COMMUNICATIONS

You Call That Deregulation? A Critical Examination of Hugh Thomas's Proposal to Deregulate Banking

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A regular reader of the *Cato Journal,* or anyone armed with a working knowledge of the English language for that matter, might be excused for assuming that Hugh Thomas's article—"A Proposal to Deregulate Banking"—in the Fall 2000 issue calls for a reduction in the government's role in the monetary and banking system. Yet, despite his article's title, what Thomas proposes is something closer to a complete nationalization of the U.S. money stock. In Thomas's "deregulated" arrangement, the only "legal money" would be high-powered money, that is, exchange media supplied directly by the Federal Reserve system or by some other "central clearing authority"; and financial intermediaries or FIs (they would no longer be allowed to call themselves "banks") would be prohibited from supplying any close substitutes for this legal money apart from checkable, equity-based "money funds."[1] The reform also calls for an expansion of the role of government in interbank payments and settlement.

I plan to argue that Thomas's proposed reform is neither prudent nor necessary for achieving its intended objectives. There is some risk, which Thomas not only acknowledges but exaggerates, that the reform could involve a wrenching readjustment of monetary policy, with a possibility of severe short-run deflation. A more certain consequence of the reform is that, once any monetary readjustment is complete, the United States' economy would be left with a reduced—

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[1]Thomas's use of the phrase "high-powered money" is unconventional, as is discussed further below, and the meaning he attaches to the term "legal money" is unclear. If he means "legal tender," then it is already the case that all "legal money" is high-powered. But I cannot see what else he might have in mind.

perhaps a substantially reduced—real flow of credit to the private sector. Finally, any gains Thomas's proposed reform might achieve could be better and more reliably achieved by means of a *genuine* (as opposed to pseudo) deregulation of banking, involving the elimination of all government deposit guarantees and the removal of all remaining restrictions on banks' ability to open mutual fund accounts for their customers. Although any attempt at genuine deregulation is likely to encounter substantial political resistance, special interests are likely to be even more fervently opposed to Thomas's plan.

The Political Economy of Bank Regulation

Before taking up the drawbacks of Thomas's proposed reform, I feel obliged to point out some other shortcomings of his article. Perhaps the most distressing of these is Thomas's utter disregard of the contributions of public choice theory, with its emphasis on rent-seeking behavior as a frequent motivation behind government intervention in the economy. He states matter-of-factly that governments "justifiably intervene to preserve the value of fiat money" and to make sure "that their payments systems [are] run in the interests of society" (Thomas 2000: 237). He also attributes Fed policies restricting access to the (interbank) payments system it operates solely to its desire to avoid a "potential breakdown" of that system. One hears not even a whisper about any role for rent seeking by the banking industry, about the Fed's bureaucratically motivated desire to maintain a large budget (which is mainly employed in supplying privatizable payments services, including check clearing), or about fiscal as well as bureaucratic pressures that have encouraged most modern central banks to *generate* inflation rather than prevent it. (If Thomas thinks that governments alter national monetary arrangements in order to "preserve the value of fiat money," just whom does he hold responsible for the observed tendency of that value to deteriorate?)

After offering his rather naïve perspective concerning the motivation behind government intervention in the U.S. monetary system, Thomas goes on to note, correctly, that many elements of that system, including many rules and procedures, were originally developed by the private sector. Prior to the establishment of the Fed, high-powered ("base") money consisted mostly of gold (supplemented, since the Civil War, by Treasury-issued legal tender notes), commercial banks issued their own circulating notes, and interbank payment services, including check clearing, were administered by private clearinghouses that could restrict membership and enforce their own rules.

There were, indeed, problems with these private arrangements as they evolved in the United States, but practically all of them were consequences of government-imposed legal restrictions, the most important of which were laws limiting banks' ability to branch. These laws resulted in an imperfectly integrated system, involving thousands of small banks, in which it was impossible for all banks to be part of a common (private) clearinghouse network. Checks often had to be cleared by circuitous means, and an efficient private wire-transfer system failed to develop. The Fed, which enjoyed the unique privilege of being able to establish branches anywhere in the country, took advantage of the restrictions imposed on private bankers, supplemented by occasional resort to subsidies or coercion, to expand its role in the payments system, eventually acquiring a near monopoly of check clearing and wholesale wire transfers.

