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Removing the basic flaw in deposit insurance leads automatically to full reserve banking.

Ralph S. Musgrave.

Abstract.

Deposit insurance is beneficial in that it ensures everyone has a safe method of storing and transferring money. That is a basic human right. Unfortunately deposit insurance also supports a **commercial activity**, namely depositing money at a bank with a view to the bank earning interest for the depositor, which a bank can only do by in effect lending out depositors' money. That is just as commercial as depositing money with a stockbroker, mutual fund or unit trust with a view to interest or some other form of return being earned. And it is not the job of government to support commercial activities. As for the idea that banks create the money they lend out, rather than intermediate, that is dealt with in the opening paragraphs below.

Preventing deposit insurance assisting the above commercial activity while retaining a form of totally safe deposits is easily done by splitting deposits into two types: first, those where the depositor simply wants money stored safely, with that money being lodged at

the central bank where it earns no interest, and second, those where the depositor wants to be into commerce. Interest is earned on the latter deposits, but depositors carry the risk involved which essentially turns those deposits into equity. And that is precisely what full reserve banking consists of.

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Definitons.

1. The phrase “fractional reserve” refers here to the existing bank system: one where commercial banks are funded partially via equity and partially via deposits, with those deposits being protected by government run deposit insurance (DI). Plus only a “fraction” of deposits are matched by reserves held by commercial banks at the central bank.

2. “Full reserve banking” (also known as “narrow banking”, “100% reserve banking” and “Sovereign Money”) is used here in a conventional manner: to refer to a system where the bank industry is split in two. One half accepts deposits which are declared to be totally safe, but as befits that declaration, nothing remotely risky is done with those deposits. For example depositors’ money is simply lodged at the central bank. The second half of the industry (run by firms or subsidiaries which are essentially separate from the first

half) grants loans, but those loans are funded entirely by equity, not safe deposits.

Do banks lend on depositors' money?

The first objection some readers may have to the above abstract is the above suggestion that banks lend on depositors' money. The reason for that objection is that it has become popular recently to emphasise that commercial banks (henceforth just "banks") create money when they lend rather than use depositors' money to fund loans, or put another way, rather than intermediate between lender/depositors and borrowers.

In fact as the second sentence of McLeay et al. (2014) explain, banks **both** create money **and** intermediate between lender/depositors and borrowers. And the reason banks do in fact intermediate can perhaps best be illustrated by considering a hypothetical bank which tries to simply create and lend out money without bothering to attract money from depositors, bond holders etc. If a bank did that, most of the money loaned out would be deposited at other banks, who would then want reserves off the original bank so as to settle up. The original bank would then have to borrow reserves from other banks or the central bank: not a good position to be in for too long.

The only possible escape from the latter “bad position” would be if the loans the new bank made were far more profitable than normal for banks, in which case the new bank would be able to afford interest paid to other banks in respect of borrowed reserves. But it is risky for a bank to assume its loans will remain much more profitable than those of other banks. So the conclusion is that banks are, as McLeay et al. suggest very much into intermediation, i.e. lending on depositor’s money.

Banks are not the only lenders.

A second reservation some readers may have about the above abstract is that instead of placing safe money at the central bank, where it does nothing, it might seem that benefits would derive from putting that money to use, e.g. if that money, or at least some of it, was loaned out to borrowers.

Unfortunately there are at least three flaws in the latter idea. First, as already intimated, the result is that government supports a commercial activity. The exact extent of that support can vary between DI which is run on strictly commercial lines and in contrast, DI run on a subsidised basis assisted by multi billion dollar loans at near zero rates of interest for banks in trouble which we saw (gratis

the Fed) in the aftermath of the 2007/8 bank crisis. The latter form of blatant subsidy for banks is clearly unjustified.

But even if support is limited to DI in the narrow sense of the phrase and run on strictly commercial lines, that is still not justified because banks are not the only form of lender. (Incidentally, if by any chance DI in whatever form provides no sort of boost at all for banks, then DI in its present form plus fractional reserve is a farce because it means accepting the downside of fractional reserve (bank crises etc) without any compensating advantage.

As to lenders other than banks, there are pension funds, mutual funds, cash rich corporations and wealthy individuals who lend to corporations when they purchase corporate bonds. Plus there are millions of people who lend to small and medium size businesses run by family members or friends. Indeed, almost every firm in the country is a lender in that firms normally allow other firms a few weeks if not months before paying for goods delivered.

Now if banks are given assistance in the form of DI provided by an insurer with an infinitely deep pocket (i.e. government), then other lenders should be free to avail themselves of that benefit, otherwise there will not be a level playing field as between different types of lender, as pointed out by Hoenig (no date given), former vice-chairman of the Federal Deposit Insurance Corporation.

Of course the complexity and bureaucratic cost of offering taxpayer backed assistance for every type of lender would be horrendous. In short, the idea that banks or lenders in general should enjoy that sort of assistance amounts to entering a mine-field, which is strong evidence that the entire idea of taxpayer backed assistance for lenders of any sort, banks included, does not stand inspection.

