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Abstract.

Sir John Vickers (Chairman of the UK's Independent Commission on Banking (2011)), published a discussion paper entitled "Some Economics of Banking Reform" (Vickers (2012)). This is my contribution to the "discussion", that is, I make some criticisms of the paper. The Independent Commission on Banking is referred to as the "Vickers commission" below, while the word "Vickers" (without an accompanying date) refers to his 2012 discussion paper.

Two central points in Vickers's paper are addressed here. First Vickers defends the existing banking system partially on the grounds that it engages in "borrow short and lend long", i.e. "maturity transformation" (MT), which Vickers claims brings a large benefit. Vickers makes the standard claim for MT, namely that depositors gain the additional interest that comes from having their money invested in long term loans or investments while still retaining quick access to their money, i.e. liquidity. One flaw in that argument is that MT involves risk, a risk which went wrong around five years ago and would have crashed the world economy far more seriously than it actually did, had banks not been rescued with trillions of dollars of public money.

A second flaw in MT is that if it is curtailed, the resulting reduced quantity of money / liquidity can be made good at zero real cost by having central banks issue more money. And that involves no risk of the bank runs, credit crunches and so on that are inherent to MT. Thus the case for MT is badly flawed.

The second central point addressed below, in Part II, is Vickers's claim that full reserve banking or "narrow banking" as he calls it, is defective.

The paragraphs below are not supposed to be a REVIEW of Vickers's paper: to repeat, it is just the above two points made in the paper which are considered here.

That is, there are various parts of Vickers's paper which I agree with, or which I am not qualified to judge.

Part I. Maturity Transformation.

As pointed out in the abstract above, Vickers defends an aspect of the existing banking system, namely that it engages in MT. Whether the phrase "existing banking system" is taken to mean the existing system enhanced by Vickers's ring fence proposals or not does not greatly matter because it is MT **as such** which is discussed here.

On p.5 Vickers advocates MT. He says: *"banks engage in maturity transformation insofar as they 'borrow short but lend long'. This brings huge efficiency benefits.....It is efficient because it reconciles the freedom for depositors to meet their short-term liquidity needs with the financing of long-term lending both to households (e.g. residential mortgages) and for corporate investment."*

To rephrase that quote, when people deposit money at commercial banks and banks lend on that money to mortgagors and so on, depositors can have instant access to their money (i.e. liquidity of a sort) while they also share in the benefits of the relatively high interest rates that are earned from making long term loans.

(Incidentally, any readers who think that banks simply lend out money they've created out of thin air, and do not in any sense act as intermediaries between lenders and borrowers, please see this [article](#). Commercial banks actually perform BOTH activities: create fresh money AND ACT as intermediaries.)

However, loans can be funded not entirely from deposits but also, to a greater or lesser degree, via shareholders. For example in contrast to the 3% or so capital ratio that was common before the recent crisis, Martin Wolf advocates a 25% or so capital ratio (Wolf (2012)). And under Laurence Kotlikoff's version of full reserve banking (FR), loans are funded ENTIRELY by shareholders (effectively a 100% ratio). Or to be more accurate, under Kotlikoff's version of FR, loans are funded by people who buy into mutual funds ("unit trusts" in the UK), but those people amount to shareholders. (Klein (2013) gives a good summary of Kotlikoff's version of FR).

In the latter sort of scenarios there is clearly less MT. That is, there is a loss of liquidity, i.e. the money supply would contract. (For the exact reasons, see endnote 3). But that would be no problem because it would cost nothing in real terms to supply the economy with extra money: the central bank could just create new base money and spend it into the economy, and/or cut taxes. As Milton Friedman (1960, Ch3) put it in reference to base money, *"It need cost society essentially nothing in real resources to provide the individual with the current services of an additional dollar in cash balances."*

Incidentally, even if there were no central banks, and savers who funded loans had to lock up their money for extended periods, COMMERCIAL BANKS would actually be able to make good the resulting loss of liquidity. (For more on that, see endnote 1 below).

