

# The Chicago Plan Revisited

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## Abstract

At the height of the Great Depression a number of leading U.S. economists advanced a proposal for monetary reform that became known as the Chicago Plan. It envisaged the separation of the monetary and credit functions of the banking system, by requiring 100% reserve backing for deposits. Irving Fisher (1936) claimed the following advantages for this plan: (1) Much better control of a major source of business cycle fluctuations, sudden increases and contractions of bank credit and of the supply of bank-created money. (2) Complete elimination of bank runs. (3) Dramatic reduction of the (net) public debt. (4) Dramatic reduction of private debt, as money creation no longer requires simultaneous debt creation. We study these claims by embedding a comprehensive and carefully calibrated model of the banking system in a DSGE model of the U.S. economy. We find support for all four of Fisher's claims. Furthermore, output gains approach 10 percent, and steady state inflation can drop to zero without posing problems for the conduct of monetary policy.

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## I. Introduction

The decade following the onset of the Great Depression was a time of great intellectual ferment in economics, as the leading thinkers of the time tried to understand the apparent failures of the existing economic system. This intellectual struggle extended to many domains, but arguably the most important was in the field of monetary economics, given the key roles of private bank behavior and of central bank policies in triggering and prolonging the crisis.

During this time a large number of leading U.S. macroeconomists supported a fundamental proposal for monetary reform that later became known as the Chicago Plan, named after its strongest proponent, professor Henry Simons of the University of Chicago.<sup>1</sup> It was also supported, and brilliantly summarized, by Irving Fisher of Yale University, in Fisher (1936). The key feature of the Chicago Plan was to call for the separation of the monetary and credit functions of the banking system, first by requiring 100% backing of deposits by government-issued money, and second by ensuring that the financing of new credit can only take place through earnings that have been retained in the form of government-issued money, or through the borrowing of existing government-issued money from non-banks, but not through the creation of new deposit money, *ex nihilo*, by financial institutions.

Fisher (1936) claimed four major advantages for this plan. First, it would allow for a much better control of credit cycles, by preventing financial institutions from creating their own funds during credit booms, and then destroying those funds during subsequent contractions. Second, it would completely eliminate bank runs. Third, allowing the government to issue money directly at zero interest, rather than borrowing that same money from banks at interest, would lead not only to a reduction in the interest burden of government financing, but also to a dramatic reduction of (net) government debt, given that irredeemable government-issued money represents equity in the commonwealth rather than debt. Fourth, given that money creation would no longer require the simultaneous creation of mostly private debts on bank balance sheets, the economy could see a dramatic reduction not only of government debt but also of private debt.

We take it as self-evident that if these claims can be verified, the Chicago Plan would indeed represent a highly desirable policy. Profound thinkers like Fisher, and many of his most illustrious peers, based their insights on historical experience and common sense, and were hardly deterred by the fact that they might not have had complete economic or econometric models that could formally demonstrate the desirability of avoiding credit-driven boom-bust cycles, bank runs, and high public and private debt levels. We do in fact believe that this approach made them superior thinkers about issues of the greatest importance for the common good. But we can also point to recent empirical evidence and theoretical results in support of the desirability of Fisher's four claims. For boom-bust credit cycles and bank runs, the evidence of Reinhart and Rogoff (2009) documents the high costs of such events throughout history. For high debt levels, there are separate literatures which show that these are associated with more frequent crises, higher real interest rates, and lower growth. Schularick and Taylor (2012) provide supporting evidence for Fisher's view that high debt levels are a very important predictor of major

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<sup>1</sup>Other commonly used names for this type of monetary reform are full reserve banking and 100% reserve banking. We will use these terms interchangeably.

crises. This is also consistent with the theoretical work of Kumhof and Rancière (2010), who show how very high debt levels, such as those observed just prior to the Great Depression and the Great Recession, can lead to a much higher probability of financial and real crises. Laubach (2009), Engen and Hubbard (2004) and Gale and Orszag (2004) have estimated that higher U.S. public debt levels lead to economically significant increases in real interest rates. Arcand et al. (2012) and Cecchetti and Kharroubi (2012) have shown that at high private debt levels, exceeding around 100% of GDP, further increases in debt can have sizeable negative effects on growth.

