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The Monetary Reform Debate as the Continuation of the Long-Standing Currency vs Banking School Debate and the Identification of Its Long-Overdue Resolution

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ABSTRACT

Aim. Since the 2008 crisis, an increasing number of economists and commentators have been calling for fundamental reform of our monetary system and financial architecture. In particular, banks have been heavily criticised, and policy proposals include the demand to abolish banking. Such calls for monetary reform are not new. In 19th century England, a policy debate among economists and policy-makers fell into two main camps, the so-called Currency and the Banking Schools. The former argues for centralisation of money issuance, the latter for decentralised money creation. **Theses and methods**. We show that present debates on reforming the monetary system, including introducing central bank digital currencies and a drastic shrinkage (if not elimination) of commercial banking, continue this familiar dichotomy, of which the protagonists seem unaware. In addition to pointing out that present-day debates about monetary reform merely restate the centuries-old positions of the Currency and Banking School protagonists, we argue that it is high time to resolve the dichotomy between the two schools. We do this by presenting and explaining an **empirically** successful compromise between the extreme positions of the two schools of thought that achieves the goals of both. **Results**. It consists of the successful decentralised banking structure of countries such as Germany, whose banks are mostly not-for-profit enterprises in public and/or local hands that lend mainly for productive business investment, while a central bank exists that can avoid crises by monitoring aggregate bank lending for non-GDP (asset) transactions. **Conclusion**. We believe this constitutes an important contribution to the present debate about the potential reform of national and international financial architectures.

Keywords: "Currency School"; "Banking School"; David Ricardo; Thomas Took; credit operations; central bank

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ОРИГИНАЛЬНАЯ СТАТЬЯ

Дебаты о денежной реформе как продолжение давних дебатов «Денежной школы» против «Банковской школы» и определение давно назревшего решения

Пламен Иванов, Ричард А. Вернер

АННОТАЦИЯ

Цель. Во-первых, результаты проведения анализа ситуации, сложившейся после кризиса 2008 г. призывают к фундаментальной реформе денежно-кредитной системы. В частности, резкой критике подверглись банки. Звучат призывы политиков упразднить банковскую деятельность. Во-вторых, подобные предложения не новы. В Англии XIX в. политические дебаты среди экономистов и политиков разделились на два основных лагеря: на «Денежную (Валютную)» и «Банковскую школу». Первая выступала за централизацию эмиссии денег, вторая — за децентрализацию. **Тезисы и методы**. По мнению авторов, нынешние дебаты о реформировании денежной системы, введении цифровых валют и резком сокращении (если не ликвидации) коммерческого банкинга продолжают эту знакомую дихотомию. Авторы считают, что современные дебаты о денежной реформе просто повторяют позиции сторонников обеих школ. Значит, пришло время разрешить дихотомию между двумя школами, представляя и объясняя **эмпирическим методом,** доказанный успешный компромисс между крайними позициями двух школ. **Результат**. Он состоит из успешной децентрализованной банковской структуры таких стран, как Германия, чьи банки в основном являются некоммерческими государственными или муниципальными организациями, предоставляющими кредиты для бизнеса. В то время как центральный банк занимается мониторингом всех банковских кредитных операций, не связанных с ВВП (активами), что помогает избежать серьезных банковских кризисов. **Выводы**. Авторы убеждены, что этот успешный опыт необходимо использовать не только в научных дискуссиях, но и при разработке практических подходов к потенциальному реформированию национальной и международной финансовой архитектуры.

Ключевые слова: «Денежная школа»; «Банковская школа»; Давид Рикардо; Томас Тук; кредитные операций; центральный банк

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1. Introduction

The 2008 crisis highlighted 'flaws' in macroeconomics, see, for example, Greenspan's Congressional testimony), especially the omission of banking [1]. The realisation that banks create money when they grant credit [2–4] triggered attempts to introduce banking into DSGE models [5, 6] and a debate about which role banks and central banks *should* play in the economy. Some propose to fully concentrate the power of money creation in a monopolistic central bank [7–9]. On the other end of the spectrum are those criticising the central banks for the policy failures that caused the 2008 crisis [10] and calling for a decentralised system of credit-creating private banks responding to the financing needs of the real economy [11–13], or consider central banks unnecessary [14–16].

This debate between those who want a central bank and no banks vs those who want banks and no central bank repeats the unresolved dispute between the Currency and Banking Schools, a prominent feature of the monetary economic policy discourse in the 19th century. Recent economic history suggests that financial crises trigger such discourse about the architecture of the monetary and financial system. So far, central banks have gained greater powers, to which the private banking sector responded with financial engineering to maintain its influence. Figure 1 illustrates the three waves over the last 200 years.

