An Introduction to the Law of Money and Banking

Lev Menand

April 9, 2021

Overview

What Is Money and Banking?

How Is the U.S. System of Money and Banking Supposed to Work?

What’s Gone Wrong With the U.S. System of Money and Banking and What Should We Do About It?

What is Money?

The Neoclassical View

- Money is a thing—like gold or silver or paper—that people use as a medium of exchange to avoid the problem of the double coincidence of wants that plagues a barter economy.
- Money serves four functions:
  - It is a *medium of exchange* – people use it to buy and sell goods and services and tangible and intangible assets;
  - It is a *unit of account* – people use it to measure the value of goods and services and tangible and intangible assets;
  - It is a *store of value* – people hold it so that they can acquire goods and services and assets in the future; and
  - It is a *means of deferred payment* – people use it to create and discharge debts.

  See WILLIAM STANLEY JEVONS, MONEY AND THE MECHANISM OF EXCHANGE 13–18 (1875).

An LPE Approach

- Money is constructed.
- Key concept is *the monetary unit*.
- It is an abstract accounting entry in a ledger.
- It need not take any physical form at all.
- The hard part is getting people to accept units for goods and services and tangible and intangible assets.

See CHRISTINE DESAN, MAKING MONEY: COINS, CURRENCY, AND THE COMING OF CAPITALISM (2014).

How to Make Money That Works?

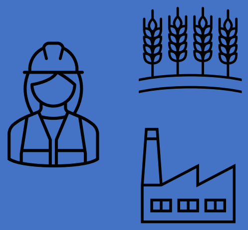
1. Tax and Spend In It
2. Tokenize It
3. Embed Collateral
4. Issue Judgments In It
5. Limit the Supply of It
6. Require Its Use/Prohibit Alternatives

Why Do States Make Money?

To Extract Resources

To Create More Resources

To Influence Resource Production & Distribution



What is Banking?

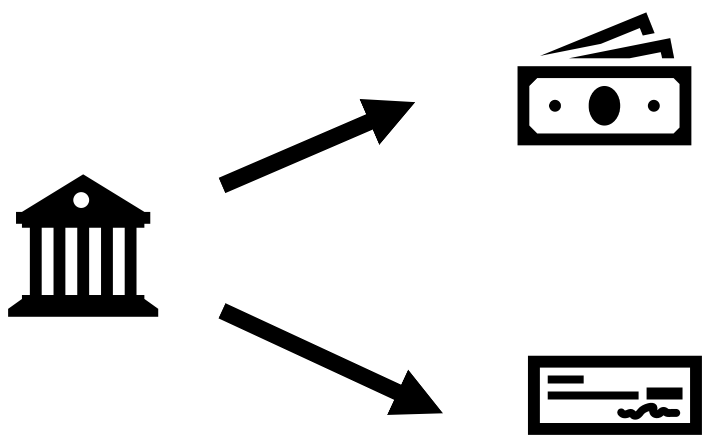
The Neoclassical View

Banks as "Financial Intermediaries"

ASSETS	LIABILITIES
Loans ($80)	Deposits ($90)
Vault Cash ($20)	Equity ($10)

An LPE Approach

- Banks are a special type of lender: they do not need existing money to lend.
- Banks lend by issuing new money: deposits and certificated deposits known as notes.



Paper money (bank notes, cash)

Account money (checks on deposits/wires)

Banks as Monetary Institutions

When a bank makes a loan, it expands its balance sheet on both sides going from $100 to $110:

ASSETS	**LIABILITIES**
Loans ($80)	Deposits ($90)
Vault Cash ($20)	Equity ($10)
+ New Loan ($10)	+ New Deposit ($10)

See Bob Hockett & Saule Omarova, *The Finance Franchise*, 102 Cornell L. Rev. 1143 (2017); Morgan Ricks, *Money as Infrastructure*, 2018 Colum. Bus. L. Rev. 757 (2018).

Withdrawals

When a depositor withdraws cash, the bank shrinks its balance sheet on both sides:

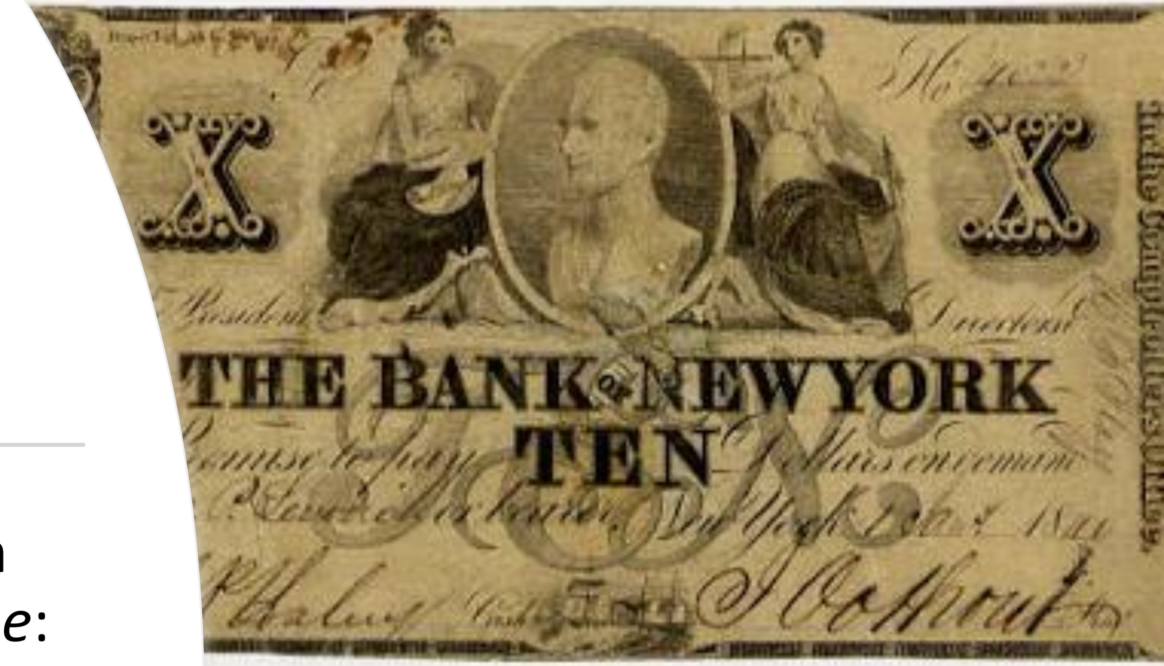
ASSETS	LIABILITIES
Loans ($90)	Deposits ($100)
Vault Cash ($20)	Equity ($10)
- Vault Cash ($10)	- Deposit ($10)

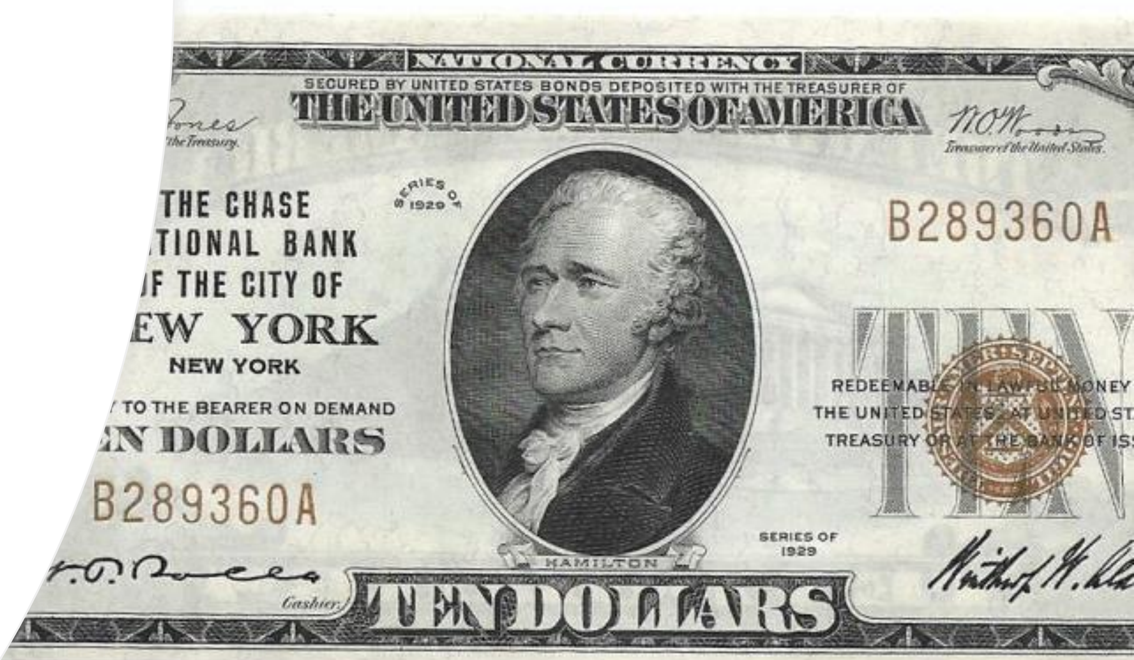
ASSETS	LIABILITIES
Loans ($90)	Deposits ($90)
Vault Cash ($10)	Equity ($10)