We now turn to a more detailed discussion of each of Fisher's four claims concerning the advantages of the Chicago Plan. This will set the stage for a first illustration of the implied balance sheet changes, which will be provided in Figures 1 and 2.

The first advantage of the Chicago Plan is that it permits much better control of what Fisher and many of his contemporaries perceived to be the major source of business cycle fluctuations, sudden increases and contractions of bank credit, and therefore of money, that are not necessarily driven by the fundamentals of the real economy, but that themselves change those fundamentals.

In the current financial system, which requires little or no reserve backing for deposits, and where government-issued cash has a very small role relative to bank deposits, changes of a nation's broad monetary aggregates depend almost entirely on changes in banks' willingness to create deposits. But bank deposits can only be created (or destroyed) through the creation (or destruction) of bank loans. Sudden changes in the willingness of banks to extend credit must therefore not only lead to credit booms or busts, but also to an instant excess or shortage of money, and therefore of nominal aggregate demand. Crucially, the present system imposes almost no constraints on the ability of banks to act on such changes in sentiment. The reason is that banks are able to generate their own funding, deposits, in the act of lending, an extraordinary privilege that is not enjoyed by any other type of business. Specifically, and without exception, whenever a bank makes a new loan to a non-bank customer X, it creates a new loan entry on the asset side of its balance sheet, and at the same time it creates a new and equal deposit entry on the liability side. Both entries are in the name of customer X. There is therefore no intermediation whatsoever at the moment a new loan is made. No resources need to be diverted from other uses, by other agents, in order to be able to lend to borrowers. What is needed from third parties (i.e. other than the bank and X) is not a new deposit, but only the acceptability of the newly created money in payment for goods and services. This is given by legal fiat and therefore never in question. Note that at the level of the aggregate banking system it makes no difference that the new deposit (or the new loan, e.g. through securitization) might subsequently be transferred to another bank – so long as the loan remains outstanding at some bank, so does the deposit, at some other bank. The aggregate money supply has therefore increased.

In contrast to the current financial system, under the Chicago Plan the quantity of money, which is now provided exclusively by government but administered by private banks, and the quantity of credit, which continues to be provided by private financial institutions, would become completely independent of each other. This would make it much easier to control the volatility of these two key aggregates. The growth of broad monetary aggregates could be controlled directly via a money growth rule, and the banks

administering this money supply would be completely safe without any need for deposit insurance, which could therefore be abolished. Control of potentially destructive credit cycles would become much more straightforward because lending banks, now referred to as investment trusts, would no longer be able to generate their own funding in the act of lending. Rather, they would become what many erroneously believe banks to be today, pure intermediaries that depend on obtaining outside funding before being able to lend it to potential borrowers. This would much reduce their ability to create credit cycles, because in this world what is needed from third parties *is* a deposit of existing government-issued money, and making this deposit involves a real economic trade-off. Namely, by giving up their money balances depositors lose the benefit of real economic transactions, and they also lose the guaranteed safety of their money balances as an investment asset, while they gain a higher, but risky, return on lending. In such an environment the need to attract investors, and the constant vigilance of investors in the face of risk, would impose serious additional constraints on the ability of the financial sector to start lending booms that are not supported by economic fundamentals. In addition, we will show that policy could also become more effective under this system, by using a set of instruments that are mostly already available today, but whose effectiveness in controlling credit growth is circumscribed by banks' ability to create their own funding.