To summarise this section, intermediaries that connect savers and borrowers make sense in that lending requires various skills, including legal skills. However, making the relevant savers' investment highly liquid (aka MT) is totally unnecessary, because central banks (at zero cost) can issue whatever amount of liquidity / cash is needed to keep the economy operating at capacity or full employment (aka NAIRU).

Having depositors fund lenders means bank fragility.

Moreover, there is a serious problem involved in having commercial banks (or more generally “lending entities”) funded by depositors: depositors can withdraw their money on demand or at short notice, and if depositors withdraw too much, the relevant bank is insolvent.

For example, if a bank is funded about 3% by capital and about 97% by deposits or other debt (which was common prior to the recent crisis), the value of the loans made by a bank only has to fall by slightly more than 3% (e.g. when it is discovered that incompetent loans have been made), and the bank is technically insolvent. And if faith in the bank is lost, a bank run starts, leading to ACTUALLY insolvency.

That system is defective, to put it mildly. And it’s not just the recent crisis that demonstrated that the existing system is defective. According to Robert Peston (2012, Ch1) various large UK banks were in dire straits in the 1970s, 80s and 90s. There has to be a better way to run a railroad.

And as distinct from depositors, funding loans via bonds and loans from the wholesale money market poses an equally serious problem (as Northern Rock discovered). Loans from the wholesale market amount to little more than very big depositors.

As to bonds, they have in common with deposits the fact that they represent a liability which (on maturity) is fixed in value (inflation apart), though repayment i.e. “maturity” may not be for several years. (That is as distinct from shares which have no fixed value).

Commercial banks cannot give us liquidity without fragility.

In short, there is a big problem with commercial bank provided MT or liquidity, which is that that method of liquidity or money creation gives us fragile banks and worse: bank runs, and credit crunches as a side effect.

Indeed, the latter point was made by Douglas [Diamond](#) (1999). In his abstract and in reference to the liquidity producing characteristics of commercial banks he says, *“We show the bank has to have a fragile capital structure, subject to bank runs, in order to perform these functions.”* And Vickers himself says *“Banking, including retail banking, is inherently risky.”*

To summarise so far, the “huge efficiency benefits” of MT to which Vickers referred in the above quote are beginning to look unimpressive.

Decent capital ratios and government guarantees.

Of course the latter fragility can be reduced by requiring banks to have decent capital ratios and/or having government stand behind private banks. But the problem with having government stand behind private banks (e.g. offer the “lender of last resort” facility or deposit guarantees) is that in practice that usually amounts to a subsidy of private banks. IN THEORY, those types of support for banks need not amount to a subsidy, but in practice, and because of political pressures, they normally do amount to subsidies. (Politicians always prefer quickly papering over cracks to implementing fundamental reforms). And as it explains in the introductory economics text books, subsidies misallocate resources and reduce GDP (unless there are very good social reasons for subsidies, as is the case for example with children’s education). Or as

the Vickers commission final report put it *“The risks inevitably associated with banking have to sit somewhere, and it should not be with taxpayers”*.

But lender of last resort (LOLR), deposit guarantees, etc do not really influence the argument here and for the following reasons. If those types of support for banks are in fact subsidies, they misallocate resources and are unjustified. But if they are not subsidies, then they are compatible with the arguments put here, namely that banks should be treated like any other business: that is, no special favours should be extended to banks by governments (i.e. taxpayers).

A further weakness in LOLR is thus. Walter Bagehot is often said to have given his blessing to it. Indeed Vickers cites Bagehot in support of LOLR. In fact Walter Bagehot did not approve of LOLR. In the last chapter of his book “Lombard Street” he said he did not intend opposing it because he thought it was so entrenched that it would be near impossible to remove.

Deposit insurance is flawed.