Although technical innovations, legal reforms (the most important being the 1980 Monetary Control Act, which required the Fed to charge prices for its services reflecting those services' full cost), and the relaxation of nationwide banking barriers have since allowed private firms to compete more effectively with the Fed in supplying various payment services, the Fed has acted aggressively to preserve its market share, sometimes by resort to hidden subsidies but also by attempting to thwart private industry rivals by declaring their alternative arrangements dangerous. Such declarations aid the Fed's efforts to force further debilitating restrictions upon private payment service providers, either by means of direct regulation or by forcing them to restrict themselves "voluntarily" by threatening to close their settlement accounts, which they need to effect safe and efficient "final" reserve payments among their clients.

Thomas also shows little understanding of how a completely privatized payments system might function, and function efficiently, without government interference of any kind. He seems unaware of the large literature documenting the successful operation of entirely private or almost entirely private payments systems in the past.[2] Instead of reflecting upon the lessons of history, he appears to accept at face value central banks' self-serving propaganda regarding the necessity of securing bank deposits through government guarantees and the risks inherent in private payments arrangements, and especially in private wholesale payments systems relying on net settlement such as CHIPS—the Clearing House Interbank Payment System. CHIPS at

[2]See Dowd (1992) for some relevant historical episodes, and Selgin and White (1994) for a more general survey and critical discussion of the literature regarding laissez-faire monetary systems.

present handles a volume of wholesale transfers rivaling that handled by Fedwire—the Federal Reserve's own wholesale payments network.

Real Time Gross Settlement

This brings us to the first element of Thomas's proposed reform: his suggestion that a single "central clearing authority" administer all interbank payments on an RTGS ("Real Time Gross Settlement") basis. The authority might or might not be the Federal Reserve itself—Thomas doesn't say—but it would certainly not be an *unregulated* authority, and it would enjoy a monopoly status either alone or in partnership with the Fed. To justify this proposed change, which would do away with CHIPS and other private clearinghouse arrangements, Thomas endorses the Federal Reserve's view that traditional net settlement procedures long followed by private clearinghouses involve an unacceptable level of "systemic risk" compared to the supposedly risk-free RTGS alternative. But Thomas, like most other advocates of RTGS, never offers a convincing market-failure explanation of why CHIPS and other net settlement systems involve an excessive degree of systemic risk—the risk of a default by one participant causing others to default as well. Instead he settles for noting that RTGS can avoid systemic risk entirely, while relying on a reference to "the sheer volume of [wholesale] transactions" being undertaken to justify his claim that a traditional net settlement arrangement could not handle all such transactions without risking a catastrophic payments-system breakdown.

But it is not at all clear why a zero level of "systemic" risk in wholesale (or, for that matter, retail) payments should be considered optimal. Nor has anyone offered a convincing market-failure explanation (note the qualifier) to support the claim that private systems like CHIPS do not tend to achieve an efficient risk-return mix when left alone.[3] Some have argued that systems like CHIPS (or like CHIPS before Fed pressures forced it to deviate from standard private clearinghouse practice) depend on massive amounts of "intraday" lending, the volume of which is driven solely by the volume of payment messages sent by bank customers. But this view involves a serious misunderstanding of how net settlement systems operate. In fact, under traditional net settlement rules, payments are considered unconditionally "final" (and hence irrevocable) only after all end-of-

[3]The following discussion draws on Selgin (2000).

day settlements have been successfully completed, and participant banks are under no legal obligation to release funds indicated on a payment order to their customers until all dues have been settled. (If you doubt this, check your bank's "deposit account agreement and disclosure" statement.) Should any bank fail to settle, all payment orders involving the defaulting bank are declared null and void, and settlement is attempted once again. This procedure is known as a payments "unwind." Thus, the only intraday lending that goes on in net settlement arrangements is the lending that occurs if a bank chooses to advance funds to *its own customers* in anticipation of a successful settlement later in the day. It should be obvious enough that banks are entirely in control of the volume of any such intraday loans.

