

BOOK REVIEWS

Jimmy Stewart Is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking

Laurence J. Kotlikoff

Hoboken, N.J.: John Wiley & Sons, 2010, 241 pp.

Chapter 1 of the book is titled “It’s a Horrible Mess,” and in it Laurence Kotlikoff, a professor of economics at Boston University, reminds the reader of the breadth, depth, and horror of the global financial crisis. It is a cure for the dispassionate observer of events, an indictment that would send all but those with ice water in their veins to sign up for the Tea Party Express. The book is a particularly well-written account of the crisis that begins in housing finance, spreads throughout the financial system, and then throughout the real economy. The crisis hit in tsunami-like waves beginning in 2007 and continued into 2009.

In Kotlikoff’s words, “We thought we had well-functioning banking and insurance companies with competent directors, world-class managers, responsible regulators, and incorruptible rating companies. But overnight, we it learned it was a sham.”

The theme that financial capitalism was a sham runs throughout the book. He asks and answers in the affirmative whether Wall Street is running a Ponzi scheme. Russ Roberts, an economics professor at George Mason University, has reached the same conclusion, and similar indictments have been made across the political spectrum. Former Fed chairman Paul Volcker has suggested much of what occurs on Wall Street involves moving economic rents

around without creating economic value. In short, Kotlikoff echoes the opinion of many observers.

Other themes include both the perfidy and sheer incompetence of those who ran major financial institutions, the failures of the regulatory apparatus, and the haplessness and confliction of those directing financial policy.

Kotlikoff employs a journalistic style, but underlying the account is the analytic mind of a first-rate economist. He is eclectic in his theoretical approach, telling the reader “I’m neither a Keynesian nor a monetarist,” but I believe in the possibility of “multiple equilibria associated with coordination failures.”

As the subtitle suggests, the analysis of the crisis is a prelude to a proposal for reform: limited purpose banking. LPB is a variant of narrow banking. He expands on traditional narrow banking proposals in two dimensions, and thereby moves to a much broader financial reform.

Traditional banking is a debt-based system in which banks borrow money from the public in the form of deposits. Bankers keep only a portion of the borrowed funds in the form of cash or reserves, and lend the rest out. As banker George Bailey (played by Jimmy Stewart in *It’s a Wonderful Life*) had to explain to his angry depositors, their money was not really in the bank but on loan to their neighbors. The system is called one of fractional reserves.

Over the centuries, bankers learned to forecast normal cash demand and kept cash reserves on hand (or in correspondent banks, and later central banks). The smart ones kept a little extra. Fractional reserve banking works in normal times, but is prone to break down in times of financial stress when most or all banks face extraordinary demands for cash.

In the United States, the weaknesses of fractional reserve banking were compounded by an artificial system (in many states) of a large number of small, unitary banks (one office). Local economic downturns would sour the loans of such banks, lowering the value of their assets, and increase cash demands as stressed borrowers drew on their bank deposits to meet expenses. The system of small banks with fractional reserves made them prone to bank runs and failure. It is that combination that explains the appeal of narrow banking in the U.S. context.

These problems were long recognized, and the onslaught of the Great Depression brought proposals for banking reform.

Economists at the University of Chicago put forth the Chicago Plan in 1933, and Yale Economist Irving Fisher proposed his own system of 100 percent money in 1935. Though plans differed in details, the essential idea was to separate banking into two parts. The payments system was protected by requiring 100 percent reserves against transaction or checking accounts (demand deposits) in a narrow bank. Reserves would comprise vault cash plus deposits by commercial banks at their local Federal Reserve Bank. Traditional bank lending would be separated from risky investment banking.

Milton Friedman was a notable exponent of narrow banking, and he updated the Chicago Plan in *A Program for Monetary Stability* (1960). In 2009, Ronnie J. Phillips and Alessandro Roselli further updated the proposal in a policy brief entitled “How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal.”

Such plans were considered but rejected in the 1930s in favor of retaining fractional reserve banking and unit banks, and adding deposit insurance to forestall bank runs. That adherence to the status quo ensured an unsafe banking system and periodic bailouts. Many banking economists believe that deposit insurance could have been avoided and banking stability achieved by moving to nationwide branch banking—a scheme that sustained the Canadian banking system through the Great Depression and the recent financial crisis.

The wonder is that it has taken so long for a serious reconsideration of narrow banking. Though at some pains to distance his plan from earlier proposals, Kotlikoff builds on those models. He goes considerably beyond them, however, in two important dimensions.

First, he includes *all* financial institutions in his plan. Previous narrow banking plans shared a common problem. Nonbank financial firms would have an incentive to issue close substitutes for demand deposits to compete with the restricted narrow banks. These nonbanks could offer higher yield on such substitutes because of the riskier, higher-yielding assets they would hold on their balance sheets. In its modern form, that is the problem of shadow banking. Even in the 1930s the problem was recognized. Chicago School economist Henry Simons wanted to limit all forms of short-term credit.

Kotlikoff's second innovation may be bolder than the first. He wants to switch from debt-based banking and finance to an

equity-based system. At the level of the financial firms (banks and all others), all financial activity would take place through mutual funds. Financial firms could not leverage themselves by borrowing money. Banks would not suffer losses or book gains on their activities, though their customers would.