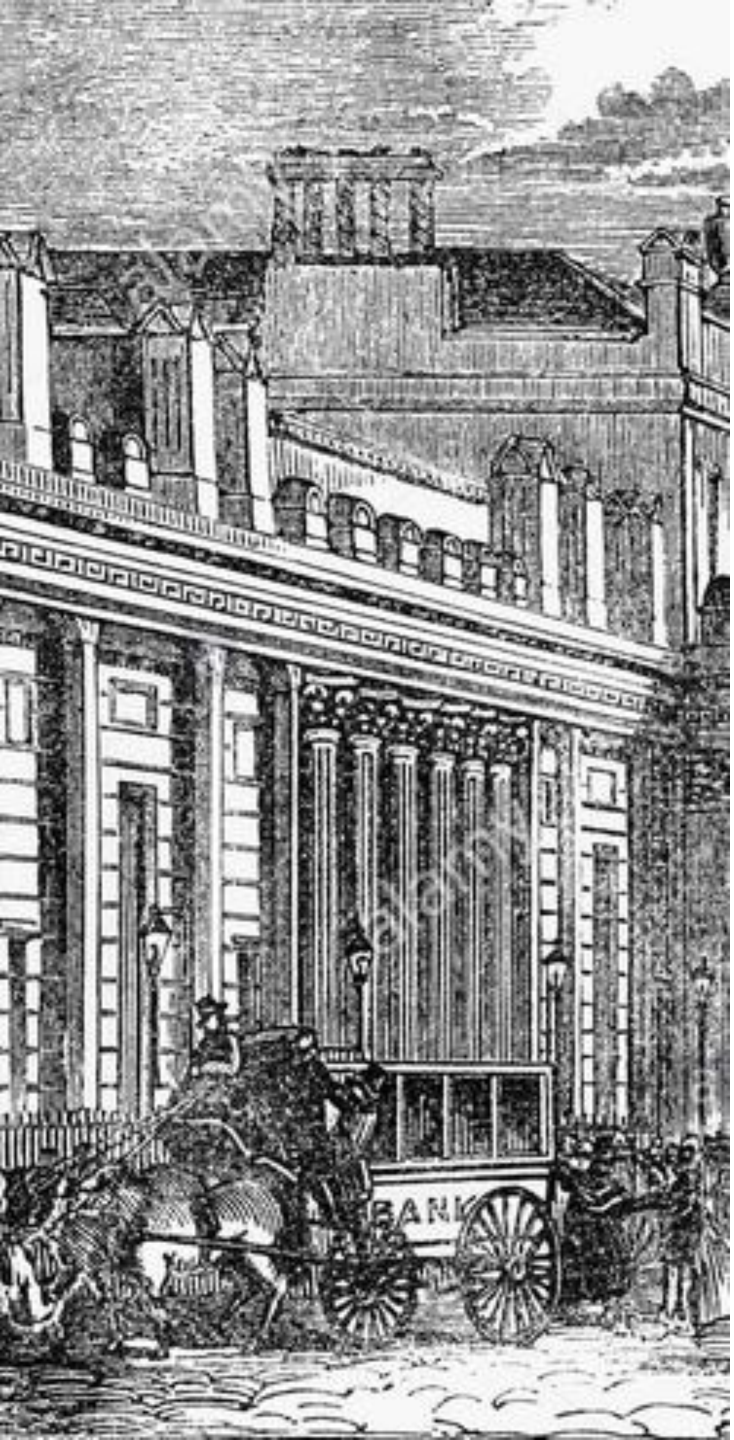
How Is the U.S. System of Money and Banking Designed to Work?

Banks Expand the Money Supply

- The U.S. banking system is an *outsourcing scheme*: banks expand the money supply.
- Congress *delegated* the power to expand the money supply to banks.



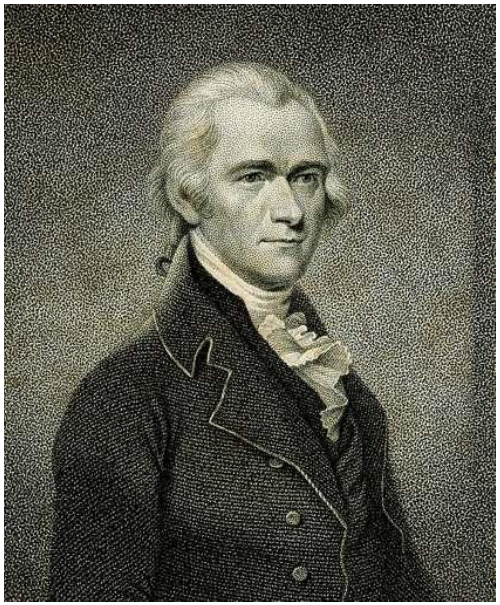




English Origins

- This approach comes from England where, in the 1690s, Parliament set up a new monetary system.
- This system had three pillars:
    1. Delegation
    2. Separation
    3. Monopoly

