system and the activities of financial institutions so that they can be regulated and supervised effectively. Some paths to such simplification, however, are not worth treading. Against the backdrop of renewed present-day interest in the Depression-era “Chicago Plan,” featuring 100 percent reserve backing for deposits, Kregel turns to Hyman Minsky’s consideration of a similar “narrow banking” proposal in the mid-1990s. For reasons that eventually led Minsky himself to abandon the proposal, as well as reasons developed here by Kregel that have even more pressing relevance in today’s political climate, plans for a narrow banking system are found wanting.

In the mid-1990s, Minsky was contemplating a proposal for a reformed post-Glass-Steagall architecture in which the deposit-taking and investment banking functions of the financial sector would be split into separate subsidiaries of a bank holding company. The deposits of the deposit-taking subsidiary would be backed by safe, liquid assets by requiring 100 percent reserves in government bonds or currency, and investment banking would be conducted by a separate subsidiary with a 100 percent ratio of capital to assets. When looking at such a system, we might be tempted to say that, if these separate subsidiaries were appropriately capitalized, this would stave off many of the problems that plagued the financial system in the last meltdown, including the need to bail out institutions engaged in speculative trading in order to save the payments system.

But for reasons elaborated on by Kregel, such a narrow banking structure is not, in fact, a solution to our problems. This narrow banking proposal would create a system in which voluntary savings decisions would completely determine investment decisions. This would be a system marked by a chronic tendency toward deflation, making it even more reliant on demand injections from the government. A perfectly separated system would effectively eliminate leverage and liquidity creation; for all intents and purposes, it would eliminate banking. Banks would not be able to finance the process of “creative destruction” essential to innovation. On top of all this, 100 percent reserve banking would still not ensure the stability of capital financing institutions—or the stability of the real economy.

Dodd-Frank, before it has even been finalized, may already be outmoded and outdated. The regulatory regime fashioned by the 2010 law, old before its time, will need to be replaced with a simpler alternative, preferably before the next crisis comes bursting through its numerous gaps and loopholes. But narrow banking is not the answer.

As always, I welcome your comments.

Dimitri B. Papadimitriou, President
August 2012
Introduction

The recent losses at JPMorgan Chase, the money laundering activities of HSBC, and the recent discovery of collusive activity to influence the London Interbank Offered Rate by the money market desks of some of the largest global banks, some two years after the adoption of the Dodd-Frank Act, have led to calls for a more rigorous approach to the regulation of large multifunction banks that are clearly too big to manage and too big to regulate. One response has been to suggest a simple breakup of the largest banks.

Both the president of the Federal Reserve Bank of Dallas, Richard Fisher (2012), and the former president of the Federal Reserve Bank of Kansas City, Thomas Hoenig (2009), have formally proposed the dissolution of the largest complex US financial institutions that dominate the financial system. But this proposal deals only with the size of financial institutions; it does not indicate what the structure of the smaller institutions should be. Creating a greater number of smaller, independent financial holding companies would not necessarily simplify supervision if these companies were still dealing in multiple types of complex, interconnected financing activities involving structured lending instruments. Simply making institutions smaller need not make them safer and more stable, if they are permitted the same range of activities involving the same types of financial instruments. And in the absence of effective antitrust legislation, breaking up the larger institutions would in all likelihood simply be followed by another process of concentration by merger and acquisition similar to that seen after the suspension of branching restrictions.

In response to this problem, others have suggested a return to a regulatory framework closer to the Glass-Steagall Act’s separation of the commercial and investment banking functions of finance in different legal institutions. As Hyman Minsky noted, one little-appreciated benefit of the 1933 act was that “the scope of permissible activities by a depository institution was to be limited to what examiners and supervisors could readily understand. ... It was not so much the differences and riskiness as it was the ease of understanding the operations that led to the separation of investment and commercial banking” (Minsky 1995a, 5). In other words, Glass-Steagall’s limits on the size and activities of financial institutions should make it easier for regulators, supervisors, and examiners to understand and monitor institutions’ operations.