The second advantage of the Chicago Plan is that having fully reserve-backed bank deposits would completely eliminate bank runs, thereby increasing financial stability. This would greatly improve the effectiveness of banking, by allowing one set of financial institutions to concentrate on the core lending function, without worrying about funding uncertainties from the liabilities side of their balance sheet, while at the same time allowing another set of financial institutions to concentrate on the core function of managing the payments system, without worrying about the effect of asset quality problems on the safety of transactions liabilities. The elimination of bank runs will be accomplished if two conditions hold. First, the banking system's monetary liabilities must be fully backed by reserves of government-issued money, which is of course true under the Chicago Plan. Incidentally, these monetary liabilities can have various degrees of liquidity, or "money-ness", and they can include even longer-maturity assets that nevertheless exhibit some substitutability with money because they are safe, and because they can be used as collateral for borrowing transactions balances. Associated with these different degrees of liquidity would be a range of interest rates, including perhaps also negative interest rates for the most liquid liabilities, as suggested by Gesell (1958). Second, the financial system's credit assets must be funded by non-monetary liabilities that are not subject to runs. This means that policy needs to ensure that such liabilities cannot become near-monies. The literature of the 1930s and 1940s discussed three institutional arrangements under which this can be accomplished, namely lending by non-bank investment trusts funded by treasury credit, by private equity, or by private non-monetary deposits (or some combination of the three).

The easiest of these is to require that investment trusts fund all of their credit assets with a combination of equity and loans of money from the government treasury, and completely without private debt instruments, thereby ruling out bank runs. This is the core (but not the only) element of the version of the Chicago Plan considered in this paper, first for reasons of model economy, because it allows for a clearer exposition of the results, and second because this arrangement has a number of advantages that go beyond decisively

preventing the emergence of near-monies. But both in the model and in the real world a greater extent of private funding can easily be incorporated.

There is an important reason why privately funded investment trusts need to be part of any real-world solution. Our model makes the conventional assumption of representative agents, with no borrowing and lending within each agent group. In that world the treasury credit solution alone can be sufficient to fund all lending. But in the real world there continues to be a need, after the implementation of the Chicago Plan, for lending between highly heterogeneous net savers and net borrowers within each group, and the treasury loans solution is insufficient to satisfy this need. It must therefore be accompanied by either one or both of the other two institutional arrangements.

One of these is investment trusts that are funded exclusively by net savers' equity investments, with the funds either lent to net borrowers, or invested as equity if this is feasible. This is the solution favored by Kotlikoff (2012) in his Limited Purpose Banking proposal. The other institutional arrangement is investment trusts that are funded by a combination of equity and private debt. However, unlike today's banks, these institutions would be true intermediaries, in that the trust can only lend government-issued money to net borrowers after net savers have first deposited this money in exchange for risky and non-monetary debt instruments issued by the trust.<sup>2</sup>

The third advantage of the Chicago Plan is a dramatic reduction of (net) government debt. The overall outstanding liabilities of today's U.S. financial system, including the shadow banking system, are far larger than currently outstanding U.S. Treasury liabilities. Because under the Chicago Plan banks have to borrow reserves from the treasury to fully back these large liabilities, the government acquires a very large asset vis-à-vis banks, and government debt net of this asset becomes highly negative. This asset, which we will refer to as treasury credit, represents a very large stock seigniorage gain by the government. In effect the government reappropriates, in one instant, banks' cumulative historic money creation, which is equal to their stock of deposits. Governments could leave the separate gross positions of government debt and treasury credit outstanding, or they could buy back government bonds from banks against the cancellation of treasury credit. Fisher had the second option in mind, based on the situation of the 1930s, when banks held the major portion of outstanding government debt. But today most U.S. government debt is held outside U.S. banks, so that the first option is the more relevant one. The effect on net debt is of course the same, it drops dramatically.

In this context it is critical to realize that the stock of reserves, or money, newly issued by the government is not a debt of the government. The reason is that fiat money is not redeemable, in that holders of money cannot claim repayment in something other than money.<sup>3</sup> Money is therefore properly treated as government equity rather than government debt, which is exactly how treasury coin is currently treated under U.S. accounting conventions (Federal Accounting Standards Advisory Board (2012)). It is therefore instructive to think of the Chicago Plan as requiring that all money in existence must have the same status as treasury coin.

