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Putting money where "goodwill is" – comment on Thomas Mayer, "A Copernican Turn in Banking Union", RWER, issue no.65, pp.44-50

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It is one thing to pray for a renaissance in thinking in monetary matters, quite another to deliver a blueprint for alternative monetary arrangements. Kudos to Thomas Mayer for providing a revolutionary but closely-argued macroeconomic schema for the European Union.

One hundred percent reserve banking, also called narrow banking, harks back to centuries before the Chicago School, Professor Mayer informs us. A well-known propagator was Milton Friedman and, from a completely different perspective, Hyman Minsky embedded the institution in his model for preventing "it" happening again. The serious attention to the proposal despite its origins in competing worldviews I take as support for the vibrancy and complexity of the heterodox economics programme. In the usual format, the innovation goes with "firewalls" separating deposit-issuing banks from financial institutions. Professor Mayer's banks, on the other hand, have a hierarchy of separate correspondences across sides in their balance sheets. The problem of floor crossing, therefore, remains. It is not clear how safe deposits will not be used to retire risky debt.

Judging by the footnotes, it seems that Professor Mayer's impulses flow from the Austrian school. It is not difficult, therefore, to note a gap in the reasoning when it comes to Central Banks (CBs hereafter) holding government debt. By so doing, Professor Mayer claims, government money will be unbacked.

We approach the subject from the other end, the stock-flow-consistent macroeconomics pioneered by the late Wynne Godley and developed by scholars at the Jerome Levy Institute, New York. Even otherwise, the following is an important post Keynesian identity.

$$G - T \equiv S - I.$$

In words: the government deficit equals the private sector surplus. It is for the evidence to support the causal arrow flying from the right-hand side to the left through the cycle. In dynamic terms, and with the addition of an equation or two, the relation is the basis for built-in stabilization policy. It is only with the inclusion of behavioural parameters and so-called stock-flow norms that the stability properties of the system can be worked out.

In the simplest case, in the period under consideration a government deficit can be financed by fiat money:

$$\Delta H = G - T$$

In terms of our discussion, the (increment in) high-powered money is backed by the private sector surplus. Finally, banks are required to hold a proportion of their deposits as reserve requirements with the CB. That is,

$$H = \rho M$$

with $\rho = 1$ in the case of 100% reserve banking. The sparse accounts now are:

Banks

Assets	Liabilities
ΔH	ΔM

Central Bank

Assets	Liabilities
ΔH	ΔH

The novel term in the balance sheet of Professor Mayer's CB is "goodwill" in place of ΔH as the asset. The item is supposed to move in one direction only. However, it is not difficult to conceive, even independent of the cycle, a shrinkage in the balance sheets across the board, and the corresponding dilution of CB moral capital. For instance, since fees on items on the balance sheets above are implicitly controlled by the government, bank profits will emerge from non-cash operations.

One lesson from Glass-Steagall is that bank managers will look wistfully at the greenbacks on the other side of the regulatory fence. Secondly, customers might be not be attracted by deposits whose rate of return is dominated by other assets. Many claim that commercial banking is dying. Also, Professor Mayer believes that CBs can influence investment activity by changing premia/discounts on deposits. However, we know that bounds of zero or infinity on interest rates are necessary but not sufficient to generate/dampen growth in output and employment. Nowhere is the adage that pulling is different from pushing on a string more applicable than in matters of financial incentives. It is precisely when animal spirits are dim, for instance, that government expenditure of the appropriate scale and quality can ignite activity. Prof Mayer, furthermore, seems to suggest that CBs, through these price (dis)incentives, can move banks (up) down habitats in his balance sheets. Austrians, old and new, would frown at the presumption that organs of government possess the information required to calibrate private sector plans. Indeed, what thought to the motivation of banks to chuck it all up and go off-balance sheet? At the same time, stick, if not carrot, can be applied to government expenditure as well. The CB can decline to monetise deficits that are not the outcome of employment-generating schemes, environmentally-friendly infrastructure projects, and so on. The profession has long moved from regarding G in the macroeconomic equation as consisting of dead-end activity like digging holes in the ground and then filling them up. Post Keynesians have been writing up portmanteaux of projects not excluding social welfare schemes that have clear employment-generating and multiplier effects.

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