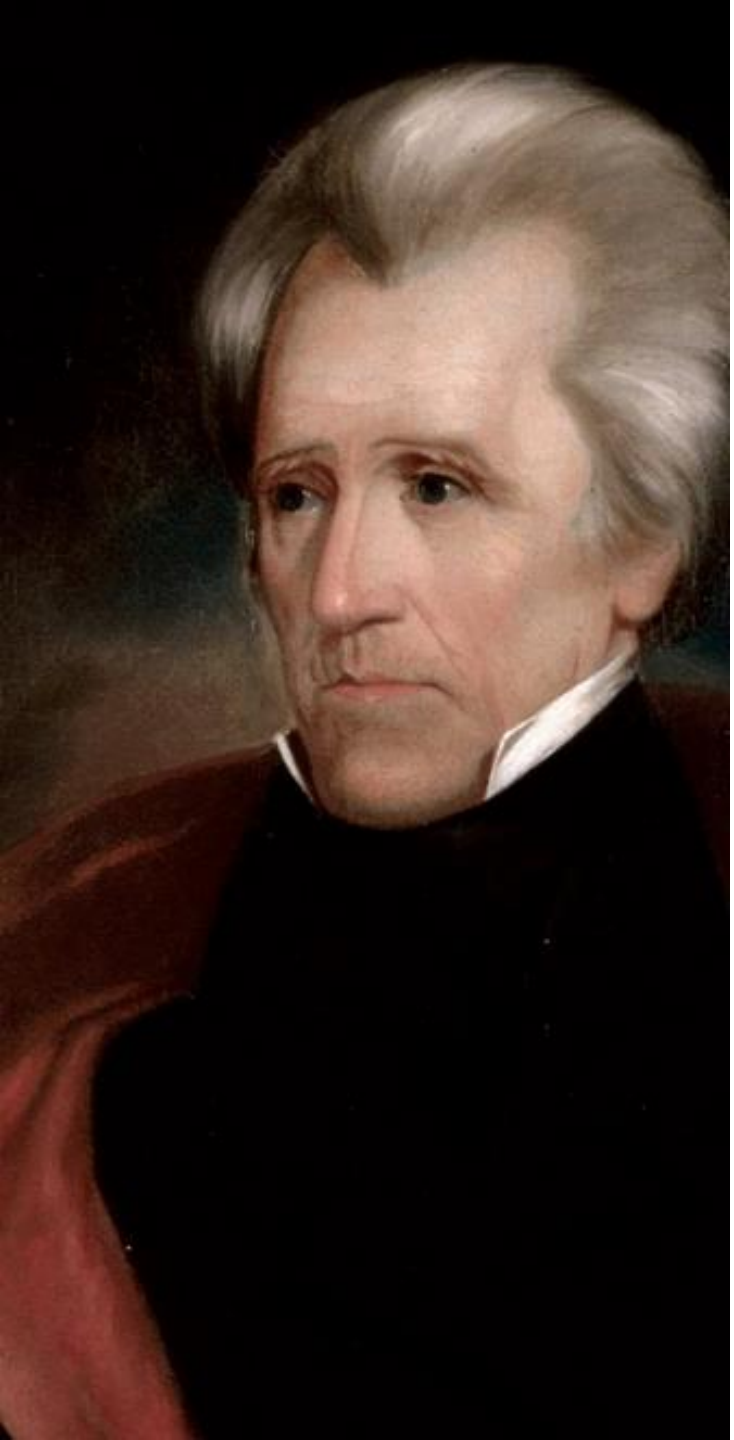
Hamilton's Plan



Bank of the United States (1791)
Philadelphia, PA

United States Mint (1792)
Philadelphia, PA

- A national bank for paper money
- A national mint for metal money

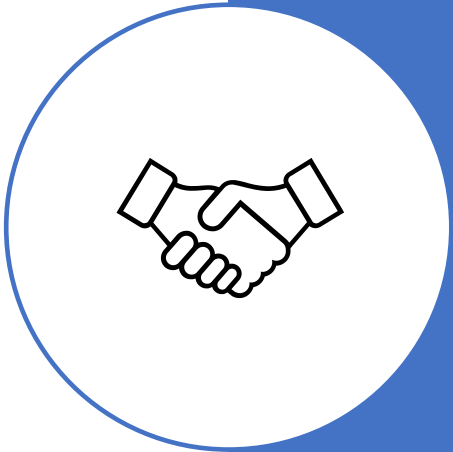


The Bank Wars

- Problem 1: The directors and officers of the Bank of the United States were like an *aristocracy*.
- Problem 2: The directors and officers of the Bank of the United States were mostly *federalists*.

