

Bundesbank rejects 100%-money based on sophistry and false claims

In its [April monthly report](#), Deutsche Bundesbank explains that banks create money ex-nihilo and rejects the proposal of 100%-money. The full English version is now online. The arguments employed to discredit 100%-money are a mix of sophistry and misleading or false statements.

With some delay, Bundesbank has joined the [Bank of England](#) in explicitly stating that the treatment of banks and money creation in most textbooks is wrong and that banks are not intermediaries, transferring money from savers to investors, but rather creators of money.

A key statement is this:

Sight deposits are created when a bank grants a credit or purchases an asset and credits the corresponding amount to the customer's bank account in return. This means that banks can create book money just by making an accounting entry. This refutes a popular misconception that banks act simply as intermediaries at the time of lending – ie that banks can only grant credit using funds placed with them previously as deposits by other customers.

All the explanations are impeccable, albeit framed in a way that is very friendly toward the interests of commercial banks. The Bundesbank is stressing the “services” that banks provide. It does not even mention the benefits, which banks derive from their extraordinary privilege of having their short-term debt instruments treated as money.

Still, overall the article is a welcome attempt to bring knowledge and sanity back into the treatment of money.

The Annex titled “[Remarks on a 100% reserve requirement for sight deposits](#)”, however, is quite disappointing.

First, the Bundesbank correctly states that proponents of 100%-money view commercial banks’ ability to create money to be a major cause of damaging credit cycles, aka boom-bust cycles. Reforms aimed at making the banking system more stable should therefore, in their opinion, limit money creation by commercial banks. This is how Irving Fisher reasoned more than 80 years ago in his proposal for 100%-money.

For an example of a fatal boom-bust credit-cycle (which the Bundesbank does not give) one does not have to go back to the great depression, which influenced Fisher and other proponents of 100%-money and related concepts. About 15 years ago, banks in the US and parts of Europe started to increase real estate lending with increasing rates. The new money flooding into real estate markets and the economy pushed up real estate valuations and boosted the economy. Banks felt ever more comfortable lending, and borrowers felt more comfortable borrowing; until at some point not enough new borrowers could be found any more to increase the flow of new money. Real estate prices stopped rising and finally turned negative. The whole Ponzi scheme, which relied on ever increasing rates of credit growth, collapsed into a debt crisis. In Europe it turned into a government debt crisis, which continues to this day.

Always at our service

The Bundesbank reminds us, that banks do us a favor by giving credit and buying stuff with money they can create out of thin air:

Money and more

Blog by Norbert Häring

<https://norberthaering.de>

As the main text already states in detail, one central service provided by profit-maximizing commercial banks is that they make sight deposits (book money) available by extending loans.

Honestly, I would pay quite a lot to be allowed to provide the service of buying staff or lending money against interest by giving out short term debt obligations (IOUs) that I will not have to repay. The Bundesbank continues by explaining how maturity transformation by banks creates liquidity for the economy, another very lucrative (for them) service they provide:

Although banks invest in comparatively illiquid projects or assets, they provide liquid and – in principle – interest bearing assets (from the banks' viewpoint, these are liabilities) in the form of sight deposits, which **promise smoother patterns of return** than other investment forms. By making sight deposits available while “simultaneously” investing in illiquid projects, banks provide a **maturity transformation service**. They create liquidity and give depositors the ability to consume intertemporally, whenever they want to.

Translation: Banks buy high-yielding (long-term) assets in exchange for giving out very low-yielding (short-term) IOUs. This works because the IOUs are not really short-term. Due to their functioning as money, very few of them are ever repaid. The vast majority circulates in the banking sector continuously. The function of the strange insertion that bank IOUs serving as money are “in principle interest bearing” and “promise smoother patterns of return than other investment”, is hard to understand other than as an attempt to deflect from the fact that providing this service is so lucrative. After all, interest on sight deposits is usually very near zero, which is the reason, why the return of depositors promises to be quite stable (near zero). The flipside is simply: banks make a lot of money that way.

The fact that banks make promises, which they can only heed in good times – this awkward fact, which causes these terrible busts at the end of the booms - is cast as another favor they do us:

As long as the liquidity risks of the individual depositors holding sight deposits with banks do not correlate perfectly, banks can bundle resources (and risks) such that, on balance, they only need to maintain a comparatively small fraction of liquid funds as a reserve and can invest the greater part of the available funds in illiquid and therefore higher-yielding assets. Thus, the **banks can offer depositors short-term sight deposits** so that depositors faced with an unexpected need for liquidity are not compelled to sell illiquid assets or long-term investment projects at a loss. From the depositors' viewpoint, this is equivalent to **insurance against illiquidity** which can be implemented by a banking system maintaining a fractional (ie not a 100%) reserve.