This does not mean, of course, that the risk of a payments unwind is zero: it simply means that banks can control the extent to which such an unwind exposes them to losses (and, hence, to an increased probability of defaulting and thereby causing a further unwind) by controlling their own intraday credits to wire-transfer beneficiaries. In principle, no bank has to default just because another has failed to make final payment so long as none has made loans in anticipation of such payments. As a matter of fact, although participants in net settlement systems have always routinely advanced funds to payment beneficiaries in anticipation of final settlement, unwinds have been exceedingly rare (and never cataclysmic), and CHIPS itself has *never* had an unwind.

So much for the market-failure argument. There is, however, another cause of excessive intraday lending and other forms of excessive risk-taking in private-market payments arrangements: government guarantees to banks and their customers. Thomas rightly believes we ought to do away with such guarantees; but he errs in assuming that the only or best way to do this is by throwing the net settlement and bank deposit babies out along with the government-guarantee bathwater.

Ironically, although Fed officials and their apologists view the problem of excessive intraday lending risk as being a problem mainly for net settlement systems like CHIPS, but not for RTGS systems like Fedwire, the truth is just the other way around. Of the many RTGS systems now present in the world (Thomas mentions 10 of them), only *one*—Switzerland's—really makes do without intraday loans, and does so at the expense of private agents whose payment orders are frequently rejected by the system for want of adequate reserves.

In all other RTGS systems, some kind of intraday lending occurs, and in most cases the lending gives rise to a genuine externality

problem. The externality arises because interday credits are provided, not by recipient banks to payment beneficiaries, but by central banks to *sending* banks to cover their payment orders exceeding immediately available reserves and to guarantee immediate and irrevocable final settlement *even in the event that intraday credits are not repaid*.

Consider Fedwire. Until several years ago Fedwire participants received intraday loans free of charge. The result was a predictable explosion of intraday credits and associated default risk. Now the Fed does charge fees, which are supposed to price that risk. But there are good reasons for thinking that these fees continue to involve an implicit subsidy (they are much lower than market interest rates, allowing for the loans' short duration). It is true that, because the default risk in question is all borne proximately by the Fed, it needn't be the cause of a "systemic" payments-system crisis. But this is so only because the Fed can always avoid insolvency by adding to its good assets via open market operations, that is, by shifting losses to the general (money-holding) public.

Thomas's own RTGS proposal avoids the dilemma of frustrated payments versus excessive intraday lending by requiring 100 percent Treasury-security backing of all privately issued exchange media. This allows intraday loans to be fully collateralized at all times no matter the sequence of payments. But as we shall see, that solution to the RTGS dilemma has a very high price.

"Democratized" Payments

Although I share Thomas's opinion that the Fed should not restrict access to its final payment facilities to a narrow set of financial institutions (the Fed should, at very least, allow all mutual funds and private clearinghouses, as well as banks, to open accounts with it), I think it a mistake to allow the Fed or any other public or quasi-public authority to supply privatizable payments services to the general public. To suggest, as Thomas does (p. 240), that everyone should be allowed to open a settlement account with the Fed or some other central clearing authority makes little sense, because for most citizens such an account could not serve any purpose that could not be equally well or better served by a private safety-deposit box or bank deposit. In a fiat monetary system, financial firms cannot help doing business with a "banker's bank" unless they are to adopt the dangerous and inconvenient practice of keeping all their reserves, including settlement reserves, in the form of actual cash. But firms and individuals who are not themselves suppliers of payment services have no need for a Fed (or central clearing authority) account, and could not possibly benefit from having such an account unless the central authority

chose to compete directly with the private sector in supplying non-cash payments media, such as interest-bearing checkable deposits.