The American Monetary Settlement

1. <u>Delegation</u>: privately-owned banks, not the government, expand the money supply.
2. <u>Separation</u>: bankers cannot engage in commerce and vice versa.
3. <u>Open Access</u>: anyone is eligible to apply for a charter to expand the money supply as long as they are willing and able to comply with the terms and conditions.
4. <u>Supervision</u>: special government officials, empowered to stamp out “unsound” banking, ensure that banks fulfill their public purpose.



The National Bank Act (1863/4)

- The NBA creates the Comptroller of the Currency to charter and supervise national banks.
- It allows anyone to apply for a charter.
- It authorizes national banks to expand the money supply, subject to oversight by the Comptroller.
- National banks, alongside state-chartered banks, are meant to have a monopoly on monetary elasticity.

The NBA is a Compromise

- There was an alternative: money known as Greenbacks directly issued by the legislature.
- The NBA is an attempt to preserve delegation, and avoid Greenbacks, in order to (1) bolster confidence in money, (2) avoid government corruption, and (3) satisfy powerful constituencies.

See Lev Menand & Morgan Ricks, *Federal Corporate Law and the Business of Banking*, 88 U. CHI. L. REV. (2021).

How Do “Central Banks” Fit In?

What is a Central Bank?

- The term “central bank” is used to describe two distinct institutional arrangements:
  1. Privately owned bankers’ banks with a special position by virtue of their size or legal privileges.
  2. Monetary authorities that are part of the government.

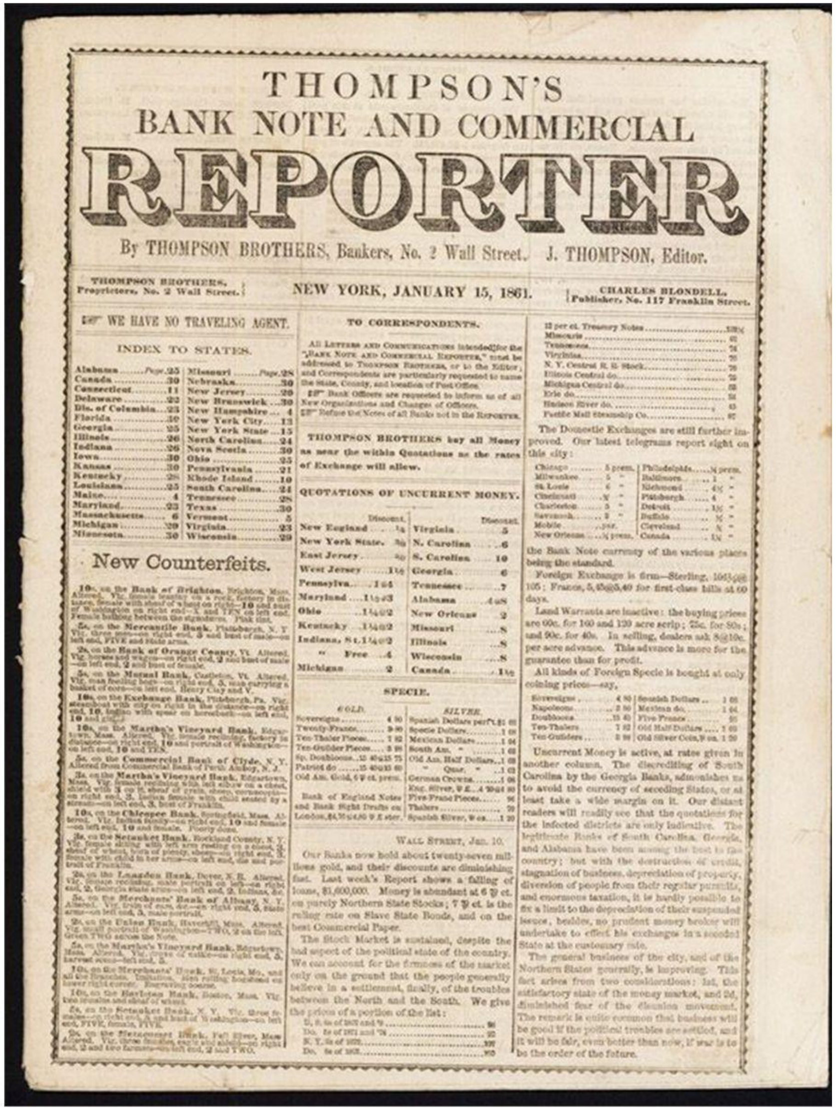
$\neq$

The Federal Reserve Act of 1913

- The Fed is a *monetary authority*.
- It is designed to administer a system of privately owned and operated banks.