Since the present debate and proposed reforms repeat the unresolved dispute between the Currency and the Banking Schools of the 19th century, we consider it important to find a balance between the extreme positions of the two Schools that serves as an acceptable compromise as it enables proponents of both Schools to claim victory by delivering their key declared policy aims. At the same time, this compromise is shown to have delivered superior economic performance.

1.1. Currency School

The Currency School advocates a centralised monetary system with a powerful central bank representing the public while abolishing the other banks (e.g., rendering them non-bank financial intermediaries in a 'full reserve' system). Influential economists such as Ricardo [17], Mises [18] and Fisher [19] advanced such proposals in earlier epochs.

Ricardo's Plan for the establishment of a National Bank was to appoint five central bank commissioners, "in whom the full power of issuing all the paper money of the country shall be exclusively vested" [17, p. 15]. Two decades later, the 1844 Bank Charter Act seemed to implement Ricardo's proposal in England and Wales, rendering the Bank of England (although privately owned) the sole issuer of bank notes. This apparent Currency School victory was short-lived: Banks continued to create credit money via ledger-entry, today's dominant digital currency, whereby ca. 97 per cent of the money supply is created by the banks [3]. Furthermore, the 'bank wars' in the US failed to establish a lasting central bank

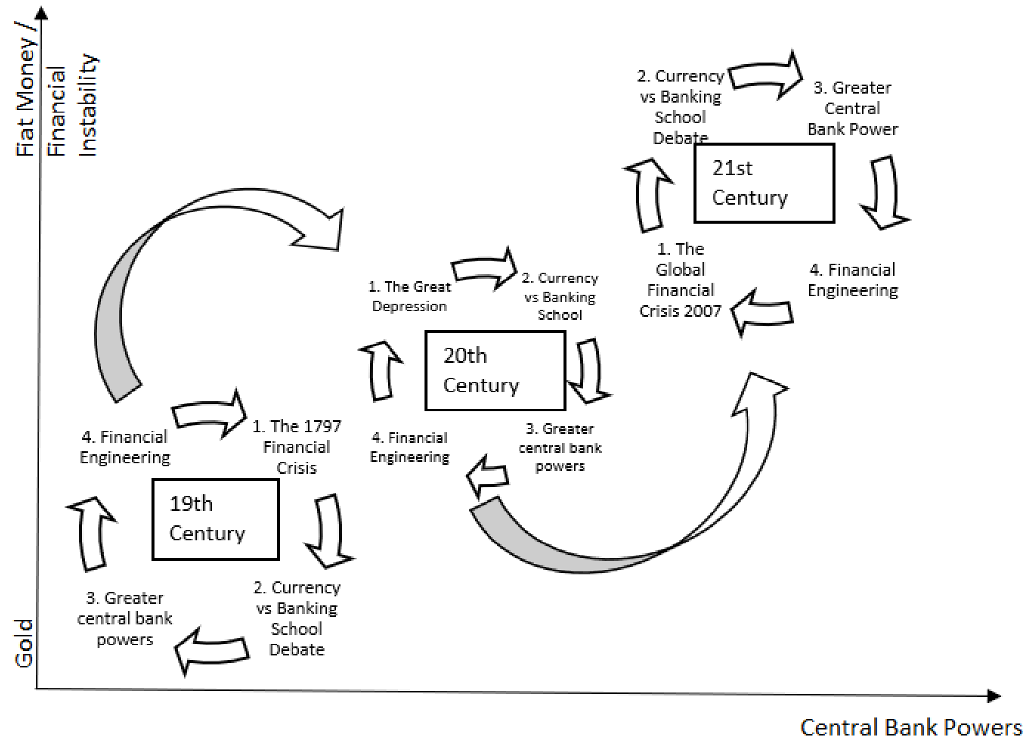

Fig. 1. **Currency-Banking Debates over the last 300 years**

Source: Central Bank Powers.

institution until 1913, leaving the Banking School the victor, with decentralised bank credit creation in an almost 'free banking' regime.