As to deposit insurance, clearly if that is funded by taxpayers, it amounts (to repeat) to a subsidy of banking, which does not make economic sense. But deposit insurance does not actually make much sense even when it is funded by depositors and for the following reasons. (Incidentally it might seem that deposit insurance of the self-funding FDIC type in the US is paid for by banks, not depositors. In fact any payment made by a corporation, if it calculates its costs correctly will be debited to the people or products that occasion that payment.)

Suppose a bank is funded entirely or almost entirely by depositors (to take the extreme case), and suppose the risk of their being wiped out is 1%pa. Obviously the

appropriate insurance premium will be 1%pa of total deposits. But suppose instead, all those depositors had been shareholders. The chance of their being wiped out would be exactly the same (assuming the bank funds the same set of mortgages and other loans). Thus the return that depositors and shareholders would want in respect of that risk will be EXACTLY THE SAME. Ergo assuming that depositors insure themselves rather than being insured by taxpayers, banks are not funded any more cheaply when funded by entirely by depositors as distinct from entirely by shareholders.

The only difference between those two scenarios is as follows. When depositors do the funding, and assets of the lending entity fall in value far enough relative to the value of liabilities (say assets fall to X% of liabilities) the entity is declared insolvent and depositors get about X pence in the pound. In contrast, when shareholders do the funding and assets fall to X% of liabilities (if one can call shares a liability), all that happens is that the value of the shares fall to about X pence in the pound.

So what is achieved by having lending entities funded by depositors? All that is achieved is that the entity may go insolvent when it doesn't need to: not much of an achievement.

And indeed under Kotlikoff's version of FR, incompetence by lending entities does not result in insolvency. (Lehmans was a classic example: its liabilities never actually exceeded its assets – that is, it ran short of cash or encashable assets, not assets as such.)

As George Selgin put it in his book on banking (Selgin (1988)) "For a balance sheet without debt liabilities, insolvency is ruled out...". (Incidentally, that was an aside made by Selgin: his book did not actually advocate FR).

Incidentally there are other versions of FR, e.g. Milton [Friedman's](#), Positive Money's and so on. But Kotlikoff's is my preferred version, so I'll stick with that. There are a few details on the different versions of FR in Endnote 2 below.

Funding partly by deposits and partly by shares does not cut bank funding costs.

Of course it is possible to have a bank or other lending entity funded PARTIALLY by depositors and partially by shareholders, and indeed that is a more usual arrangement. And in that scenario, and given serious problems, shareholders are wiped out before depositors. But that still has no effect on the TOTAL RISKS involved in running bank, as Messers Modigliani and Miller explained. There is therefore no effect on the total charge made by shareholders, depositors and any other bank funders for funding the bank.

The Modigliani Miller theory (MM) has been criticised of course. But the criticisms are feeble. See this [paper](#) of mine, section 1.4 under the heading "Flawed Criticisms of Modigliani Miller." Also Vickers devotes several paragraphs to MM, and suggests a few possible weaknesses in the theory, but does not seriously question it.

To summarise so far, the liquidity produced by banks funded by depositors brings fragility with it (i.e. bank runs, and credit crunches). But that liquidity is useless because liquidity / money can be produced by central banks at zero cost. Moreover, funding lending entities via depositors does not result in banks being funded any more cheaply than when they are funded by shareholders. Ergo having lending funded by depositors is pointless: it involves risk and brings no benefits.

Thus the best set up for the lending industry is one in which lending is funded just by shares, while money is produced only by central banks, and that is exactly what full reserve banking (a la Kotlikoff) consists of. (Incidentally, while as just pointed out there are different versions of FR, having just central banks issue money is a characteristic they all have in common)

As to the central bank which issues money, that cannot fail either.

The price paid for bank capital does not equal its real cost.

Having said that there is no difference cost-wise between funding a bank via shares rather than deposits, bonds, etc, that is not quite how it works out in the real world, but that does not alter any of the above conclusions.