Three Problems with the NBA

1. Deflation
2. Maldistribution
3. Insufficient Public Accountability and Control



THOMPSON'S
BANK NOTE AND COMMERCIAL
REPORTER

By THOMPSON BROTHERS, Bankers, No. 2 Wall Street. J. THOMPSON, Editor.

THOMPSON BROTHERS, Proprietors, No. 2 Wall Street. | NEW YORK, JANUARY 15, 1861. | CHARLES BLONDELL, Publisher, No. 117 Franklin Street.

WE HAVE NO TRAVELING AGENT.

INDEX TO STATES.

TO CORRESPONDENTS.

THOMPSON BROTHERS buy all Money as near the within Quotations as the rates of Exchange will allow.

QUOTATIONS OF UNCURRENT MONEY.

New Counterfeits.

SPECIE.

GOLD. SILVER.

WALL STREET, Jan. 10.

The Banking Acts of 1933 & 1935

- Created the Federal Deposit Insurance Corporation
- Redirected monetary elasticity
- Strengthened supervision

"There must be a strict supervision of all banking…so that there will be an end to speculation with other people's money and an adequate but sound currency." – F.D.R.

Who Wins? Who Loses?

- Delegation entrenches existing hierarchies.
- It empowers *private actors* to decide who benefits from monetary elasticity.
- The Community Reinvestment Act (1977) attempted to reverse some of the most flagrant abuses (redlining, etc.).
- But private banking remains wildly unrepresentative.

Board of the Main Bank Advocacy Group

First woman CEO of top U.S. bank ***ever*** – just added in 2021!

William Demchak

Chairman of BPI and Chairman, President & Chief Executive Officer of The PNC Financial Services Group

Andrew Cecere

Chairman, President & Chief Executive Officer of U.S. Bancorp

Jamie Dimon

Chairman of the Board and Chief Executive Officer of JPMorgan Chase & Co.

Curtis C. Farmer

Chairman, President & Chief Executive Officer Comerica Incorporated and Comerica Bank

Jane Fraser

Chief Executive Officer of Citi

Todd Gibbons

Chief Executive Officer, BNY Mellon

Christopher M. Gorman

Chairman, Chief Executive Officer, and President of KeyCorp

Kelly King

Chairman and Chief Executive Officer of Truist Financial Corporation

Bharat Masrani

Chairman of the Board of TD Bank and Chief Executive Officer of TD Bank Group

Brian Moynihan

Chairman & Chief Executive Officer of Bank of America Corporation

Ronald O'Hanley

Chairman and Chief Executive Officer of State Street Corporation

Charlie Scharf

Chief Executive Officer and President of Wells Fargo & Company

Jes Staley

Group Chief Executive of Barclays

Kessel Stelling

Chairman and Chief Executive Officer of Synovus Financial Corp.

John M. Turner, Jr.

President and Chief Executive Officer of Regions Financial Corporation

Bruce Van Saun

Chairman and Chief Executive Officer of Citizens Financial Group, Inc.

Darryl White

Chief Executive Officer, BMO Financial Group

What’s Gone Wrong With the U.S. System of Money and Banking?