In his considerations of possible improvements in the structure of the financial system, Minsky suggested that the benefits of simplicity and transparency inherent in Glass-Steagall might be preserved within a bank holding company structure by restricting the permissible assets and liabilities of the separate subsidiaries. In a number of documents prepared for the mid-1990s discussions of the reform of Glass-Steagall, Minsky proposed,

One or more subsidiaries of a post Glass-Steagall bank holding company will have monetary liabilities. These subsidiary institutions will enjoy protections from the central bank and treasury which guarantee that their monetary liabilities will not fall to a discount from their face value. ... In exchange for this protection the assets they can own will be restricted. A representative post Glass Steagall bank holding company will have specialized financial subsidiaries which include not only a combination of commercial, investment and merchant banking subsidiaries but also a sampling of more specialized financial institutions such as credit card operations, payment operations, finance companies and the brokering and underwriting of insurance. Each subsidiary will have a dedicated equity, which protects the holders of the liabilities of the subsidiary. (Minsky 1995c, 3)

Minsky drew out the implications of such a system: “once the distinction between the payments and financing operations of banks is recognized, it follows that post Glass Steagall banking firms will be structured as bank holding companies in which the payments subsidiary is clearly separated from the financing subsidiaries. In exchange for this protection the assets of the payments subsidiary will be limited to government debt and interest earning accounts at the Federal Reserve: the assets of the payments banks will not include business and household liabilities” (10–11). Thus, the “holding company structure of post Glass Steagall banking [would] quite naturally lead to 100% money” (12). But such proposals are not new. The National Banking Act was based on government liabilities backing the issue of national banknotes. It was also an integral part of Henry Simons’s “Positive Program for Laissez Faire” (1934) and supported by Irving Fisher (1935). It was revived by Milton Friedman (1959), and was part of formal reform proposals made by James Tobin (1987) and Robert Litan (1987), among others, in the 1980s.
discussions of bank reform, as well as by Ronnie Phillips (1995). As the failings of Dodd-Frank become more and more obvious, these proposals have again become part of the active discussion of regulatory reforms.

In this approach, a single subsidiary would be dedicated to the provision of deposit-taking transactions services, while other subsidiaries would provide investment and merchant banking services. If all subsidiaries were sufficiently and separately capitalized, it is argued that there could be no problem of “bailing out” speculative activities to save the payments system, there would be no possibility of using customer deposits for proprietary trading and speculation, and, with appropriate balance sheet restrictions on the transactions subsidiary, even the moral hazard created by deposit insurance could be eliminated.

**Minsky’s “vision” of the economic system and “narrow banking”**

For Minsky, it was the fact that “development financing involves taking risks” that created the need 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 protection of the payments system from the consequences of the losses which may ensue from development financing” (Minsky 1994, 10–11). As a result, Minsky characterized the role of the financial system as servant to two mutually conflicted masters: “any capitalist banking and financing system,” he wrote, is “drawn between two masters” that it “needs to serve: one master requires assurance that the financing needed for the capital development of the economy will be forthcoming and the second master requires assurance that a safe and secure payments mechanism will be provided.” It is clear that Minsky considered the narrow bank proposal as a way for the financial system to meet its basic objectives of financing the capital development of the economy and providing a safe and secure payments system by insuring that “the payments and the financing of the capital development of the economy functions will therefore be separated in a post Glass Steagall banking structure” (Minsky 1995c, 8).

Minsky’s adaptation of the Simons/Fisher proposal may thus be seen as an attempt to ensure financial stability by separating financial institutions by function, or “master,” so that each would serve only one master. Banks that provide payment services can be made perfectly safe and secure by requiring 100 percent reserves in government currency and coin or other risk-free government liabilities. The financing of the capital development of the economy would then take place via retained earnings of corporations or by means of investors’ conscriptions committed to financing specific private business activities. Organized and supervised as an investment “trust,” such an institution would have a 100 percent ratio of capital to assets and thus should not be considered a threat to the financial stability of the economic system.

