Banking: Intermediation or Money Creation
H. E. Jackson, Towards a Mixed View

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It's a pleasure to participate in the launch of the Just Money Blog and congratulations to my colleague Professor Christine Desan for undertaking this new initiative.

As one measure of the effort's promise, I've already learned a good deal from reading over the initial postings, including Morgan Ricks helpful review of historical debates over whether banks take or make deposits. From my preliminary count, the majority of the contributors seem inclined towards the banks-as-creators-of-deposits camp. The exchanges remind me, however, that in the world of finance, some controversies take on the character of Escher prints, their interpretations being highly dependent on the priors of the observer.

My own priors date back to my years of practice right out of law school several decades ago, when I worked as a young associate for a number of financial institutions focused intensely on increasing their deposit base. Many of my clients purchased failed or failing institutions, often paying a substantial premium to acquire additional core deposits. Others reached across geographic boundaries to raise funds through high-cost brokered deposits in faraway markets. All were feeling threatened by the rise of money market funds, competing for funds with a lower cost business models and unconstrained by the vestiges of Regulation Q. They were living the intermediation theory of banking, which – I suppose – is why my books on financial regulation feature those balance sheets that Robert Hockett and Saule Omarova mentioned in their post.

Working through all of this learned commentary, I find myself wondering how my former clients would have reacted had I informed them back in the 1980s that they had fallen under the sway of James Tobin’s tilt towards intermediation, and, were they simply to take the time to cogitate upon the wisdom of the then-forgotten money-creation theory of banking, they would have discovered that they had the power to create as many deposits as they wanted simply by issuing new loans and could have forgone their costly efforts to raise funds through attracting new depositors.

My clients were, of course, the kinds of practical bankers to which Keynes was referring in one of the trenchant quotations that Morgan Ricks includes in his posting. To my imagined proposition, my clients would no doubt have immediately noted (as Keynes anticipated) the many direct costs of pumping up their balance sheets in the manner I suggested: higher capital charges, reserve requirements, deposit premiums, just to name a few. But most critically, I expect, they would have stressed that deposits raised in this way would immediately run off as loan proceeds were drawn down and would need to be replaced with “real” deposits costing real money. In other words, they would have argued that, in the end, deposits created through the extension of loans would end up being replaced with the intermediation that Professor Tobin emphasized.

Of course, a practical bankers’ eye view of deposit taking is not the end of the story. Here, as in many contexts, private views may differ from the public perspective. On a system-wide basis – that is, with a macro-economic perspective that many of my fellow bloggers share – policy makers must definitely take into account the interactions between various intermediaries and the capacity of the banking system as a whole to create deposits or other money-like claims. Indeed, the quotations from Keynes that Morgan Ricks has extracted explicitly acknowledge the interdependencies that money-creating across banks requires. And, I can readily accept

Michael Kumhof's and Zoltan Jakab's assessment that models built around a deposit-creation model produce more accurate predictions of macro-economic consequences than ones based on life-cycle savings models.[i]

But it would strike me as foolhardy for policymakers – even those focused on macro-economic matters – to abandon entirely the intermediation theory of banking. After all, the central event of a financial panic is the bank run (or a run on money market funds or repo markets). That event is quintessentially an event of dis-intermediation, with liquidity running out the door and credit supplies being constrained. Indeed, the classic (and still essential) public response to a bank run is for central banks to serve as "lender of last resort," a funding mechanism designed to facilitate intermediation at the firm level. While macro-economists may prefer to build money-creation theories into their macro-economic models, when panic strikes and financial markets fail, individual firms with their practical bankers operate under the intermediation theory. In a crisis, government officials cannot solve problems by giving speeches about the deposit-creation powers of banks; they must focus on how the mechanics of bank regulation – capital requirements, reserve or liquidity requirements, and a host of other supervisory matters – affect the incentives of banks to convert their deposits into credit on their balance sheets. Indeed, a major component of our new system of macroprudential regulation is the development of time-variant regulations that regulate intermediation differently at different points in the business cycle.[ii]

The intermediation theory is also useful as it focuses macro-prudential authorities on other potential sources of panic and disintermediation in times of financial stress. While I appreciate Marc Lavoie's point that other intermediaries – whether money market funds or market place lenders – lack the access to payments systems that regulated banks enjoy, an abrupt loss of funding to such entities, once they reach sufficient scale, can have adverse macro-economic consequences and may warrant something akin to lender-of-last resort support. To the extent that the intermediation theory helps identify such entities, I would think that the theory very much belongs in the macro-economist's toolkit. And, indeed, much of Morgan Rick's impressive body of work stresses the need to bring these other kinds of intermediaries (aka shadow banks) into the regulatory system.

To my way of thinking, the intermediation theory of banking is a bit like Newtonian physics.[iii] It does a pretty good job describing how practical bankers think about their businesses, and it aligns fairly well with the way they experience the challenge of maintaining stable funding sources. The theory works less well on a system-wide basis as it does not embrace fully inter-dependencies and interactions of the sort that the money-creation creation theory takes into account. As Newtonian physics breaks down in vast domains of time and space, the money-creation theory may well best explain macro-economic phenomena. The appropriate response, in my view, is not to embrace one or the other, but to integrate the two together (and perhaps some other theories as well) into some unified theory of banking. To differ in one modest respect from Morgan Ricks, the choice is not one of policy, but rather of finding the best theory to fit the question at hand.

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[i] While I have not dug into the models they mention, I would have thought that the primary disruption in financial crises would come from the shifting of financial assets – for example, out of money market funds in the 2008 or out of Jimmy Stewart's thrift in the cinematic 1930s – rather than from life-cycle savings adjustments, shifts that the intermediation theory would, I think, also accommodate.

[ii] See Daniel Tarullo, Time-Varying Measures in Financial Regulation, 83 Law & Contemp. Probs. (forthcoming 2020),

available at: https://ssrn.com/abstract=3464668.

[iii] As Morgan Ricks reminded me in a sidebar, Sir Isaac Newton served for many years as the Master of the Mint and his theories are thus appropriately invoked in the Just Money blog.