Banks would offer mutual funds comprising assets of various categories, duration and risk. They would be only intermediaries in doing so, and would more resemble a mutual-fund family like Fidelity than a modern bank. One such fund would be a cash mutual fund and would most resemble the narrow bank. Thus, as Kotlikoff emphasizes, narrow banking is but an element of his proposed total transformation of the financial system.

Kotlikoff tells the reader upfront that he comes to the issue not as a specialist, but with the freshness of an outsider. That brings its advantages, but on this second, far-reaching aspect of his reform proposal it brings problems. He appears unaware of the large and contentious literature on equity banking; certainly he cites none of it. His proposal invokes the contributions of Fischer Black, Eugene Fama, and Robert Hall—the so-called BFH system. Their proposal for mutual-fund banking was perhaps most ably advanced by Robert Greenfield and Leland Yeager. It has been criticized by, among others, Lawrence H. White and myself. A good deal of the debate occurred in the pages of the *Cato Journal*. In short, Kotlikoff has prodded an intellectual hornet's nest with his proposal.

Without reviewing the many contentious (and sometimes technical) issues involved, I will raise one serious and practical one. There has been no observed tendency for equity banking to crowd out debt banking. Quite the contrary. White has argued that par-valued debt-claim notes and deposits have historically evolved as media of exchange instead of mutual fund shares. He attributes that evolutionary dominance to lower transaction and information costs.

In proposing reforms, one should attend to what has actually worked historically and evolved as the result of market forces. Kotlikoff correctly attributes the problem of existing banking arrangements to the ability of banks and other financial institutions to leverage not just their own money but the taxpayers'. That is because governments routinely bail out creditors of these over-leveraged institutions. The response surely should be to end bailouts, not leverage. The fact that, under existing public policy, banks over-leverage does not imply that zero-leverage is the preferred outcome.

The breathtaking changes required of the existing financial system to move to LPB are illustrated by Kotlikoff's plan to break up Citigroup to conform to the new model. Nothing less than a kind of robust and unprecedented antitrust policy would be required.

All the problems mentioned thus far pale in comparison to what I consider the Achilles heel of Kotlikoff's proposal. Almost in passing, he proposes a single, overarching regulator of financial services: the Federal Financial Authority. It would take over the functions of all existing financial services regulators and then add to that portfolio. Just consider FFAs role in the mortgage market, as a hypothetical borrower, Robby seeks a loan. "The FFA would verify Robby's income statement using federal income tax returns; it would certify his credit rating; it would verify, using independent local appraisers, the value of the home he intends to purchase; it would verify the property taxes and insurance costs on the home; and it would specify all other pertinent information that would help a mutual fund understand the value of buying Robby's mortgage."

Suffice it to say that the FFA makes LPB a nonstarter on grounds too numerous to catalog in a review. Let me just clarify, however, what the FFA would be in reality: a super-SEC. Kotlikoff wants the FFA to do for the entire financial services industry what the SEC is supposed to do for the securities industry. The SEC is the poster child for failed financial services regulation, and justifiably so. Kotlikoff details some of its notable failings, particularly the Madoff case. I can understand the desire for a new acronym, but changing the name will not change the substance.

Kotlikoff excels at detailing the failings of the existing regulatory structure, but does not explain why his proposed system would work any better. If the regulators at the FFA face the same incentives as do those at the SEC (and the rest of Washington's alphabet soup panoply of regulators), then we should expect the same outcome. Government regulation, no matter the industry, typically fails for two reasons. First, there is the Hayekian knowledge problem. The information needed for effective regulation is dispersed across firms, the industry, and even the economy. There is no effective means for marshaling and centralizing the information within the agency.

Second, regulators are routinely captured by the industry they regulate. Through frequent interaction with members of the industry, regulators come to identify with the industry's interests over the public's. The revolving door between industry and government

exacerbates that problem. These two factors go a long way to explain the SECs sorry record, and help explain why Kotlikoff's idea for an FFA is so ill-conceived. It might very well be the case that LPB could be run without an FFA, but not as Kotlikoff has designed it.

There is a great deal to recommend this book. First, there is Kotlikoff's recounting of the crisis itself. Second, there is sense of the manifest injustice of a system in which bad actors get to gamble with other people's money. Third, there is the challenge to do something radical to reform a system that is radically dysfunctional.

Kotlikoff has performed a service by challenging the existing institutional structure. As I have suggested, he can make common cause with many other economists of divergent political persuasions. James Buchanan has made what may be the strongest argument for 100 percent reserve banking in his article "The Constitutionalization of Money," which recently appeared in the *Cato Journal*. He observes that the economic case for fractional reserve banking was to economize on reserves in a commodity money system. Commodity money is costly to produce. Not so fiat money. "The central logic of leverage banking, of any sort, is absent under the operation of a pure fiat money system."

Whether the case for narrow banking can finally be convincingly made remains to be seen. The case for mutual-fund banking is a giant leap beyond that. The FFA would, I predict, create an even more horrible mess than yet witnessed in financial services.

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The New Holy Wars: Economic Religion vs. Environmental Religion in Contemporary America

Robert H. Nelson

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Robert H. Nelson, one of the world's leading natural resource economists, long has argued that the ideologies in economics are secularizations of traditional religion and that this concealment is ill advised. Less convincingly, he advocates linking these new ideologies to their religious roots. He now also brands environmentalism as a