The most important implication of this proposal is that in such a perfectly separated, dual system there would be neither a deposit-credit multiplier, nor leverage, nor creation of liquidity. This point was raised in the context of the Diamond-Dybvig model of the existence of banking by Neil Wallace (1996), who interpreted “the narrow banking proposal as one requiring the banking system to be liquid without any reliance on liabilities subordinate to deposits,” and concluded that “the narrow banking proposal eliminates the banking system” (7–8).

However, there is another drawback of the proposal that was not raised in the mid-1990s discussion and is even more relevant in today’s political environment. The proposal would create a financial system that would respect Hayek’s idea of “neutral” money, in which all investment decisions are the consequence of the voluntary savings decisions of individuals. The Wicksellian alternative formulation of this condition is the equality of the nominal rate of interest and the “real” rate of return on investment. The idea of this approach was to eliminate any “monetary” disturbances to equilibrium in the “real” economy so that savings determine loanable funds available for investment.

While a financial system that was regulated via a 100 percent reserve requirement on deposits and a 100 percent ratio of capital to assets for investment trusts would then appear to resolve the conflicting objectives noted by Minsky, such a system could neither ensure the stability of the real economy nor assure stability of the capital financing institutions. First, the real investments chosen could still fail to produce the anticipated rate of return; and second, sectoral overinvestment and financial bubbles could still exist if there were herding behavior by the investment advisers of the trusts that produced procyclical financing behavior. There would always be a risk of investors calling on the government to save them from financial ruin.
Narrow banking and a “monetary production economy”

Indeed, for Minsky and Schumpeter, such a “narrow banking” system could not be considered a modern “capitalist” system; it would be akin to what John Maynard Keynes defined as a “real wage,” as opposed to a “monetary production,” economy. In a monetary economy, it is the role of the financial sector to ensure the financing of the acquisition and control of capital assets by increasing the liquidity of the liabilities of the business sector.

But more important, such a system would create an additional problem for what is now called “macroprudential” regulation. In a narrow banking system the liabilities of the financial system would be composed of (1) investment fund shares representing household savings and business profits used to finance real investments; (2) deposits held by households and businesses in the narrow banks backed by government debt or currency and coin; and (3) government-issued coin and currency held by households and firms.

In such a system it is evident that total private saving would exceed investment by the private sector’s holdings of narrow bank deposits and government currency, creating a tendency toward deflation or recession. Price and/or output stability would require an exogenous addition to demand to offset this imbalance, such as might be provided by government expenditures financed by the issue of either currency or government bonds, if such issues were held as reserves for the narrow banks or the direct discounting of business sector liabilities.

Alternatively, the central bank could engage in the direct financing of public or private sector investment expenditures. The “macroprudential” stability of the financial system would then require the application of what Abba Lerner (1943) called “functional finance.” The size of the deficit creating the additional government means of payment required for macroprudential stability would be determined by the private sector holdings of narrow bank deposits and currency, adjusted for the current account position.

Thus, what Minsky believed was the major factor stabilizing the postwar Glass-Steagall system—the existence of a “Big Government” deficit providing a floor under private sector incomes—would become even more important in a narrow banking system holding company structure than it was under Glass-Steagall. Indeed, Minsky’s use of the Keynes-Kalecki profits equation was meant to show that it is primarily the generation of corporate income resulting from investment expenditures that allows current profits to cover the cash flows associated with the liabilities issued to finance investment. It is the level of business investment and government net expenditure that generates the cash flow that validates the corporate liabilities and produces the real source of financial stability in the system.