There is, in short, no good reason for expanding the Fed's role in payments beyond the minimum role it must play to sustain the present fiat standard. In order to perform this minimum role efficiently the Fed must supply base money in the form of currency and financial-institution settlement balances, and it must credit and debit the latter balances in accordance with account holders' instructions.[4] The Fed's minimum role does not require it to offer either intraday or overnight loans to its account holders, or to operate a wholesale payments network, or to be involved in check clearing. All payments apart from final reserve transfers are best handled by private institutions, including private clearinghouses that may treat their participants as members of an exclusive club, who can be expelled for behaving recklessly.

Demonetized Banking

The heart of Thomas's reform is his proposal to "demonetize banking." This proposal seeks to "eliminate the specialness of banks in the payments system" (p. 241) by preventing conventional bank deposits from serving as exchange media. Thomas is extremely vague about precisely which deposits he would prohibit. Can the reformed (and renamed) institutions issue Certificates of Deposit, or are these to be banned along with more transactable bank IOUs? Although Thomas never gives a clear answer, his claim that bank "demonitization" would solve the moral hazard problem implies that it would involve a ban on all presently insurable bank liabilities, if not on all fixed-nominal-value bank liabilities (since these also may be propped up by implicit guarantees). Indeed, if Thomas has his way demonetized banks would have to forswear their old designation entirely in favor of the presumably less disreputable "FI" (for Financial Intermediary). This is another example of Thomas's unorthodox take on "deregulation."

High-Powered Money

Thomas's proposal is, of course, far from being *merely* a matter of names: conventional bank deposits would in fact cease to exist, their

[4]In suggesting that the Fed continue to supply currency I do not mean to endorse a currency monopoly. Private-market financial institutions should also be allowed to issue circulating notes. The popular view, to which many economists subscribe, that private currency must be inferior to what central banks are capable of supplying, is hopelessly at odds with the historical record.

place being taken either by increased (real) public holdings of high-powered money or by FI-administered "money fund" accounts backed entirely by Treasury securities. Thomas does not offer any precise estimate of the extent to which money fund accounts would fill the void left by the elimination of conventional bank deposits. I plan to consider two extreme possibilities. But in order to do so I must first address Thomas's unorthodox use of the expression "high-powered money." As employed by other economists, this expression refers to the outstanding stock of coin and Federal Reserve notes plus commercial bank deposit claims against the Fed. Although Thomas initially (p. 237) acknowledges this standard definition he later (p. 246) defines high-powered money as the outstanding sum of "coins, notes, and government securities available for repo (or collateralized borrowing) through accounts with the clearing authority (including government security holdings of money funds)"—a sum that, according to Thomas, "would be greater in amount than current measures of high-powered money but . . . lower than current M1."

Let's assume, for the sake of argument, that the *overnight* value of FI and other account balances with either the Fed or the newly constituted central clearing authority is initially the same as the value of bank deposit credits at the Fed just prior to the reform, and that this value continues to be strictly controlled by the Fed, mainly through open-market operations. Thomas's measure of high-powered money will then exceed the standard measure by the nominal value of government securities held by clearing-authority account holders. These security holdings are included, presumably, because they can be used to secure intraday clearing-authority loans, the proceeds of which serve to (temporarily) augment available clearing account balances.

One is, of course, free to define things as one pleases. Nevertheless it is generally unhelpful to play around with words' generally accepted meanings when asking readers to evaluate a reform proposal that also involves some sweeping substantive changes. Moreover, Thomas's revised definition of high-powered money is inferior to the standard definition, because it ignores the fundamental distinction between *actual* and *potential* settlement balances as well as that between *intraday* and *overnight* balances. An actual deposit credit is one thing; a line of very short-term credit (or stock of collateral eligible for securing such credit) is another. First-time money and banking students are thus quite properly disabused of their temptation to include unspent credit-card lines of credit as a component of one or several monetary aggregates. The same reasoning one uses to dissuade them applies to the present case, to wit: that the general behavior of nomi-

nal magnitudes is more closely geared to *actual* money holdings than to *potential* holdings. Were this not the case, monetary policy as conventionally understood would be entirely incapable of influencing aggregate demand and the general price level.