For example the tax treatment of capital and deposits and other types of debt is different in the real world. But the answer to that is that tax is an ENTIRELY ARTIFICIAL imposition and should thus be ignored for the purposes of working out REAL COSTS AND BENEFITS, which are the important criteria here.

Second, the cost of bank capital will currently doubtless be higher than the cost of debt because bank shareholders in the US have recently had to pay around \$100bn in fines for sundry crimes committed by banks and for which shareholders were not responsible. Yes that's billion, not million. (The people ACTUALLY RESPONSIBLE, i.e. sundry bank executives have got off Scott free.) But that again is an entirely artificial imposition: it does not reflect REAL costs and benefits.

As to the UK and other countries, similarly large fines have been born by bank shareholders.

Third, as capital ratios are raised, implicit subsidies are inevitably withdrawn. That is, and ignoring the fact that as capital ratios are raised the return demanded by shareholders declines because there are more shoulders to carry the risk, shareholders will want a bigger return when investing in a bank with a decent capital ratio as opposed to one where the ratio is ridiculously low and everyone knows that the risk is really being covered by taxpayers. But again, implicit subsidies are ENTIRELY ARTIFICIAL: they do not represent REAL COSTS OR BENEFITS.

Conclusion and summary of Part I.

Maturity transformation achieves nothing. First, while it produces liquidity i.e. a form of money, it can only do so while also giving us bank fragility. Moreover, the liquidity or money issuing function can be performed by central banks at zero real cost.

Second, having lending entities funded by depositors and bond-holders does not result in those entities being funded at any lower cost than where they are funded just by shareholders. Third, in the event of problems and where lending entities are funded just by shareholders, there is no need to close down lending entities. And having just shareholders fund lending entities is what Kotlikoff's version of full reserve banking amounts to.

And finally, exactly that policy is being imposed on money market mutual funds in the US at the time of writing. That is, funds which invest in anything other than government securities and base money will not be allowed to promise not to break the buck. (See [Weiner](#) (2014) and [SEC](#) (2014)). In short, FR is being imposed on money market mutual funds in the US, which very much calls into question any claims that FR is not workable or practical.

Part II. Narrow / full reserve banking.

The above paragraphs explained the flaws in the existing banking system and the flaws in MT and suggested that FR is a better system. Vickers's objections to FR are now considered.

Vickers actually uses the phrase "narrow banking" rather than "full reserve banking", but his definition of narrow banking (his p.15) amounts to the same thing as for example Werner's "full reserve banking" (Werner (2011)). It also comes to the same thing as Milton Friedman's "100% reserve" banking (Friedman ([1960](#), Ch3 and [1965](#)), and Laurence Kotlikoff's "limited purpose banking" . I'll use the phrase "full reserve" (FR).

Vickers's definition of FR (his "narrow banking") and his criticisms of it are as follows.

"So-called 'narrow banking' is the idea that the basic services of deposit-taking and payment systems should be separated from other, inherently risky, banking activities by a requirement that deposits are fully backed by safe liquid assets. This idea faces several problems. First, as the crisis has underlined, even government bonds are not necessarily safe liquid assets. Second, despite large government debts, there might not be enough government bonds to back retail deposits, especially of short- to medium-term maturity. Third, narrow banking could lead to a very inefficient misallocation of resources. Natural holders of government bonds such as pension funds would find them in short supply, while credit in the economy was deprived of a prime funding source – deposits. Narrow banking would also lose the natural synergy that exists between deposit-taking and the provision of overdraft facilities. Fourth, deposit-taking and payments systems are not the only banking

services for which continuous provision is essential; the same is true of some credit supply, which would happen outside the narrow bank. So narrow banking, despite entailing large economic costs, would not address a major part of the problem.”

1. Safety of government debt.

I'll take those points in turn. The first point (to repeat) was:

“First, as the crisis has underlined, even government bonds are not necessarily safe liquid assets.”

The answer to that is as follows.

