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Bank Solvency and Economic Activity

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Preface

This note explains why bank solvency is supremely important in a modern economy. While it is true that banks provide many services such as loans to business and to consumers, these are secondary. Their paramount role is provision of various means of payment. Every transaction in a modern economy involves a means of payment offered by the buyer and acceptable to the seller.

David Hume in 1752 said "Money is not, properly speaking one of the subjects of commerce; but only the instrument which men have agreed upon to facilitate the exchange of one commodity for another. It is none of the wheels of trade: It is the oil which renders the motion of the wheels more smooth and easy."

Means of Payment

A means of payment is a fixed nominal amount in the monetary unit. It takes many forms. The owner regards it as an asset. It may result from a liability of the borrower in the form of a claim by the lender. Because of this, some forms of the means of payment have default risk. I use this cumbersome language to avoid misleading connotations of the term money. The forms of the Means of Payment are as follows.

1. Personal,
    1. Checks
    2. Credit and Debit Cards
2. Impersonal, Payable to Bearer

The source of impersonal means of payment is the monetary authority, the Federal Reserve Banks and the U. S. Treasury. These are free of

default risk.

Before widespread use of credit and debit cards, checks drawn on demand deposits were the lion's share of the means of payment. It hardly needs mention that transactions in a modern economy involve offer and acceptance of some form of a means of payment. A seller who accepts a check believes two things. The bank on which the check is written is solvent. The account in the bank on which the check is drawn has enough funds to cover it. Even if these funds come from a loan from the bank to the account holder, this does not affect acceptability of the check as a means of payment. However, widespread bank failures do affect acceptability of checks. Such failures took place in 1931, 1932 and early 1933. They did impose serious damage on the economy. A modern economy cannot function without reliable means of payment. The contraction of the money supply was a cause of the Great Depression only in a superficial sense but it was not the actual cause. The actual cause was bank failure. As bank failures rose, cash alone became the acceptable means of payment. Few would accept a check as a means of payment given the chance it might bounce. I invite a reader to look at contemporary newspaper accounts for vivid descriptions of ordinary business when trust in the means of payment vanishes. The slogan Great Contraction is good advertising and easy to remember but it is sloppy economics.

It is wrong to emphasize bank lending by itself as a major factor in economic activity. First, a loan always involves two parties, a borrower and a lender. The terms of the loan require mutual agreement. Second, typical commercial loans take the form of a line of credit that does not determine the size of a loan. It only determines the upper limit on how much can be borrowed. There is no one-to-one relation between loans and the amount of the line of credit. A borrower writes a check on his bank account but the amount of the check depends on how much he bought. Purchase decisions may depend on the size of the line of credit but causality typically goes the other way in ordinary business. Some consumer credit is different. Household mortgages and auto loans rarely if ever come from a bank line of credit.

Individuals use credit cards. This entails 3 conditions. First, the credit card company, Master Charge, Visa, Discover or American Express is

solvent. Second, the bank standing behind the credit card transaction is solvent. Third, the user of the credit card is bona fide. The first link in the chain resembles the clearing house for banks. Just as a clearing house in the banking system cannot operate hand-to-mouth so too a credit card company needs enough secure assets to handle unforeseen changes in its liabilities.

Reducing Bank Risk

A lender who matches the term to maturity of his loan to the asset that the loan can acquire forgoes risk of loss if the interest rate rises as well as chance of gain if the interest rate falls. Thus it removes the effect of changes of interest rate on the lender's position. However, hedging does not remove the chance of borrower's default. To deter deliberate default a lender may require collateral from the borrower worth more than the amount of the loan. Should the value of the collateral fall below the amount borrowed, it raises a prospect of gain to a borrower who decides to default. This shows that a collateral requirement is not certain to prevent loss from default.

Turning to the borrower reveals more problems. A borrower may acquire an asset worth more than his loan, the difference is called margin. A loan from a broker finances the margin. Adverse changes in the value of the asset leads to a margin call and immediate loss to the borrower who owns the asset if the margin call is not met. A brokerage firm cannot protect itself from loss on unmet margin calls unless it takes a position on the other side of its client in the same commodity. If brokers and banks are joined in the same firm, then the solvency of both is at risk.

A lender to a bank, a depositor, must believe that the bank can meet its obligations to its depositors. Even if the bank does not conceal the nature of its business, this does not suffice. Given its role as a producer of different forms of the means of payment, it must be subject to rules that restrict the types of investment it may undertake. Whatever be the form of the particular means of payment, a paramount function of banks remains - to enable transactions in a modern economy.

Policy Implications

The Fed's response to the Great Recession was a huge increase in reserves held by member banks at the Fed. This came about via Fed purchases of non performing, translate bad loans, from member banks. While this saved the banking system from collapse and secured most of the means of payment, revival of the economy has been slow and tepid notwithstanding very low interest rates. At present member banks may regard their interest bearing deposits at Federal Reserve Banks as safe havens competitive with riskier loans to commercial customers. We are now in a situation resembling the 1930's.

Unless buyers use cash, their purchases incur a debt in some form depending on the nature of their means of payment. Unless the seller requires cash, the seller obtains an asset from a buyer equal to the buyer's liability. Credit card debt cannot exceed an upper bound. Credit card transactions often do not exhaust the buyers' lines of credit. Individuals may be reluctant to buy because they are reluctant to incur debt especially at the high interest rates typical of credit cards. In light of this, how can the government encourage purchases? The government usually pays by checks drawn on its accounts at Federal Reserve Banks. This piles up the reserves of its member banks. Yet these lie idle owing to reluctant buyers of goods and service. This causes a liquidity trap.

The lesson from the past is clear. Somebody has to start hiring more people. This happened in 1938 not because the Federal government went on a hiring spree but because European governments began rearming. Soon the Federal government joined in on a very large scale and for the same reason. A newly hired worker at a Ford plant had a real job, not raking leaves, but making trucks for the armed forces. Today the same remedy would work, more employment by government agencies on useful public projects, not preparation for war. A stronger US dollar that reduces export profits and adversely affects employment in export industries could be offset by sensible fiscal policies.

Incurring a Federal deficit by cutting income taxes encounters an obstacle. Most taxes are paid by the super rich. Cutting their taxes will not lead to much new employment. The tax cuts most likely to stimulate the economy are reductions of regressive personal taxes, those paid by the lower 90 per cent of the tax paying population. Social Security payments come first to mind as the leading regressive tax. An increase in the deficit that results from cutting Social Security payroll taxes paid by the working population could immediately raise employment. Eliminating COLA in 2016 moves the economy in the wrong direction.