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<sup>2</sup>This would not be a dramatically new type of institution, because many non-bank financial institutions operate today without the ability to create and allocate new money.

<sup>3</sup>Furthermore, in a growing economy the government will never have a need to voluntarily retire money to maintain price stability, as the economy's monetary needs increase period after period.

The fourth advantage of the Chicago Plan is the potential for a dramatic reduction of private debts. As mentioned above, the establishment of full reserve backing by itself would generate a highly negative net government debt position. Instead of leaving this in place and becoming a large net lender to the private sector, the government has the option of spending part of the windfall by repaying large amounts of private bank debt. This can be accomplished through a transfer of a part of government-held treasury credit balances to citizens by way of a citizens' dividend, whose mandatory first use is the full repayment of any outstanding private debts by the recipient. Because this policy would have the advantage of establishing low-debt sustainable balance sheets in both the private sector and the government, it is plausible to assume that a real-world implementation of the Chicago Plan would involve at least some, and potentially a very large, repayment of private debt. In the simulation of the Chicago Plan presented in this paper we will assume that the citizens' dividend covers all categories of private bank debt except loans that finance investment in physical capital. Another way to look at this result is that much lower private debt levels would be the natural longer-term outcome for a world in which money creation no longer requires the simultaneous creation of debt on bank balance sheets.

We study Fisher's four claims by embedding a comprehensive and carefully calibrated model of the U.S. financial system in a state-of-the-art monetary DSGE model of the U.S. economy.<sup>4</sup> We find strong support for all four of Fisher's claims, with the potential for much smoother business cycles, no possibility of bank runs, a large reduction of debt levels across the economy, and a replacement of that debt by debt-free government-issued money.

At this point in the paper it may not be straightforward for the average reader to comprehend the nature of the balance sheet changes implied by the Chicago Plan. A complete analysis requires a thorough prior discussion of both the model and of its calibration, and is therefore only possible much later in the paper. But we feel that at least a preliminary presentation of the main changes is essential to aid in the comprehension of what follows.<sup>5</sup> In Figures 1 and 2 we therefore present the changes in bank and government balance sheets that occur in the single transition period of our simulated model. The figures ignore subsequent changes as the economy approaches a new steady state, but those are small compared to the initial changes. In both figures quantities reported are in percent of GDP. Compared to Figure 3, which shows the precise results, the numbers in Figure 1 are rounded, in part to avoid having to discuss unnecessary details.

As shown in the left column of Figure 1, the balance sheet of the consolidated financial system<sup>6</sup> prior to the implementation of the Chicago Plan is equal to 200% of GDP, with equity and deposits equal to 16% and 184% of GDP. Banks' assets consist of government bonds equal to 20% of GDP, investment loans equal to 80% of GDP, and other loans (mortgage loans, consumer loans, working capital loans) equal to 100% of GDP. The implementation of the plan is assumed to take place in one transition period, which can be broken into two separate stages. In the first stage, as shown in the middle column of Figure 1, banks have to borrow from the treasury to procure the reserves necessary to

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<sup>4</sup>To our knowledge this is the first attempt to model the Chicago Plan in this way. Yamaguchi (2011) discusses the Chicago Plan using a system dynamics approach.

<sup>5</sup>We thank George Akerlof for this suggestion.

<sup>6</sup>As discussed in Section VI on model calibration, this includes the shadow banking system.



fully back their deposits. As a result both treasury credit and reserves increase by 184% of GDP. In the second stage, as shown in the right column of Figure 1, the principal of all bank loans to the government (20% of GDP), and of all bank loans to the private sector except investment loans (100% of GDP), is repaid.<sup>7,8</sup> Government debt is cancelled against treasury credit, while private debt is repaid through the citizens' dividend. Furthermore, banks pay out part of their equity to keep their net worth in line with now much reduced capital requirements, with the government making up the difference of 7% of GDP by injecting additional treasury credit. The separate balance sheets for deposit banks and credit investment trusts in the right column of Figure 1 represent the now strict separation between the monetary and credit functions of the banking system. Money remains unchanged, but it is now fully backed by reserves. Credit shrinks dramatically, it consists only of investment loans, which are financed by a reduced level of equity equal to 9% of GDP, and by what is left of treasury credit, 71% of GDP, after the repayments of government and private debts and the injection of additional treasury credit following the equity payout.