There have of course been numerous governments throughout history which have defaulted on their debts. But if you live in that sort of country then obviously it is not wise to put your life savings into government bonds: better to keep your savings under the mattress or in the form of gold or a more trustworthy currency.

However, the “ring fencing” system which the Vickers commission advocated was based on the assumption that UK citizens are not living in some sort of Greece or Zimbabwe: it was based on the assumption that the UK government CAN BE TRUSTED. So Vickers cannot claim that government might be IRRESPONSIBLE when it comes to FR: that is not a fair comparison between the existing banking system (enhanced or not by Vickers’s ring fence proposals) and FR.

2. Not enough government debt?

Vicker’s next criticism in the above passage was thus.

“Second, despite large government debts, there might not be enough government bonds to back retail deposits, especially of short to medium-term maturity.”

The answer to that is that the above mentioned advocates of FR (Werner, Kotlikoff, etc) do not basically argue that safe accounts under FR should be backed by government debt. They advocated that it should be backed by base money. Or put another way, they advocated that where people want total safety (or something as near total safety as is possible in this world) the relevant money should be lodged at the central bank or be backed by base money.

However, government debt, short term debt in particular is very similar in nature to base money. That is, short term government debt is simply a promise by government to pay the holder of the debt some base money in the near future. And Milton Friedman (1960, Ch3) and other advocates of FR have indeed argued that SOME of the money which people want to be totally safe should be put into short term government debt. But if there is not enough (or indeed ANY) of such debt, that is not a big problem for FR because, to repeat, most advocates of FR argue that money in the safe half of the banking industry should be backed by base money, with backing in the form of government debt being an optional extra.

Another weakness in Vickers’s claim that shortage of government debt / bonds is a problem is that it is not entirely clear that government borrowing makes any sense at all. Certainly Milton Friedman argued for the abolition of government debt ([Friedman \(1948\)](#), see para starting “Under the proposal..”). [Mosler \(2010\)](#) argued likewise (see his second last paragraph). And [Kellerman \(2006\)](#) also questioned the logic of government debt.

So the “shortage” of government debt / bonds which Vickers claims to be a potential problem for FR, it not a problem at all. Indeed FR could function perfectly well where there is no government debt at all.

Of course that scenario would mean that those wanting their money lodged in a totally safe manner would get no interest (assuming government does not pay interest on reserves / base money). But my answer to that is “tough luck”. In particular, there is no obligation on one set of people to provide a form of saving that pays interest just because some other set of people want same. Moreover, people with large amounts of cash to spare are the better off, while it’s the average taxpayer who effectively pays the interest. Thus the mere fact of paying interest on reserves tends to increase inequalities. And finally it is arguably a bit of a cheek to demand total safety AND INTEREST. Reason is that interest can only be earned by lending out or investing money, and lending or investing money is never an entirely safe activity.

Put another way, if any given set of people want a profitable form of investment, and none is available, then it’s up to that set of people to create their own form of profit yielding investment: perhaps building houses to let.

Not enough base money?

Also, in connection with Vickers’s above point about there possibly not being “enough government bonds” to meet demand, that point could be extended to base money. That is, since base money and short term government debt are so similar, those of a “Vickers” persuasion might argue that by the same token, a shortage of base money might arise.

In fact it wouldn't because given an increased demand for base money, the state would just have to create about the quantity demanded. Put another way, if the private sector won't spend at a rate that brings full employment unless it is supplied with some given quantity of base money / government debt, then government just has to supply that base money / government debt if government wants to bring about full employment.

The latter point is nicely illustrated in Japan. The Japanese have a high propensity to save, or to be more accurate to save government bonds and/or base money. The result is that the Japanese government IS FORCED to issue a relatively large amount of debt. (Japanese government debt stands at over 200% of GDP).

But that is not to suggest that the supply of base money will EXACTLY equal demand on an hour by hour basis. However, any significant disparities between supply and demand can always be dealt with by manipulating interest rates, including having interest rates at a small negative level when appropriate. Also banks can maintain THEIR OWN stock of reserves / base money, and allocate some of that to customers when customers demand same.