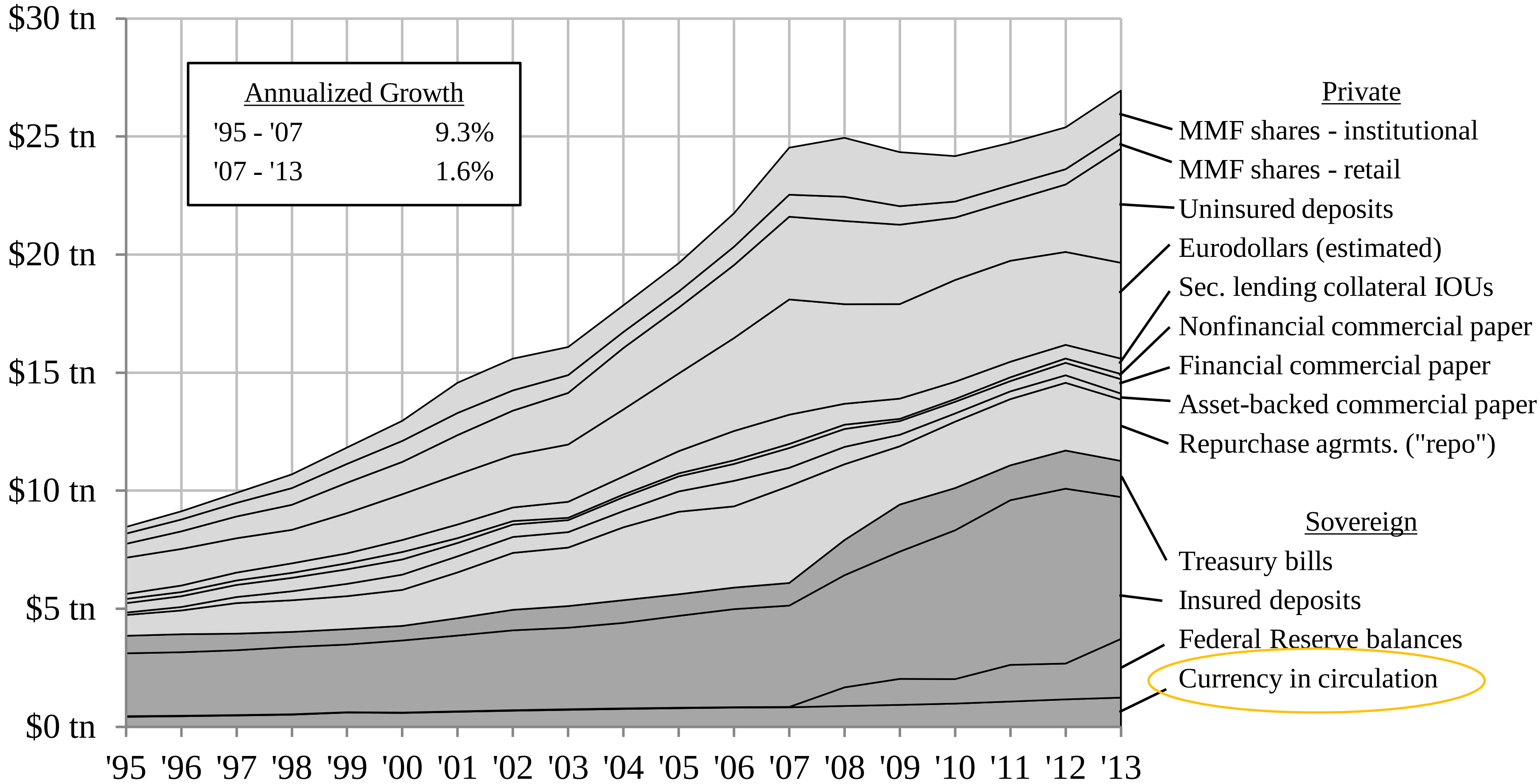
Law and Practice Diverge…

- Shadow Banking
- Universal Banking
- Desupervision
- Contractionary Panics
- The Monetary Financial Complex

Shadow Banking

- Shadow banks = firms without banking charters that expand the money supply by issuing deposit substitutes.
- Shadow banks undermine the AMS.
- Shadow banks could not exist at scale without the implicit support of the Federal Reserve.

The Dollar Money Supply



See MORGAN RICKS, THE MONEY PROBLEM (2016)

Universal Banking

- Shadow banking begot universal banking.
- Banks got into all sorts of nonbanking businesses.
- Banks combined into holding companies with nonbanking businesses.

Intellectual Shift

- OCC (1980): “Shift in emphasis” – “the **marketplace normally is the best regulator** of economic activity.”
- OCC (1987): Embraced “a **modern** concept of banking as **funds intermediation**”

See Saule Omarova, *The Quiet Metamorphosis: How Derivatives Changed the Business of Banking*, 63 U. MIAMI L. REV. 1041 (2009); Morgan Ricks, Money as Infrastructure (2019).