Suppose, for example, that following the implementation of Thomas's recommended reforms the Fed undertakes an open-market operation involving a large purchase of Treasury securities from private financial firms with clearing-authority accounts. This open-market operation would reduce the outstanding stock of "government securities available for repo (or collateralized borrowing) through accounts with the clearing authority" by the same amount as it expands the quantity of (indisputedly high-powered) Federal Reserve liabilities. Employing Thomas's definition, the total stock of high-powered money would remain unchanged, leaving one to wonder how the Fed could possibly remain "no less able to control the money supply than [it] is today" (p. 247). In other words, either Thomas's revised definition of high-powered money is misleading, or his claim that his reform would still leave the Fed in control of the money stock (and, by implication, other nominal magnitudes) is suspect.

If (as I believe to be the case) Thomas's revised definition of high-powered money is simply misleading, then we can get a better grasp of the consequences of his proposed reforms by rejecting that definition in favor of the conventional one and by rejecting as well (as nothing other than a semantic quibble) Thomas's claim that his reform would automatically *increase* the stock of high-powered money. If the reform wouldn't really alter the stock of high-powered money, what affect would it have on the *broad* money stock? The answer depends on the extent to which equity-based "money funds" take the place of proscribed bank liabilities. Thomas himself suggests that only a very partial substitution will occur. For the sake of completeness I think it best to consider two extreme cases, which together encompass the case Thomas himself has in mind. The first of these is the case in which *no* money funds are held, so that (conventionally defined) high-powered money becomes the only available exchange media.

100 Percent Money

Were it to lead in practice to the complete abolition of low-powered (bank-supplied) money, Thomas's proposal would be far from original. Numerous proponents of a "100 percent" high-powered monetary arrangement can be found among economists starting from the days of Adam Smith. The idea fell into neglect after the first half of the 19th century, but was revived in the mid-20th

century by several Chicago School economists including Henry Simons, Lloyd Mints, and Milton Friedman.

It is worth noting that proponents of the "Chicago Plan" saw it as one possible solution to a very specific problem, namely, the tendency in modern banking systems for the money multiplier and money stock to fluctuate in response to changes, including routine changes, in the public's desired currency-deposit ratio. At least some proponents of the plan, Lloyd Mints (1950: 187–88) and Milton Friedman (1959: 69) among them, understood that the problem it was meant to address could also be solved by abolishing legal restrictions that prevented commercial banks from issuing their own convertible paper notes on a fractional-reserve basis.[5]

Thomas's own (near) 100 percent money plan, if that is in fact what it would amount to, has a somewhat different motivation than its Chicago School predecessor. Thomas wants to deny banks the ability "to attract subsidized deposits to fund risky activities" (p. 241). Conventional bank deposits are supposedly "subsidized" by means of government guarantees, in the form of either deposit insurance or potential central-bank-administered last-resort aid. So why not just end the subsidies by abolishing the guarantees, that is, by doing-away with the FDIC and by shutting down the Fed's discount window?[6] Because, Thomas assures us, so long as conventional bank deposits exist, deposit guarantees are needed "to protect society from the costs of bank failure" (pp. 240–41). Thus, in order to "protect" everyone's bank deposits, while avoiding any serious moral-hazard problems, we need to prevent people from having bank deposits.

But is such a drastic remedy really necessary? A number of advanced economies today have well-functioning monetary and (con-

[5]Mints (1950: 187–88) regarded the ban on competitive note issue as an "unnecessary legal restriction" of commercial banks and viewed it as a fundamental cause of the "incomplete interconvertibility of notes and deposits" and subsequent "perverse behavior of bank loans" that could also be avoided through the more dramatic remedy of abolishing fractional reserves.