Incidentally, the idea that the state is forced to supply whatever amount of debt and/or base money the private sector wants is widely accepted in Modern Monetary Theory circles.

To summarise, Vickers's fears about there not being enough government bonds are unfounded and for the following reasons. 1, there is no obligation on the state or any set of individuals to supply interest yielding bonds in the quantity wanted by savers. 2, in contrast, the state IS FORCED to supply whatever amount of base money the private sector (pension funds included) wants, but that "supply" would happen more or less automatically under any sort of well run government.

3. Allocation of resources.

Vickers's third point in the above passage is thus.

“Third, narrow banking could lead to a very inefficient misallocation of resources. Natural holders of government bonds such as pension funds would find them in short supply, while credit in the economy was deprived of a prime funding source – deposits. Narrow banking would also lose the natural synergy that exists between deposit-taking and the provision of overdraft facilities.”

As readers will doubtless notice, that point is a bit of a repetition of the second point dealt with above. But never mind: there is actually another point that can be made against Vickers's “shortage” claim and as follows.

Why does a shortage of government debt mean a “very inefficient misallocation of resources”? If demand for stock exchange shares exceeds supply, no one complains about a “misallocation of resources”. All that happens is that the normal laws of supply and demand kick in and the Dow or FTSE rises. Likewise, if there is increased demand for government debt, then its price rises and interest rates fall. As to why falling interest rates should be a big problem, Vickers does not tell us.

Moreover, there is yet another option for pension funds experiencing a shortage of government debt, and that is not to invest at all: they can always move towards an “investment free” system, that is a pay as you go system. The biggest pension system in the UK, the state pension system, is pay as you go, as are a proportion of private pension systems.

Deposits are a source of credit?

Vickers's next claim in his above third point is that separating deposit accepting from lending means the economy is deprived of a source of credit. That's the passage which runs

“credit in the economy was deprived of a prime funding source – deposits.”

What actually happens on converting to FR is that depositors have a choice. Either they can have their money lodged in a totally safe manner, in which case it is not loaned on, i.e. it is not used as a “funding source” (except perhaps being loaned to government). Alternatively, they can have some or all their money loaned on, i.e. used as a “funding source” or source of “credit”, but THEY THEMSELVES carry the risk if incompetent loans are made instead of taxpayers carrying the risk.

Now it is hard to see what is wrong with that especially since the Vickers commission and other regulators (to repeat) disapproved of subsidies for the private banking industry, and quite right. Subsidies misallocate resources, as explained in the economics text books, and result in reduced GDP.

Plus under FR there is no need for savers to take any significant risks in order to earn interest. That is, under FR savers have A CHOICE as to what to put their money into. If they want to put it into conservative mortgages (i.e. mortgages where mortgagors have a minimum 20% or so equity stake) they can. The chance of losing money on that sort of investment is vanishingly small.

To summarise, converting to FR does not, as claimed by Vickers result in borrowers being denied a “source of funding”. What happens is that they are funded, but on a commercial basis, rather than a subsidised basis.

Obviously that would result in a finite rise in interest rates (and a decline in total debts). But interest paid by mortgagors in the UK in the 1980s was up to THREE TIMES what they pay nowadays. That did not result in a widespread homelessness or an inability to buy houses. Plus economic growth was far better in the 1980s than during the last five years during which we have enjoyed the dubious benefits of very low interest rates.

Of course a SUDDEN rise in interest rates is best avoided, but a significant and SLOW RISE would do no harm.

Another point which weakens Vickers's claim about lenders being starved of funds is that he claimed a few sentences earlier that pension funds under FR would be SHORT OF ways of investing their funds.

Should deposits fund loans?

The next phrase in Vickers's above third point is thus.