Moreover, the latter reductio ad absurdum gains support from the fact that government employed bureaucrats are easily fooled, with taxpayers footing the bill: i.e. in a system where anyone holding liabilities of any firm (bank or non bank) can have those liabilities insured by the state against loss, everyone would try to have the state insure liabilities with hidden problems, while insuring liabilities which they know perfectly well to be safe themselves. That phenomenon, namely cheating taxpayers, is something that banks have proved themselves experts at over the decades.

Bankers' blandishments.

Apart from bureaucrats, politicians have over the decades proved themselves incapable of resisting bankers' blandishments. For example the finance industry in the UK spends about £100 million a year lobbying politicians (see Mathiason et al. (2012)). And as to the US, as Senator Richard Durbin said in relation to bankers and Capitol

Hill “frankly they own the place” (see Watson (no date given). That is, while a commercially viable DI system may sound desirable, the reality is that once it is introduced, bankers will very likely persuade politicians to charge them an insurance premium below the commercially viable rate. Indeed, up to quite recently, banks in the UK were not charged at all by government for DI: a complete farce! And for another and slightly different example of bankers’ blandishments working a treat, Sir John Vickers, chairman of the main UK investigation into banks in the wake of the 2007/8 bank crisis said, bank regulations are still not good enough (see Clements (2017).

And the reason banks fool politicians so easily was set out very nicely by Paul Volker, former chairman of the Fed. As he put it, "Just about whatever anyone proposes, no matter what it is, the banks will come out and claim that it will restrict credit and harm the economy....It's all bullshit".

In other words bankers only have to tell politicians that withdrawing any sort of featherbedding for banks will cut growth, and politicians believe it often as not! The trick there is obvious – well obvious to everyone apart from politicians. That is, it is perfectly true that if assistance for banks is withdraw then **all else equal** growth will fall. But of course all else does not need to be equal: that is, any deflationary effects of less bank activity can very easily be countered

via stimulus, monetary and/or fiscal. The net result would be much the same **overall** level of economic activity, but with less lending / debt based activity and more non lending / debt based activity.

The conclusion is that as soon as governments offer **any sort** of assistance for banks, even just DI run on strictly commercial lines, bankers will try every trick in the book to get ever increasing amounts of taxpayers' money from politicians, which is a good argument for abolishing all forms of government support for banks.

The third flaw.

The third flaw in the idea that the stock of safe money that exists under full reserve should be loaned out is that that stock has to be largely or wholly destroyed if it is in fact loaned out and for the following reasons.

When DI was first introduced, the effect was to convert a significant amount of banks' liabilities from what can legitimately be called "unsafe money / equity" into safe money, or if you like, "real money". But that increased stock of money will have increased demand (all else equal) since peoples' weekly spending varies with the size of their stock of money. Thus if the economy is at capacity when DI is introduced, government has to impose some sort of countervailing deflationary measure, like raising taxes and

confiscating some of the private sector's stock of money: presumably an amount that is more or less equal to the latter increased stock.

To put that another way, full reserve certainly restricts what can be done with money, but it cannot be automatically concluded that any deflationary effect stemming from that is harmful, because increasing the stock of money to compensate for those restrictions is very easily done: new central bank created money can be created simply by pressing buttons on computer keyboards, which costs next to nothing. Conversely, abandoning full reserve and reverting to fractional reserve plus DI does not mean large amounts of extra money becomes available to spend or invest. The reality is that much of, or all of that money has to be withdraw.

We've had totally safe accounts for decades.

Another minor point in favour of totally safe accounts is that such accounts have actually been available for decades if not centuries without causing any obvious problems. For example there are state run savings banks in some countries ("National Savings and Investments" in the UK). NSI accounts are not quite as flexible as normal bank accounts, for example they do not offer debit cards, but there is no reason they should not, and if they did, then NSI accounts would essentially amount to Central Bank Digital Currency accounts.

And apart from NSI type accounts, the wealthier section of the population have always been free to buy government debt, which (at a stretch) is a form of totally safe account. And as to the US, the function performed by NSI is performed by mutual funds which invest just in government debt.

Deposit insurance hits the innocent.

Another problem with DI is as follows. The popular and naïve view of DI is that government stores up money it earns from insurance premiums in good years and then pays out money from that store in years when there are more than the usual number of bank failures. But there's a problem there, as follows.

Governments also attempt to minimise unemployment in as far as is compatible with hitting the inflation target, i.e. governments try to bring about full employment in the latter sense. Now assuming government more or less achieves that objective and it then has to spend more than the usual amount by way of compensation for depositors who would otherwise lose their money, then government will have to rein in spending in other areas, or raise taxes if demand is to remain constant.