Although he does not refer to Mints' work, Thomas refers to and has presumably read Friedman's 1959 *Program for Monetary Stability*. Yet he never mentions the Chicago Plan. Moreover, his one reference to Friedman's book involves a serious misrepresentation of Friedman's views: whereas Friedman (1959: 62) merely claims that short-term Treasury debt is a *closer* substitute for money than long-term debt, Thomas quotes him in support of his peculiar practice of treating some non-Fed holdings of Treasury securities as an actual component of high-powered money. Clearly Friedman (a monetarist, after all) could not possibly have regarded Treasury securities as *perfect* substitutes for Federal Reserve notes or deposit credits.

[6]On the feasibility and desirability of shutting down the discount window see Goodfriend and King (1988) and Kaufman (1991).

ventional) banking systems that do not rely on government guarantees. New Zealand is a good example. Hong Kong, where Thomas teaches, is another.[7] There have been many more examples of such arrangements throughout history, of which Scotland's before 1845 (when Peel's Act was made applicable to Scottish banks, for no good reason) and Canada's before 1967 (when the Canadian Deposit Insurance Corporation was established, also for no good reason), and especially before 1935 (when the Bank of Canada was established, once again for no good reason), are perhaps best-known.[8] These and other examples suggest that government interventions, including central-bank misconduct and ill-designed deposit insurance schemes, have often been, not devices for preventing bank failures, but the most important *cause* of both individual bank failures and systemic banking crises (cf. Selgin 1989 and Benston and Kaufman 1995).

Of course bank money would not be entirely risk free even in the best (unregulated) banking system. Individual bank failures would still occur, and deposit (or note) holders might suffer losses in connection with such failures. But the fact that conventional bank money cannot be a truly "riskless" medium of exchange is hardly a reason for condemning it. The belief, which unfortunately seems to be gaining hold even among otherwise sound monetary theorists,[9] that a banking system cannot be any good so long as bank depositors bear any default risk at all is regrettable. Indeed, the opposite view is more true: you can't have a good banking system in which the persons who chose which banks to fund don't ever suffer from making bad choices. Thomas is right to recognize that the only way to have truly risk-free money is to do away with banks altogether. But he is wrong in assuming that such a risk-free monetary system would be desirable, let alone ideal.

Monetary Contraction and Deflation

Before turning to consider the advantages of "risky" bank money, let's consider some of the dangers posed by Thomas's purportedly "riskless" alternative. Thomas himself admits that his proposed reform might confront the Fed with a situation in which "prices are

[7]Chu (2000) convincingly rebuts the claim that Hong Kong would be better off with deposit insurance.

[8]On the extension of Peel's Act to Scotland, see White (1995: 85–88); on Canada's decision to establish a central bank, see Bordo and Redish (1987). Thomas himself (Saunders and Thomas 1997: 427) has discussed the politics behind Canada's Bank Act of 1967. Calomiris (1990) surveys historical evidence bearing on the alleged necessity of deposit insurance.

[9]See, for example, Bordo and Schwartz (1995), and my reply (Selgin 1995).

dropping rapidly and the value of its currency on foreign exchange markets is increasing" (p. 246). The reform could, in other words, cause a serious deflationary crisis. But not to worry: Thomas assures us that the crisis could be avoided *if* the Fed expanded the stock of high-powered money sufficiently to offset the more intense demand for it that would arise from the suppression of conventional base-money substitutes. Well, of course the Fed *could* do this. It could, by the same token, prevent a similar deflation stemming from the sort of banking crisis Thomas seems so anxious to rule out. Nevertheless one ought to consider that the Fed might already have enough on its plate without having to worry about dramatic policy-induced swings in base-money demand. One ought to consider as well the very real possibility that the Fed might fail to respond as needed, as happened, with dire consequences, in the 1930s. A good monetary reform ought to reduce the risk of a deflationary crisis, instead of enhancing that risk, if only temporarily.

A second criticism is that the reform would deprive the U.S. economy of an important source of loanable funds. Thomas himself forthrightly "acknowledges that a drop in lending would likely occur," although he does not discuss how large the "drop" might be. Instead, he argues that what matters "is not the amount of [lending] in society but [the loans'] productivity" (p. 247).