“Narrow banking would also lose the natural synergy that exists between deposit-taking and the provision of overdraft facilities.”

That phrase, again, rather repeats a point already made by Vickers when he said “credit in the economy was deprived of a prime funding source – deposits” (a sentence dealt with above). However there is an additional point to be made in connection with those two sentences, as follows.

A problem with that claim is that it begs one of the BASIC QUESTIONS addressed by and solved by FR, which is thus.

Using deposits to fund loans means by definition that banks have liabilities that are FIXED IN VALUE and assets that can fall in value (when incompetent loans are made). And that is asking for trouble: indeed the world experienced several trillion dollars of “trouble” during the last five years. That is trillions of dollars of public money had to be used to deal with the consequences of the above risks involve in having deposits (and bonds) fund loans. In other words it is precisely the fact of funding loans via deposits rather than via shares that gives us bank “fragility”, to use Douglas Diamond’s phraseology.

FR solves that problem by having bank SHAREHOLDERS fund loans rather than depositors or bond holders.

Let’s leave the last word on that to the economics Nobel Laureate, James Tobin: “The linking of deposit money and commercial banking is an accident of history...”

4. Continuous provision of loans.

Vickers fourth criticism of FR is thus.

“Fourth, deposit-taking and payments systems are not the only banking services for which continuous provision is essential; the same is true of some credit supply, which would happen outside the narrow bank. So narrow banking, despite entailing large economic costs, would not address a major part of the problem.”

The first answer to that is the only reason the EXISTING BANKING SYSTEM managed to “continuously provide credit” over the last five years or so was thanks to trillions of dollars of assistance in the form of public money.

In contrast, under FR, the half of the banking industry that lends just CANNOT go insolvent (if it is funded entirely by shareholders).

Nevertheless, it is legitimate to ask what would happen under FR in the scenario that played out around five years ago, that is where banks suddenly found their loans / assets were worth much less than book value.

Well the answer is, first, that on finding that bank or lending entity's assets are worth say X% less than book value, the price of those banks' shares would drop to about X% of their initial value. Or in the case of Kotlikoff's system, the value of stakes in relevant mutual funds would drop to X% of initial price.

Second, banks / lending entities would realise their lending activities had been over-optimistic, thus they'd cut down on lending (in exactly the same way as any business contracts its operations when it realises it has over-estimated what it can sell). But there'd be absolutely no reason for banks to cease lending altogether. That is, as loans were repaid, they'd tend to use that money to lend to obviously credit worthy customers. Indeed, that is more or less what happened during the recent crisis: banks reduced their lending.

The big difference of course is that it required billions of pounds of taxpayers' money to keep banks lending at that reduced rate during the crises, whereas under FR, there'd be no need for one penny of taxpayer support because, to repeat, it's plain impossible for a bank to go insolvent under FR. Instead of taxpayers taking a hit, bank shareholders take a hit if they sell out during the above sort of crisis. Of course if those shareholders hang on for a year or two, their shares might recover in value.

Would introducing full reserve banking reduce aggregate demand?

A final possible criticism of FR to be considered here (not one made by Vickers) is thus. As pointed out just above, when FR is introduced, depositors have a choice of having their money lodged in an entirely safe manner or alternatively they can have it loaned on to mortgagors, businesses, and so on, but those depositors themselves carry the risk involved.

Now if we assume that the state does nothing with the money that is lodged in a totally safe manner, rather than use it to fund extra state owned investments, then the effect would be to reduce demand and raise unemployment. However, that is no problem because demand can be raised any time by standard stimulatory measures: interest rate cuts, an increased deficit, quantitative easing, and so on.

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Endnote 1. Liquidity creation by commercial banks.

As explained in the main text, if lending entities are funded just by shares, that reduces the amount of MT or money creation done by those entities, and some form of compensatory money creation would probably be required. The private or commercial bank system can actually do that, and as follows.