Desupervision

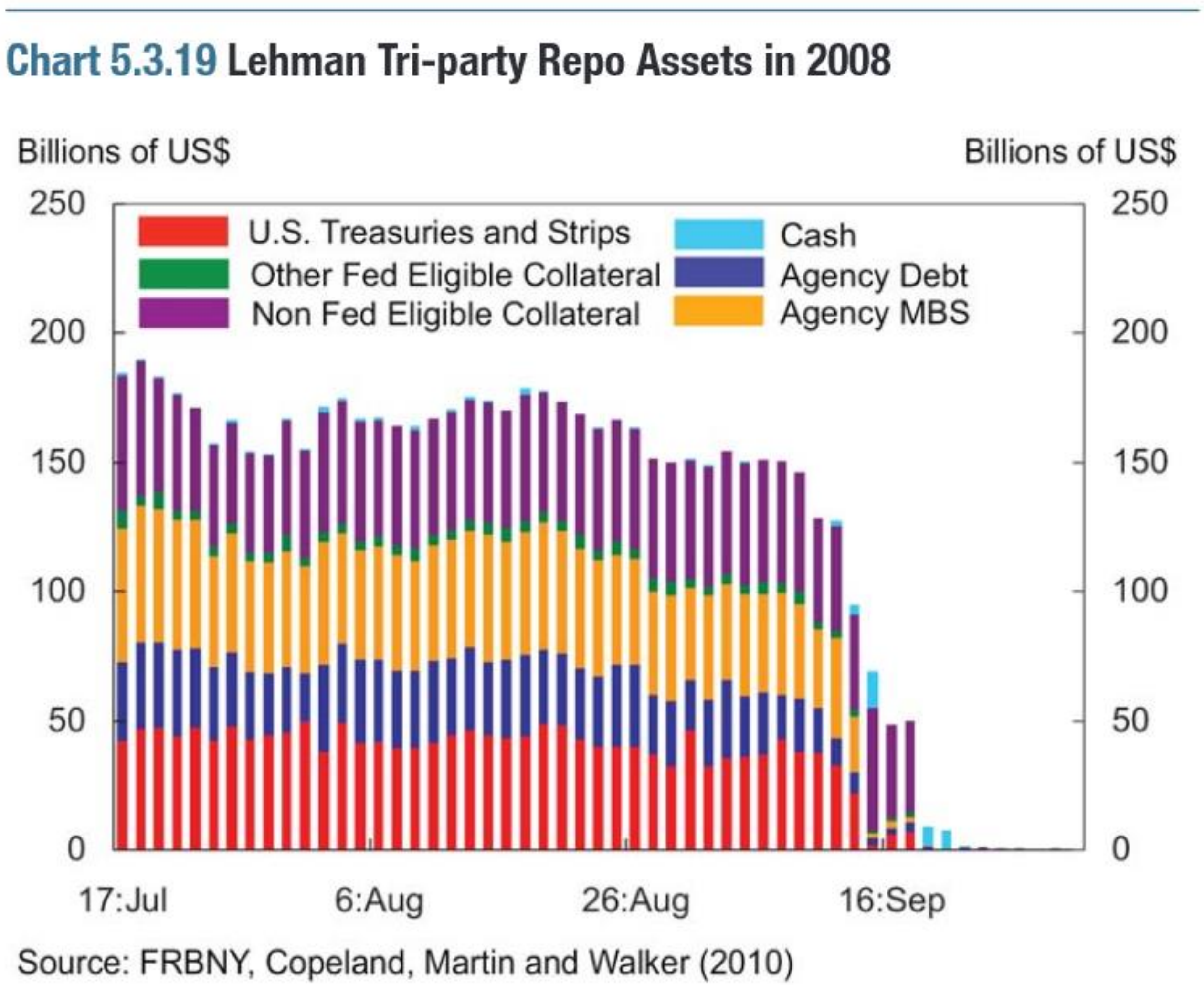
- Shadow banking and universal banking undermined public sector oversight.
- Supervisors voluntarily disarmed.
- They argued that banks were intermediaries that should be disciplined by market forces not public officials.

See Lev Menand, *Too Big To Supervise: The Rise of Financial Conglomerates and the Decline of Discretionary Oversight in Banking*, CORNELL L. REV. (2018)

Contractionary Panics

- 2008: a classic bank run on shadow banks.
- Fed forced to backstop shadow banks to prevent monetary system collapse.
- Cost = trillions in lost output.
- 2020: another classic run on shadow banks.
- Fed lent $1 trillion to stop the run and made $2 trillion in “market functioning purchases.”

Shadow Bank Run



The Monetary-Financial Complex

- Entanglement of monetary system and private financial activity.
- Massive transfer of wealth to financial system.
- Financialization of the economy.

What Should We Do About It?

Four Approaches to Delegation

	Political Control	**Technocratic Control**
Public Elasticity	*Democratic Structuralists*	*Technocratic Welfarists*
Private Elasticity	*Monetary Libertarians*	*The Corporatist Consensus*

Alternatives to Delegation

1. Private Money (e.g., Bitcoin, Diem): non-state money without central bank or delegation.
2. Public Money (e.g., full reserve banking, CBDC): state-issued account money to augment or replace bank-issued account money.

diem

Thank You!!

The accompanying slides draw on four forthcoming articles (in addition to the sources cited above):

- *Why Supervise Banks? The Foundations of the American Monetary Settlement*, VANDERBILT LAW REVIEW (2021)
- *Administering Money: The Federal Reserve System in Theory and Practice*
- *The Collapse of Banking Law*
- *The Monetary-Financial Complex* (with Morgan Ricks)