But that's a blatant injustice: it involves people who have had nothing to do with silly loans suffering the inconvenience of their take home pay fluctuating. Now who should be made to suffer the latter inconvenience? Should it be people who have had nothing to do with granting or taking out those loans, or should it be those responsible for such loans, i.e. those who have funded the loans or taken out the loans?

Well it's pretty obviously those **responsible** for loans who should bear the inconvenience. If I sign a contract with a decorator to re-decorate my house and the decorator makes a hash of it, there is no obligation on the community at large to compensate me. It was my fault for not doing enough checks on the decorator.

Indeed, perhaps the most glaring example of those who have had nothing to do with bank incompetence being made to bear the cost came in the aftermath of the 2007/8 bank crisis: government and central banks dished out billions to Wall Street bankers, money which could have gone to those who suffered the consequences of bank incompetence, i.e. those on Main Street. Of course that form of support for banks was not DI strictly speaking, but it certainly was support for banks in a broader sense.

Moreover, it is not only justice or injustice that is involved in the above question as to who should bear the cost when lenders and borrowers make a hash of it: there is also a strictly economic point here, and as follows.

The free market involves voluntary participation.

DI in its present form is not a free market arrangement. Reason for that is that a free market is a system where all participants do so **voluntarily**, and it is widely accepted in economics that free markets maximise GDP, except where it can be shown that aspects of the market are quite clearly **not maximising** GDP: for example where externalities arise.

In other words if those who wanted their deposits to be insured took out insurance with a private sector insurance company, that would be an entirely voluntary arrangement: in bad years, shareholders in the insurance company would be hit, but they would have no reason to complain because that is what they signed up for when buying shares in the insurance company.

In contrast, state run DI involves **coercion**: a proportion of those who are hit in bad years (e.g. the above mentioned residents of Main Street) have no choice but to take a hit. That is not a free market arrangement. Thus a not unreasonable assumption is that it is an

arrangement which does not maximise GDP. (Or for those who do not want to see GDP increased for environmental reasons, an alternative "not unreasonable assumption" is that "that is an arrangement which does not" maximise output per hour with the average number of hours worked per week being cut pari passu.)

Similarities to health insurance.

It might seem there is a flaw in the latter insurance point, as follows. It might seem that DI is similar to state run health insurance, like the National Health Service in the UK. With NHS type systems, obviously those who are not responsible for particular illnesses sometimes find themselves footing the bill for those illnesses, the current Covid virus being an example.

But there is an important difference between DI and NHS type systems. NHS type systems were set up for **moral or social** reasons, not commercial reasons. That is, the view of the population at large (in the case of the UK just after WWII) was that some sort of basic medical attention was a human right.

But that type of social point cannot be applied directly to DI because DI is partly about matters **commercial**: i.e. government support for those who want their money loaned out.

In particular, and to repeat, where anyone deposits money at a bank with a view to the bank earning them interest, that is every bit as commercial as depositing money with a stock broker, mutual fund, unit trust etc for the same purpose.

Uninsured deposits.

Having argued above against letting banks fund loans via insured deposits it is clearly of relevance to mention what is in some senses a relatively new form of money, namely **uninsured** deposits. Some US banks have recently applied for the right to issue such deposits (Martens and Martens (2020).

Those non government backed "promises to pay" (i.e. deposits) would seem to be a legitimate free market activity, as long as it is made very clear to anyone invited to hold that money that there is no government backing.

Also those uninsured deposits are not as novel as they might seem. Bank issued money is a promise to pay base money, and uninsured promises to pay are actually very common. For example bonds issued by corporations are uninsured promises to pay. Plus when one firm delivers goods to another, the second implicitly if not formally

gives the first a promise to pay. Plus there is Bitcoin which, if not a promise to pay, is certainly an uninsured form of money.

To summarise, uninsured deposits would seem to be a legitimate free market phenomenon, as long as they are clearly and openly declared to be uninsured. What would certainly be unacceptable would be a return to the days prior to the introduction of DI when banks suggested that deposits were safe, when in fact they quite clearly were not, because those banks were at the same time lending out money, which meant that when unwise loans were made, banks could not repay depositors their money.

Objections to full reserve.

A large number of objections have of course been raised to full reserve banking. Those objections are very easily demolished, and I demolished large numbers of them in section two of Musgrave (2018). Plus some risible arguments were put by Mervyn King, former governor of the Bank of England and by Charles Goodhart, former member of the Bank of England Monetary Policy Committee dealt with in Musgrave (2020a) and Musgrave (2020b) respectively.

Conclusion.

It has long been obvious that there is something seriously wrong with our bank system. Hopefully the above paragraphs have put some good arguments for the full reserve banking solution, a solution supported by many economists – see Musgrave (2020c) for a list of them. Full reserve disposes of the subsidy for banks that is inherent to full reserve plus deposit insurance. Plus under full reserve, bank failures are impossible because if a bank makes silly loans, all that happens is that the value of its shares decline: the bank does not actually go bust. That of course would not totally dispose of "boom and bust", in the form of 2007/8 type bank crises or in other forms, but it would help.

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