With a view to obtaining day to day transaction money as distinct from getting a loan, anyone can have any amount of money credited to their account by a bank by depositing enough collateral. If they don't have collateral, they'll still be able to get

day to day transaction money, but will have to pay more interest, perhaps the extortionate rates charged by pay day lenders. By way of a simple example, suppose everyone has £Z credited to their account.

Assuming that money is used just for day to day transaction purposes, the balance on everyone's account will fall below £Z and rise above £Z several times a year, but ON AVERAGE over the year the balance will be £Z. Thus no long term loan takes place. In short, money can be created when the existing or fractional reserve banking system makes loans, but the reverse does not apply. That is the existing banking system can issue or create money without any long term loans being granted.

Put another way, there is a distinction in principle between the creation of day to day transaction money and granting long term loans, though of course those two activities get mixed up in the real world.

Endnote 2. Different versions of FR.

As pointed out in the main text above, Kotlikoff's version of FR involves lending entities being funded just by shareholders. In contrast, there is Milton Friedman's version. In Ch3 of Friedman's book "A Program for Monetary Stability" he says (under the heading "How 100% reserves would work"):

"The effect of this proposal would be to require our present commercial banks to divide themselves into two separate institutions. One would be a purely depository institution, a literal warehouse for money. It would accept deposits payable on demand or transferable by check.....The other institution that would be formed would be an investment trust or brokerage firm. It would acquire capital by selling

shares or debentures and would use the capital to make loans or acquire investments. Since it would have no power to create or destroy money, monetary considerations would not demand any special control over its activities.”

Note that Friedman contemplates funding lending entities via “debentures” (i.e. bonds). As explained in the main text, that has the problem that it means such entities can go insolvent.

The same goes for the Werner / Positive Money’s version of FR. That version involves those who want their money loaned on putting their money into a special investment account at their bank. Those depositor / savers are promised £X back for every £X deposited which as is explained in the main text above, makes the lending entity vulnerable and to no great benefit.

Of course of course given a depositor to shareholder ratio of say 50:50, the chances of depositors losing money is vanishingly small. However, there are still arguments for a 100% rather than 50% capital ratio and as follows.

First there are no costs involved in raising the ratio to 100% and for reasons spelled out by Modigliani and Miller. And second, 100% is a clear line in the sand. In contrast, anything less will increase the chances of bankers lobbying for a gradual reduction of that ratio back down to the ludicrous 3% or so that prevailed before the recent crisis. (Irving Fisher (1936) made a similar point about clear lines in the sand: see his paragraph starting “Furthermore, the 100% plan...”.)

Endnote 3. How commercial banks create money.

Where someone buys shares in a lending entity worth £Y and that money is loaned on, no money creation takes place.

In contrast, where someone DEPOSITS £Y at a bank / lending entity, and that money is loaned on, the borrower has £Y, but the depositor also regards him/herself as being the proud owner of £Y. Hey presto: £Y has been turned into £2Y. Money has been created out of thin air.

Endnote 4. If MT is so useless, why do banks do it?

Having poured cold water on MT above, the fact remains that commercial banks do MT, and it is a not bad assumption that where something takes place in a free market, that may well be beneficial (though of course there are glaring exceptions to that rule). At any rate, the above question merits an answer, and the answer is thus.

Banks are in competition with each other. And with a view to attracting funds, banks make impressive claims as to the safety of any funds attracted. Indeed, they take it to the point of claiming that anyone depositing £X is absolutely guaranteed to get £X back (maybe plus interest and maybe less bank charges). However that claim is fraudulent because banks lend or invest on sums deposited, and there is no such thing as a totally safe set of loans or investments. (I'm assuming a pre-1930 free market scenario where bank bail outs were unheard of).

In contrast, if banks said to depositors something like "we'll do our best to return your money, but there are not absolute guarantees", that would be more honest. But that would turn those deposits into something resembling shares. But that is precisely

what is advocated here: funding lending entities via shares rather than “guaranteed to get your money back” deposits.