Irving Fisher [19] revived the Currency vs Banking School debate during the Great Depression in the US by repeating the call to end bank credit creation and turn banks into mere financial intermediaries, as this was seen a way to end bank runs, eliminate inflations and deflations and mitigate booms and depressions. In formulating his plan, Fisher had not analysed the role of the central bank in causing the significant boom-bust cycles in the US, nor its failure to step in and prevent banking crises from turning into an economic depression — despite this having been the declared justification for the establishment of the Federal Reserve in the first place [20]. Fisher's plan was ignored in the US and the country continued to boast the largest number of banks in any one nation (at close to 30,000 banks at the peak in 1920, closely followed by Germany; and despite losing over 10,000 during the 1930s).

However, the Fisher plan to abolish banks did seem to describe the situation in the Soviet Union at the time. It thus may have been inspired by it: Here, taking control of the banking system and concentrating it into one single monobank had already been a prime target of Lenin after the Bolshevik Revolution, which was eventually realised with the economic reforms of 1930–1932, when Gosbank became the monopolist central bank of the Soviet Union and largely maintained this role for the following half-century. No doubt Lenin's economic views were influenced by another classical economist publishing in England, namely Karl Marx, who in the communist manifesto of 1848 had argued for the introduction of a single state bank:

"5. Centralisation of credit in the hands of the state through one national bank with state capital and in exclusive monopoly" [21, p. 16].

Lenin concurred around the time of the Bolshevik Revolution:

"Without big banks, socialism would be impossible. The big banks are the 'state apparatus' which we need to bring about socialism, and which we take ready-made from capitalism.... A single State Bank, the biggest of the big, with branches in every rural district, in every factory, will constitute as much as nine-tenths of the socialist apparatus. There will be country-wide bookkeeping, country-wide accounting of the production and distribution of goods; this will be, so to speak, something in the nature of the skeleton of socialist society. [Italics in the original] [22, p. 106].

Lenin also wrote soon after:

"Banking policy must not stop with the nationalisation of banks, but must work slowly but decisively toward the transformation of banks into a single accounting apparatus for the regulation of the organised socialist economic life of the country as a whole." [22, p. 220].

According to Garvy [23], Lenin

"was impressed with the technical functions performed by the extensive branch networks dominating the scene in Germany, the United Kingdom, France, and indeed, Russia itself, rather than with the possibility of using monetary and credit policy as a tool for restructuring the economy and achieving adequate growth and stability" [p. 22].

While the dissolution of the Soviet Union discredited the idea of the central bank as a sole monopoly bank on the world stage, after the 2008 crisis this idea was revived by Benes and Kumhof [7] and others who argue that the credit creation privilege should be concentrated and vested in public hands, and with the same justification as Fisher presented, namely to prevent banking crises. Again, as with Fisher, the proponents of banking centralisation and Soviet-style monobanking do not present any analysis of the role and responsibility of the central banks in the run-up to the 2008 banking crisis and their choice to ignore warning voices (such as [3, 24]). After the crisis, central bank policies reduced bank profit margins, significantly increased regulatory burdens and costs and even imposed a new tax on banks in the form of negative interest rates on banks' reserve holdings at banks. In the Eurozone, this resulted in thousands of banks disappearing. Under the watch of the ECB, 4,800 have disappeared, and their number has also been declining in the US. Central banks thus appear to be getting closer to the goal of ultimately becoming the only bank left. Central banks' preparations to compete directly against private-sector banks by offering current accounts to the public (somewhat misleadingly called 'central bank digital currency, despite banks having been offering their own widely used digital currency for many decades) seems to advance this agenda further, as CBDC will likely drive banks out of business [25, 26].

This revived Currency School proposal has drawbacks [11, 13, 27]. Krugman [28] fears abolishing banks would "drive even more finance into shadow banking and make the system even riskier". "…[S]uch a system would become even more terrifyingly pro-cyclical, indeed a recipe for disaster" [13, p. 6], as banks would financially engineer recapture of inside money creation, as after 1844 — a justified concern in the era of cryptocurrencies. Further, inelastic money supply [12] is likely to restrict growth and leave it at the mercy of anti-growth central banks that appear to be more concerned about "de-growth" recently in order to reduce carbon emissions:

"If more countries turn their Paris commitments into legislated objectives and concrete actions, the financial system will amplify the impact of their efforts by advancing sustainable investments and shutting down unsustainable activity. [29].

1.2. Banking School

Banking School proponents such as Thornton [30] and an earlier like-minded economist, John Law [31], recognised the important role banks played through their power to create credit and hence stimulate economic growth. Tooke [32] was another Banking School economist who argued against the 1844 Bank Charter Act. Their argument was that decentralised banking and hence money creation can respond flexibly to trade needs as bankers knowledgeable of entrepreneurs and their new technologies allocate newly created money productively, delivering growth and prosperity [31, 33]. The US economy seemed to prosper during decades without a central bank. Scotland's economy boomed during its free banking era. Thriving banking systems in Hong Kong, Luxembourg and Liechtenstein allowed prosperity and vibrant capitalism without central planners. As long as banks lend to the real economy, crises can be avoided.