I will argue later that it is very easy to provide this liquidity insurance for depositors in a different, much safer way.

The admission that the banks' fair-weather-promises can cause a problem, does come, but in an idiosyncratic way:

However, this advantage is offset by the risk of a liquidity problem arising in the event that a bank cannot meet demands to repay deposits. If more depositors than anticipated withdraw their sight deposits – not because they need liquidity unexpectedly but because they fear that **other depositors may withdraw their money and cause the bank to collapse** – this form of coordination among consumers can trigger a run on banks.

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Note that in this explanation, the problem is caused (triggered) by (somewhat irrational) depositors not by the usual reason for a bank run: news or rumors that a bank is in trouble because of losses and that customers need to run, to preserve their hard-earned money. The bank has made the promises it cannot keep. The bank doled out the extra profits it made that way in the form of dividends and above-average salaries and bonuses for their top brass. The bank has gone too deep into risk to reach the next level of return on capital - and then ran into trouble at some point, but has no reserves. But still, for the Bundesbank, it is the unruly, irrational depositors who are to blame, if the bank goes under.

After this idiosyncratic but generally correct way of laying out the problem, the Bundesbank spends many paragraphs on distracting sophistry. The authors claim that a 100% reserve requirement would not stop banks from creating money because:

The level of the reserve ratio in itself would have little impact on the banks' lending capacity. This finding, which may seem surprising at first glance, is owed to the fact that central banks do not steer credit dynamics through the central bank money stock but by how they set the key interest rates. Central banks use their liquidity management to accommodate higher minimum reserve requirements. (...) Since the reserves are factored into the banks' optimisation calculation as a cost factor, the amount of the reserve ratio could in principle narrow the profit margin and thus indirectly affect lending and the provision of sight deposits. However, this indirect influence on the margin is essentially irrelevant, as central banks worldwide now pay interest on the required minimum reserve holdings in the amount of the refinancing costs (rate for making central bank money available). Taken in isolation, with regard to the payment of interest on reserves, lending and thus the provision of liquidity are not constrained by already existing sight deposits or by reserve holdings.

Translation: Banks give credit first and look for reserves later; and they can trust that the central bank will supply these reserves later. Better still: central banks provide these reserves for free, as they pay as much interest on required reserves as banks have to pay to get these reserves. If this arrangement were kept in place, hiking reserves even to 100% would not impede money creation by banks.

The arrangement does describe the current – exceedingly favorable policy towards commercial banks – that central banks have put in place. There is a "reserve period" in which banks have to fulfil their reserve requirements on average. In Europe, this is a month-long period. Banks thus have plenty of time to "look for reserves later" after making a loan and they can get these required reserves for free.

However, it would be absurd to continue with an arrangement, which is designed to make money creation as easy as possible, after introducing 100%-money, which aims precisely at preventing banks from creating money. All it takes to stop money creation under 100% money is to make sure that banks can access central bank funds only at the beginning, but not toward the end of the reserve period, except maybe at penalty rates. If this change is made, banks can only intermediate existing money, but not create new money. New money would only be inserted into the system by the central bank.

It gets worse: After their distracting sophistry, the Bundesbank's economists say something that is plain wrong:

Under such a system, the credit department could grant additional loans only if it increased its capital, generated income from its lending activities or **acquired liabilities in the form of savings, the maturities of which largely matched those of the loans on the asset side of the bank's balance sheet**. Consequently, the credit department would not, **as it were**, engage in maturity transformation and therefore could not perform a key function of the banking sector. Such a financial system without maturity

transformation would likely lead to considerable welfare losses.

The 100%-money-proposal makes it necessary to distinguish accounts that can be used to make payments from savings accounts. Only the former would have to be backed by reserves.

Money in a savings account, which fulfils the requirements of not being usable for payments, does not have to be backed by reserves. It would be treated as a loan to the bank. Thus, there is nothing inherent in the 100%-money proposal that prevents banks from making a ten year loan out money that depositors have given them for, say, six months.

Banks could run into problems because of that, and their customers with them. However, the potential for this to affect the whole payment system and the whole banking system, is much more limited, as banks cannot create new money in this system and depositors cannot run on the bank within days or even hours.

