A New Financial/Credit System: An Example of a Financial System in which Deposit Taking is Separated from Loan Making

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Introduction

A few days ago, I wrote a paper[1] in which was presented my reasoning behind my conclusion that it is possible to establish a financial system which would be superior to the one currently in place- one in which the function of loaning and deposit-taking would be separate. Below I provide a more worked out example of how one such system would function.

A New System

Scope:

The following financial/credit system is designed to be a national system. That is, it is a system which is designed to be adopted by sovereign national governments which have full legal control over the laws governing the structures and regulation of financial systems, and full legal control over the creation of the national currency.[2]

Central Monetary Authority:

The following system involves a central monetary authority(CMA). The CMA could be a government controlled central bank, a national treasury, or some other institution authorized by the government to carry out the money/credit creation process described below.

As just indicated, the CMA will have the authority to create money, in the form of loans, by fiat. The Federal Reserve is an example of an agency which could fulfill this purpose.

It is a possibility to enable the CMA to make direct loans into the economy.

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[1]https://www.findingprometheus.com/single-post/2018/05/23/A-New-Financial-Architecture-An-Outline-Arrived-at-through-a-Consideration-of-the-Relationship-Between-Concepts-of-Money-and-Systems-of-Finance

[2] It will be noticed that, based on this criteria, the nations of the European Union would not currently be able to adopt this financial system. The current situation in Italy demonstrates the degree to which the nations of Europe have not only lost vital aspects of their sovereignty, but, also, the ability to reclaim those aspects of their sovereignty.

Banks:

Private banks will exist in the national economy which adopts this system. These banks will provide loans to individuals, businesses, and other entities, in economically prudent ways.

The money which a bank will loan out will not be that which the bank had received from deposits. The money which these banks loan out will only be from two sources:

1. The pool of money owned by the bank. That is, from the money owned by the bank which is in excess of the cash capital required to be held by the bank. (More respecting the capital accounts of these banks will be discussed below).
2. Newly created money which the bank will "receive" from the CMA.

Capital Requirements:

The banks will have capital requirements which limit the amounts of loans which they can make. That is, the amount of loans which the bank will be able to generate with the newly created money it can command of the CMA will be limited by the amount of capital, particularly cash capital, which the bank has on hand. The capital requirement will be set by a government agency-most likely the CMA.

It seems proper that the required cash capital of the bank would be held in an account at the CMA. A bank will be considered bankrupt, and will be placed into receivership, should the bank fail to bring the capital account it has at the CMA up to the level required by the capital requirement by the end of each closing day.

Mechanics

The CMA will create money by creating issuing loans to the banks. The banks will only be able to receive loans from the CMA in when those banks are making a loan. That is, banks will not be able to borrow money from the CMA to hoard for future use. The banks will be able to make as many loans as they wish (within the constraints of their capital requirement), and at any time they wish, by obtaining a loan from the CMA at the moment the bank is to issue a loan to a borrower. When a loan is made by a bank, it will not be with money which the bank has on hand (except in the case in which a bank loans out some of its own excess cash capital). The loan from the bank to the borrowing entity will be carried out as follows: Upon approval of the loan by the bank to the borrowing entity, the bank will make a request of the CMA to deposit an amount of money into the account of the borrowing entity for the amount of the loan. The CMA will then create an amount of money equal to the loan amount, and deposit it into the bank account of the borrowing entity. The final legal obligations will stand thus: The borrowing entity owes the amount of the loan (plus interest) to the bank. The bank owes the amount of the loan to the CMA [3]. When the bank is paid back the loan, the bank pays back the CMA. At the time the CMA is thus paid back, the money/credit "created" for the process is extinguished.

The final result is, the borrowing entity paid bank the loan to the bank (hopefully by putting the original funds to productive use); the bank has earned interest which can contribute to covering the operating expenses of the bank as well as to the profit of the bank.

In the case in which the option is taken to allow the CMA to issue loans directly into the economy, the same basic procedure will be taken. Upon authorization of the loan, the CMA creates a deposit in the account of the borrowing entity for the amount of the loan. This loan ought to be accompanied by an interest rate as insurance against loan failure. It should be noted, however, that, should the CMA make such direct loans into the economy, the CMA ought to have some sort of capital base as security against any loan defaults.[4]

<u>Example</u>

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[3] There is a question as to whether the CMA should charge interest on loans made to the banks in this way. Since the main purpose of such an interest rate would be to provide a tool by which lending in the economy were to be increased or decreased, it seem unnecessary for the following reason. The presence of the capital requirement and the ability to change it seems to be the only mechanism necessary for increasing or decreasing the amount of loans made in the economy. Adding an interest rate to CMA loans to the banks would only add another instrument by which the total lending of the society could be increased or decreased by the authority wielding the instrument. But if one instrument (the capital requirement) is already enough to control the amount of lending in the economy, it seems unnecessary to add another instrument by which the amount of lending could be controlled. However, there be some difference in the effects of these two instrumentalities which warrants the adoption of both, then it can easily be done. On a related note, it is understood that the CMA will have operating costs. Interest rates placed upon CMA loans to the banks would be a means of covering this cost. But, there are other options: Since the CMA will be controlled by the government, the government could provide the funds needed for CMA operations expenses. Also, the CMA could impose nominal fees on loans made to banks which were calculated to procure the CMA enough funds to cover all of the operating costs which it may incur.