In the recent debate about monetary reform, the proposal by centralisers such as Benes and Kumhof [7] and Kotlikoff [9], who wish to abolish banks, have been opposed by Goodhart and Jensen [13]. They argue that the track record of decentralised banking for economic growth and prosperity is very good. Meanwhile, the need for a central bank could be said to be less obvious [25]. Thus voices like Goodhart and Jensen can be seen as modern proponents of the Banking School.

2. Integrating the Currency vs Banking School Proposals

Many combinations are possible between the extremes of "only a central bank and no banks" on the one hand and "only banks, no central bank". A common pattern is a central bank and a private banking oligopoly. Currency School proponents criticise this as it "delegates a core public function — the creation of money — to a private and often irresponsible commercial oligopoly." [34].

Yet both schools want to avoid a return to credit-driven boom-bust cycles and ensure money creation is used for the 'real economy', not asset purchases [3, 8]; the Banking School always favoured bank lending to the 'real' economy, a recently self-declared goal by central banks that appears to be following the logic of Werner's Quantity Theory [2, 3]; see for instance the reasoning for the ECB's TLTROs).

A better balance between central bank and banks exists and has delivered prosperity and financial stability for the benefit of the wider public for the past 200 years. It did so by combining key features of both Currency and Banking Schools — it retained banks in a flexible, elastic and decentralised system able to react to business needs but returned the power of money creation to the people. This system has been in operation almost since Ricardo's day and has outperformed alternative banking architectures. As shown in Table 1, it is the decentralised structure of many small cooperative and savings banks ('community banks'), which are locally accountable or locally publicly owned and return their profits to local stakeholders.

Community Banking in Germany

There are ca. 1,700 banks in Germany (most in the EU), of which ca. 80% are not-for-profit community banks that deliver over 90% of all lending to small and medium-sized enterprises (SMEs). "'Relationship lending' is one of the most powerful technologies available to reduce information problems in small firm finance …" [35, p. 32]. Memmel's et al. [36] study of 16,000 firm-bank relationships in Germany found small and R&D-intensive firms prefer relationship lending due to improved access to "patient capital" — a key function performed by the community banks.

The German SMEs are usually family-run and scattered across Germany's regions, with "… the [typical] firm … heavily tied to its local community, despite being open to the world: [with] strong ties to … community banks" [37, p. 148]. The community banks help keep these SMEs competitive by funding upgrading technology. The decentralised small-scale banking architecture put money creation into the hands of the local public. It allowed Germany to out-class any other nation in the world terms of the number of SMEs that are global market leaders in their market niches (called 'Hidden Champions', since these firms are so small, their names are little known, despite holding number 1, 2 or 3 market share in the world in their respective niches). Germany boasts over 1,300 such Hidden Champions, far ahead of the largest economy with a very decentralised banking system, namely the US, which only has 366 Hidden Champions.[1]

The existence and steady support of local community banks in Germany explains why small German firms can be so successful and account for a substantial proportion of Germany's record-breaking exports, on occasion larger than China's: small German firms are able to swiftly upgrade their production to the latest available technology because their local small banks support them. On the other hand, research in the US has shown [38] that large banks are less interested in lending to small firms; small banks are more prone to lend to small firms. Hence economies with concentrated banking systems dominated by a small number of large banks are characterised by credit supply problems for small firms (as is the case in the UK). Mkaiber and Werner [38] even found that when small banks grow larger, they will also cast their lending net more towards larger firms. Thus there is a steady need to create new small banks.

There are other benefits from community bank dominated decentralised baning systems: Barboni and Rossi [40] find community banks serving economies better during and after the 2008 crisis. Small firms in Germany suffered no credit crunch. Unemployment stayed low. Community banks produce more stable earnings, are less likely to default and have fewer non-performing loans [41]. No tax money was ever used to bail out a community bank and no depositor has lost any money in 200 years. The dominance of community banks has prevented boom-bust cycles and banking crises in Germany.

3. Conclusion

German-style community banking constitutes a viable combination of the attractive features of the Currency and Banking School proposals. Money creation should only be returned to the people, as the Currency School demands if there is meaningful accountability — which is more likely to happen at a small, local scale; there is little chance to

[1] On other secrets of success of German firms, see Mear and Werner (39).