As an aside: There would be an incentive to provide savings accounts with features, which make them usable for payments or which can be very quickly and easily transferred into payment accounts. Thus, there would need to be a regulation to prevent that.

The Bundesbank goes on:

It would be more difficult in a system without the maturity transformation function to reconcile the preferences of long-term-oriented investors with any short-term liquidity needs they might have.

Not much more difficult, though. The regulation to separate savings accounts from payment accounts could impose a moderate penalty if a customer withdraws savings before the contract expires and banks could commit to accepting such withdrawal requests. To prevent bank runs, any such repayments before maturity could be made conditional on some competent authority not having issued a general hold on them or a hold for a certain bank or a group of banks.

Maturity transformation still possible, but less necessary

The Bundesbank also fails to mention that the central bank could and probably would provide enough long-term liquidity to make maturity transformation by commercial banks largely unnecessary or at least much less important. To understand, let us briefly look at possible ways in which the central bank could add new liquidity.

1. They could continue to go through banks and provide these with new liquidity by either buying asset from them, or by giving them reserves on credit. In the first case, banks receive reserves with infinite maturity. They never have to pay the money back. In the second case, the central bank can decide on the term-profile of the money they give to banks. They could easily continue the current practice of giving long-term or longish-term credit to commercial banks.
2. They could also gift the regular installments of new money either to the government or to citizens directly. If the government pays a bill with that money, by transferring it to a business partner with an account at a commercial bank, the account of that commercial bank at the central bank would be credited with indefinite maturity reserves.

Thus, the need for the maturity-transformation-service of banks is artificially created and could be taken away at any time.

After a short discussion of macro-modelling exercises of 100%-money, the Bundesbank concludes:

A reserve ratio increase to 100% would not necessarily bring about a stabilization of macroeconomic growth. It would be wrong to assume that restricting money creation for a part of the financial system ("sight deposits" sector) would in itself be sufficient to make the entire financial system resilient. This would continue to require effective regulation, supervision of banking.

That is true. 100%-money will not solve all the problems at once. However, a Porsche is still a better car for most people than a little Hyundai, even though it cannot fly any better.

Moreover, there is a risk of evasive action being taken in that new, non-regulated institutions could be set up to fill the gap. There is no a priori reason why these new intermediaries should be more resilient (or even immune) to a run than the banks that exist at present.

The individual institutions might not be immune, but their problems would not be everybody else's problems any more. Shadow banks cannot pump new money into the economy and thus it is much harder for them to blow up a big self-inflating bubble. In the past, they have caused the trouble they caused in concert with banks creating too much money. Under inadequate regulation they might be able to create near-money that floats around in the financial sector. But there would not be a boom in the economy in general and if these financial institutions went under, while the payment system was safe, there would be less damage to people and the economy than in the current system.

From the present perspective, the strengthening of the resilience of the financial system as a whole needs to be achieved by other means, notably by boosting its capital base as well as developing and expanding an effective macroprudential toolkit.

Boosting banks' capital base would be helpful under 100%-money. In the current system, however, a banking system that can print money can print all the capital it needs. This does not make this banking system any safer. All it does is enabling an even bigger bubble, which will finally burst with even more disastrous consequences. One Swiss bank reportedly increased its capital during the banking crisis by giving a loan to a Sheikh, who would use the money to put in additional "capital" into the bank. Usually, this is done in a more roundabout way. However, it remains true that if banks create money, they also providecreate the money that is used to increase bank capital. Remember the failure of the bank-capital based rule-books Basel I, Basel II, Basel III and soon Basel IV. This is no coincidence.

The macroprudential regulation that the Bundesbank is alluding to, would still be a step in the right direction, if it was done properly, which it is not (inter alia, because of international competition of banks and regulators). But it is not nearly the panacea that the Bundesbank wants it to be. It consists in regulators demanding more capital from banks in a credit upswing and becoming more lenient in a downswing. However, the extra capital demanded is modest. Once the upper limit is reached, i.e. exactly when the credit boom goes really wild, this regulation seizes to be effective.

In conclusion, the Bundesbank has to come up with better arguments, to convince people outside the banking sector that withdrawing a lucrative and very dangerous privilege from the banking sector would harm anybody but the banking sector. The banking sector would be harmed, though. The basis for far-above average remuneration in this sector would go away. This would be an additional bonus for the rest of the economy, as talent could go into more productive sectors again.

[German version](#)

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