In the absence of a large government sector 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 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 government development bank could finance innovation through the issue of debt monetized by the central bank. To meet the requirements of the “two masters,” such a system would have to combine Keynes’s idea of the “socialisation of investment” with the “socialisation” of the transactions-and-payments system. This suggests that in order to satisfy Minsky’s “two masters,” the real problem that must be solved lies in the way that regulation governs the provision of liquidity in the financial system.

The “two masters” are Siamese twins.

In the modern capitalist system that Minsky analyzed in his financial fragility hypothesis, two different types of financial institutions provide the liquidity required for the financing of Schumpeterian creative destruction. The control of real assets by productive enterprises can be financed through the issue by a financial institution of liabilities that can be used as a means of payment in lieu of the coin and currency issued by the government. This is what is commonly known as “deposit creation,” and it has traditionally been provided by what in the Glass-Steagall regulatory system were called “commercial” banks. Alternatively, productive enterprises can issue securities through the services of financial institutions that provide liquidity by acting as primary and secondary market makers offering to buy and sell the securities at announced bid-ask spreads and in standard amounts. These have traditionally been known as “investment,” or merchant, banks.

Minsky considered deposit creation the basic activity of banks. He defined it as the “acceptance function”: “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. . . . A bank loan is equivalent to a bank’s buying a note that it has accepted” (Minsky 2008 [1986], 256). Thus, for Minsky the basic activity of a bank is not the safekeeping of depositors’ coin and currency, nor is it the investment of depositors’ funds because of an informational advantage. Rather, a bank’s basic activity is the creation of its own liabilities, which are used to acquire the liabilities of productive enterprises that it has “accepted”—that is, whose payment it has guaranteed. A narrow bank on this definition is not a bank, but simply a safe house or piggy bank for government issues of coin and currency. It is for this reason that Minsky eventually gave up his support for narrow banking and sought other alternatives to replace Glass-Steagall. The proposal has no more to recommend it today than it did in the 1990s.

Notes
1. In Wallace’s analysis the returns on short- and long-term investments are known. Minsky’s proposal would provide for a government guarantee to support the mark-to-market value of the assets.
2. In addition, there are theoretical difficulties in formulating the correspondence of real and money rates (see Myrdal 1965 [1939]) or neutral money (see Sraffa 1932).
3. This is a proposal from the General Theory that is more fully worked out in Keynes’s memoranda on postwar recovery policy. See Kregel (1985).

References


About the Author

JAN KREGEL is a senior scholar at the Levy Economics Institute of Bard College and director of the Monetary Policy and Financial Structure Program. He currently holds the positions of Distinguished Research Professor at the Center for Full Employment and Price Stability of the University of Missouri–Kansas City and Professor of Development Finance at the Tallinn University of Technology. During 2009 he served as Rapporteur of the President of the United Nations General Assembly’s Commission on Reforms of the International Monetary and Financial System. He was formerly chief of the Policy Analysis and Development Branch of the UN Financing for Development Office and deputy secretary of the UN Committee of Experts on International Cooperation in Tax Matters. Before joining the UN, Kregel was professor of economics at the Università degli Studi di Bologna, as well as professor of international economics at Johns Hopkins University’s Paul Nitze School of Advanced International Studies, where he also served as associate director of its Bologna Center from 1987 to 1990. He has published extensively, contributing over 200 articles to edited volumes and scholarly journals, including the Economic Journal, American Economic Review, Journal of Economic Literature, Journal of Post Keynesian Economics, Economie Appliquée, and Giornale degli Economisti. His major works include a series of books on economic theory, among them, Rate of Profit, Distribution and Growth: Two Views, 1971; The Theory of Economic Growth, 1972; Theory of Capital, 1976; and Origini e sviluppo dei mercati finanziari, 1996. His most recent book is International Finance and Development (with J. A. Ocampo and S. Griffith-Jones), 2006.

Kregel studied at the University of Cambridge, and received his Ph.D. from Rutgers University. He is a life fellow of the Royal Economic Society (UK) and an elected member of the Società Italiana degli Economisti.