Of course the productivity of loans matters. But the fact that the productivity of loans matters does not mean that their real quantity doesn't. The question then is whether Thomas's reform would enhance the productivity of remaining loans enough or more than enough to compensate for the reduced volume of lending it entails. Thomas claims that it would, because government deposit guarantees in the present system promote inefficient bank lending to overly risky borrowers. But granting that guarantees do in fact promote inefficient lending, it is highly unlikely that the massive legal restriction Thomas would impose on financial intermediaries would constitute an improvement. For one thing, one does not observe the complete disappearance, or anything like it, of conventional bank deposits, and non-securitized lending financed by such deposits, in banking systems where deposits are not "subsidized" by government guarantees and where banks are not prohibited from dealing in equity. For another, bankers themselves bear a substantial part of the costs associated with government guarantees, so that some of them at least might not actually benefit from the guarantees. (An example would be a safe but small-enough-to-fail bank that overpays for mandatory government insurance under a flat-rate insurance scheme.) In short, the optimal allocation of credit—the allocation that would arise in the absence of

guarantees—might not be so radically different from the allocation with guarantees as Thomas supposes. In any event, such an optimal allocation can only be determined, not by legally blocking bank (or FI) funding avenues, but by eliminating supposedly distorting subsidies.

Mutual Fund Banking

By assuming that his reform would result in some significant reduction in nominal supplies of money and credit, Thomas may overstate his reform's drawbacks. Suppose that he is incorrect, and that the reform instead leads to a one-to-one substitution of money fund account balances for more conventional but prohibited bank liabilities. Suppose further that, under normal circumstances, money fund shares trade at par and are just as checkable (or otherwise debitable) as old-fashioned demand deposits. How does Thomas's proposal stack up given these more favorable assumptions?

The reform would, first of all, be no less unoriginal than was the case under the extreme opposite assumption that renders it equivalent to a proposal for 100 percent money. For under the new assumption the proposal would create a "mutual fund" banking system of the sort that has already had numerous proponents. They include Tyler Cowen and Randy Kroszner (1990), whose thoughtful article on this subject may be taken as representative of the rest. Cowen and Kroszner's proposal differs from Thomas's (given our assumption that his reform would lead to a complete substitution of transactable mutual fund shares for former bank deposits) in two important respects: first, Cowen and Kroszner's reform, unlike Thomas's, would allow mutual fund banks to invest in low-risk corporate securities. Second, whereas Thomas's reform would *force* the public to rely solely on either money funds or high-powered money as its means of exchange, Cowen and Kroszner's would merely *allow* people to switch to mutual fund banking by eliminating government-imposed restrictions that might otherwise prevent it from evolving. These differences, I think, make Cowen and Kroszner's proposal superior, for reasons that become clear once the monetary implications of mandatory mutual fund banking are examined.

What, then, would be the money and credit consequences of a mandatory and complete switch to mutual fund banking? Given the assumption of an unchanged monetary base, such a switch need not pose any transitional deflationary threat. Also, the reformed stock of low-powered money would no longer be insured by the FDIC, and would to that extent at least avoid the moral hazard problem. Finally, the total value of an FI's transactable balances, as equity shares in its

portfolio, could never exceed the value of the FI's assets. This means that FI "depositors" have less incentive to stage a run, because FIs can never be rendered insolvent by a large-scale "deposit" redemption.