[4] The question might be leveled against this assertion: Why, if the CMA created money out of nothing, and, therefore, does not owe any entity any money which it borrows, should the CMA have capital on hand to cover any defaulted loans? Why would the CMA need to keep capital on hand just to pay itself back if a loan should fail? The answer to this questio is provided in the above referenced paper under the section "Questions", linked here again:
https://www.findingprometheus.com/single-post/2018/05/23/A-New-Financial-Architecture-An-Outline-Arrived-at-through-a-Consideration-of-the-Relationship-Between-Concepts-of-Money-and-Systems-of-Finance

Let us imagine that the following situation takes place in the United States, after a reform of the financial system is made such that the system outlined above is in place. Assume the Federal Reserve (Fed) act as the CMA.

The government of the state of New Mexico (NMSG) decides that it would like to build an advanced nuclear power plant. The cost of construction is estimated at 5 billion dollars. As NMSG does not have an extra 5 billion dollars on hand, it concludes that it must obtain a loan. NMSG visits the Bank of Albuquerque (BA) to obtain the loan. BA approves the loan, and a contract is written. BA then contacts the Fed and requests that 5 billion dollars be transferred into the account of NMSG held at BA. The Fed credits the BA account of NMSG with 5 billion dollars. NMSG successfully build the nuclear power plant, and begins the process of accumulating new revenue streams from the sale of electricity and the increased tax revenue made possible by increased economic productivity resulting from the operation of the power plant. NMSG pays off BA. BA pays off the Fed. The cycle is complete.

No Connection Between Deposits and Lending

As can be seen, at no time does the question of deposits enter into the picture. Indeed, in this system, lending institutions, like banks, will no longer have any need to take deposits at all- except perhaps to procure income from fees associated with providing money management services, like card and check payment services, to persons which might deposit money in accounts at a certain bank. If banks were to take deposits at all, the system could be set up such that the banks would have no ability to use those deposits in any way (like for lending)- but that they could only initiate transfers between deposit accounts corresponding to payments made by different account holders to each other.

Another option is to require that all deposit accounts are to be held at the CMA. That is, no private lending institutions, like banks, would hold deposits at all. Again, this would in no way affect the ability of those institutions to lend.

Another Tier of Lending Institutions

In such a system, it would still be possible to have institutions set up like the banks which we have in society today. That is, institutions to which large numbers of people loan money (make deposits)- money which is then loaned out by the institution. It seems unlikely that such banks would develop since that would be at such a disadvantage to the banks which were part of the lending system described above, in which nearly free loans from the CMA would eliminate the cost of paying interest loans to depositors, but they may. A government could simply outlaw such banks as their presence would undermine the ability of central authorities to use the system described above to control the amount of lending in the economy, and, thus, things like inflation. True, new methods of controlling this second stratum of lending institutions could be established. However, it seems that this would render the national system of finances more complicated without good reason. It may be acceptable for a national government to allow such institutions to come into being, even if the above mentioned system were in place. However, in order to discourage too much of the funds of society from being diverted into these banks, measures could be taken. Legal limits on the rate of interest which these banks could pay depositors. A complete withdrawal of federal insurance of deposits at these banks. High reserve requirements. And so on.

At present, it seems to me that it would be better not to allow another such tier of banks to come into being in the national economy which were operating under the system described above.

Further Considerations

I have addressed some of the objections which I thought might be raised to the idea of establishing this kind of system in the above cited paper.[5]

I strongly encourage the identification and discussion of potential problems with the system I have laid out above. I have tried to discern how this kind of system might pose problems which would imply that the adoption of it by society today would represent a regression in the reasonableness and soundness of the kind financial system which society operates with. That is, I have tried to identify ways in which the system I have outlined above would present more problems than the one currently in place. I have not been able to identify any such problems. But, of course, sometimes we are unable to perceive the flaws of our own children.

On the other hand, I have been able to discern various ways in which this financial system would be an improvement over the one we currently have, like, for example, the elimination of the possibility of bank runs/panics, the simplification of the regulatory requirements of lending institutions resulting from the separation of deposits from loans, and the simplification and increased effectiveness of control over the amount of lending in the economy by authorized central authorities. These were discussed in greater detail in the cited report. So, I also encourage the identification and discussion of the benefits which the adoption of this system can be judged to bring to society.

I believe that the idea of adopting this kind of system warrants serious consideration.

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[5]https://www.findingprometheus.com/single-post/2018/05/23/A-New-Financial-Architecture-An-Outline-Arrived-at-through-a-Consideration-of-the-Relationship-Between-Concepts-of-Money-and-Systems-of-Finance