Table 1
Community Banks and the Currency-Banking School Dichotomy

Key Proposal	School of Thought		Community Bank System (money creation in the hands of the public)
	Currency School	Banking School	
Money Sovereignty	✓	✓	✓
Credit Supply Elasticity	✓	✓	✓
Real economy lending	✓	✓	✓

Source: The authors.

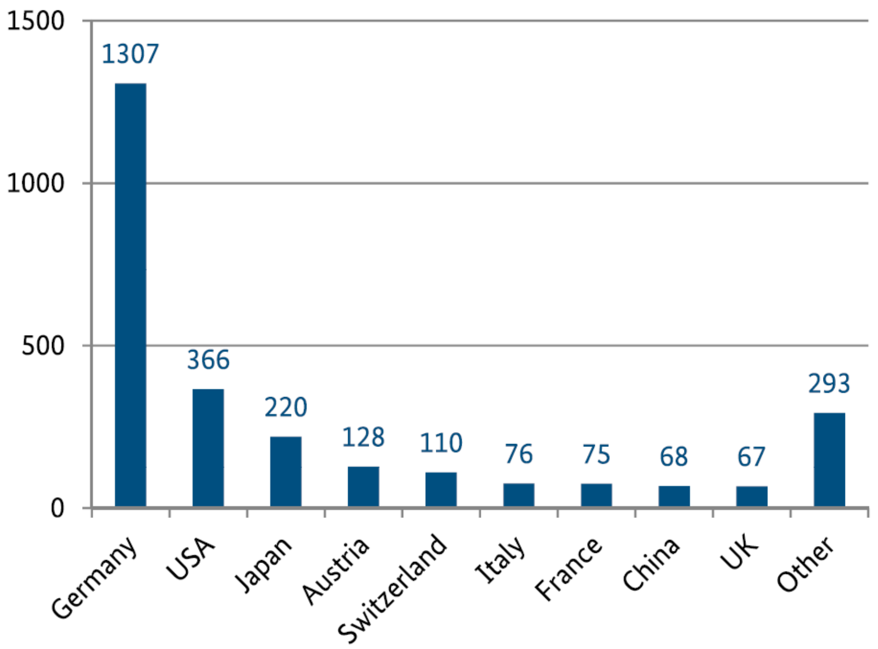

Fig. 2. **'Hidden Champion' SMEs in international comparison**

Source: German Ministry of Economics and Technology (2012).

hold a Gosbank to account (already, the ECB seems above meaningful accountability). A German-style community banking system also fulfils the Banking School's demand for decentralised decision-making by bankers that have 'kicked the tires' of tens of thousands of SMEs instead of a 'Committee of Six' central planners. Countries such as the UK, with concentrated banking systems, are more prone to boom and bust cycles, and SMEs struggle to raise finance. Even central banks appear powerless when dealing with only a small number of too-big-to-fail banking giants that may be able to capture the regulator. Instead, when the majority of banks are not-for-profit enterprises in public and/or local hands that lend to and create credit money mainly for investment by small and medium-sized enterprises, resulting in non-inflationary growth, the central bank finds it easier to monitor aggregate bank credit creation to ensure that it is mainly for productive business investment and not for non-GDP (asset) transactions. The financial stability of the German-style decentralised banking system has also been superior. During its existence as the main central bank (i.e. until the creation of the ECB), the German central bank, the Bundesbank, managed to entirely avoid bank credit-driven asset bubbles as overseen repeatedly by central banks in concentrated banking systems, such as the UK or some Scandinavian countries.

When overseen by a prudent central bank, the compromise monetary system design delivered high economic growth in Germany, Japan, Korea, Taiwan, and China.[2]

[2] The Japanese experience since ca. 1985 is testament to the importance of the word 'prudent' in the previous sentence. As Werner (2003/2018, 2005) has shown, it was the central bank

We believe this constitutes an important contribution to the present debate about the potential reform of national and international financial architectures. Community banks in the UK would improve banking services, end the recurring boom-bust cycles and banking crises, and address the problem of low productivity, as community banks mainly lend for business investment, not asset purchases. This compromise could be implemented with few practical obstacles as new local community banks can be founded at a low cost.

in Japan that decided to expand bank credit creation for non-GDP (namely property purchase) transactions between 1986 and 1990 using its informal guidance of bank credit (a.k.a. window guidance), in order to engineer a 'structural transformation of the economy' by triggering a major financial crisis and prolonged recession.

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