But while a mutual fund or money fund account may be more immune to runs than a conventional bank deposit, it does not follow that a mutual fund–based payments system would be entirely free from any risk of a serious disruption of payments in response to a large enough capital loss. That such a disruption might occur can best be understood by considering the substantial transactions costs that may be involved in the transference, clearing, and settlement of equity-based claims. If the total value of money fund balances is free to fluctuate along with changes in the market value of underlying fund assets, then checks written against mutual funds must be understood as claims against general fund assets and not against settlement balances per se. Therein lies a potential nonpar exchange problem, for were the face value of a money fund share literally allowed to fluctuate with every change in the value of underlying fund assets, dollar-denominated checks written against such funds would not have a fixed share value. Cowen and Kroszner (1990: 225, n. 3) acknowledge the problem, observing that it can be avoided by fixing the nominal price of a money fund share at one dollar, while distributing capital gains in the form of additional shares. However, this solution works only so long as fund assets appreciate: Cowen and Kroszner admit that "if an account suffers sufficiently large capital losses . . . par value clearing might no longer be sustainable." It follows that, so long as a money fund's assets have a risk of declining in value over any period (as even a pure Treasury portfolio might do as a result of managerial incompetence or a sharp upward rise in market interest rates), its owners face some risk of encountering a substantial increase in the costs of transacting with checks drawn upon it, and might even have their checks refused altogether. Such an outcome would resemble and might be no less inconvenient than a suspension or restriction of cash payments in an ordinary banking system. Moreover, it is by no means obvious that episodes of money fund depreciation would be less common in Thomas's envisioned arrangement than suspensions and restrictions have been in legally unrestricted banking systems.[10]

[10]The portfolios of many uninsured 19th-century banks were in fact similar to those of some modern money-market mutual funds: they were mostly made up of short-term, high-grade, liquid commercial paper and government securities. Grant (1992) offers a fascinating account of the conservative bent of U.S. banks prior to the advent of deposit insurance, and of how government guarantees undermined that conservatism.

Thomas is thus incorrect in treating money fund balances as an entirely "riskless money" (p. 242) or as a money that is just as low risk as (conventionally defined) high-powered money. But this is a relatively minor point. A more fundamental criticism of mandatory mutual fund banking is that, even if the overall riskiness of money funds were considerably less than that associated with conventional bank deposits in a truly unregulated banking system, it is by no means clear that the reduction in risk would represent a gain in welfare, for the simple reason that conventional bank deposits, and investments they are capable of funding, may earn higher returns. This rather obvious point casts doubt not only on Thomas's suggestion that his mandatory reform would enhance welfare but also on Cowen and Kroszner's prediction that genuine deregulation would result in a wholesale *voluntary* switch to mutual fund banking.

The welfare losses suffered by money holders under Thomas's plan have as their counterpart gains to the U.S. Treasury. By forcing money holders to hold most of their money in the form of equity shares, and by requiring FIs to back those shares with Treasury securities, Thomas's proposed reform, understood as a call for mandatory mutual fund banking, would cause a substantial diversion of loanable funds from the private sector to the government. This would, admittedly, be better than the absolute reduction in the volume of lending that would occur, according to Thomas himself, under his own assumption that money funds do not entirely take the place of former bank deposits. But it would still entail a net reduction rather than a gain in the productivity of investment, not to mention the well-being of those businesses and individuals accustomed to getting bank loans.

Real Deregulation

The one desirable end Thomas seeks to achieve through his reform—an efficient payments system—cannot be achieved by the means he proposes. But that end *can* be achieved by means of a *genuine* program of bank deregulation. This would involve (1) allowing access to the Fed's final settlement facilities to any legitimate financial firm (including mutual funds) or clearinghouse that wants a Fed account (but not to Joe Public, who can get by more efficiently with a regular bank account, or with cash); (2) eliminating any other legal restrictions that might hinder the growth of mutual-fund banking; and (3) eliminating government-based deposit guarantees by closing the Fed's discount window and by abolishing the FDIC. The last step could be undertaken gradually by limiting insurance cover-

age to aged deposits at "narrow" banks (Litan 1987) while allowing uninsured "broad" banks to compete directly with narrow ones.

I do not mean to suggest that a genuine deregulation of banking is something that can be easily accomplished or that the steps required can be adequately summarized in a paragraph or two. My point is simply that there is no obvious reason why genuine deregulation should be dismissed as a practical solution in favor of a plan that is in many respects more radical, and certainly more unprecedented, and which could have some serious drawbacks that genuine deregulation would avoid. I hope that Thomas himself, keeping in mind the experiences of places like Canada and Hong Kong, will give more serious thought to such a genuine deregulatory alternative instead of insisting upon a reform that would "deregulate" banks only after abolishing them.

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