Figure 2 illustrates the balance sheet of the government, which prior to the Chicago Plan consists of government debt equal to 80% of GDP, with unspecified other assets used as the balancing item. The issuance of treasury credit equal to 184% of GDP represents a large new financial asset of the government, while the issuance of an equal amount of reserves, in other words of money, represents new government equity. The repayment of private debts is a charge against government equity, it therefore reduces both treasury credit and government equity by 100% of GDP. The government is assumed to levy a lump-sum tax that is equal to the equity payout of banks to households, and then to inject those funds back into the investment trusts as treasury credit. This increases both treasury credit and government equity by 7% of GDP. Finally, the cancellation of bank-held government debt reduces both government debt and treasury credit by 20% of GDP.

To summarize, our analysis finds that the government is left with a much lower, in fact negative, net debt burden. It gains a large net equity position due to money issuance, despite the fact that it spends a large share of the one-off seigniorage gains from money issuance on the repayment of private debts. These repayments in turn mean that the private sector is left with a much lower debt burden, while its deposits remain unchanged. Bank runs are obviously impossible in this world. These results, whose analytical foundations will be derived in the rest of the paper, support three out of Fisher's (1936) four claims in favor of the Chicago Plan. The remaining claim, concerning the potential for smoother business cycles, will be verified towards the end of the paper, once the full model has been developed. But we can go even further than Fisher (1936), because our general equilibrium analysis highlights two additional advantages of the Chicago Plan.

The first additional advantage of the Chicago Plan is that, in our calibration, it generates longer-term output gains approaching 10 percent. This happens for three main reasons. First, monetary reform represents a very large economy-wide debt-to-equity swap. This leads to large reductions of real interest rates, as lower net debt levels lead investors to

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<sup>7</sup>The assumption that both stages take place in one period is made to simplify the exposition. There are practical reasons why a more gradual implementation of stage 2 may be advantageous. But stage 1 can and should be implemented immediately.

<sup>8</sup>The government could of course allocate the citizens' dividend differently so that, for example, mortgage loans rather than investment loans remain outstanding. This is a policy choice.

demand lower real interest rates on both government and private debts. This stimulates investment and output. Second, monetary reform permits much lower distortionary tax rates, due to much higher seigniorage income (despite lower inflation) in the government budget. And third, monetary reform leads to lower credit monitoring costs, because far fewer scarce resources have to be devoted to monitoring loans whose purpose was to create an adequate money supply that can easily be created debt-free.

The second additional advantage of the Chicago Plan is that liquidity traps cannot exist, which in turn implies that steady state inflation can drop to zero without posing problems for the conduct of monetary policy. The separation of the money and credit functions of the banking system allows the government to control multiple policy instruments, including a nominal money growth rule that controls the broad money supply and thereby inflation, a Basel-III-style countercyclical capital adequacy rule that controls excessive fluctuations in the quantity of investment trust lending, and finally an interest rate rule that controls the price of treasury credit to investment trusts. The latter replaces the conventional Taylor rule for the interest rate on government debt, with the determination of that rate now being left to the market. A critical implication of this different monetary environment concerns liquidity traps. Liquidity traps are episodes during which the central bank cannot effectively stimulate the economy, either because increases in the narrow money supply under its control are ineffective in stimulating growth in broader monetary aggregates, or because reductions in policy rates are impossible because of a zero interest rate floor. Neither of these “traps” can exist under the Chicago Plan. First, the aggregate quantity of broad money in private agents’ hands can be directly increased by the policymaker, without depending on financial institutions’ willingness to lend in order to grow broader monetary aggregates. And second, because the interest rate on treasury credit is not an opportunity cost of money for asset investors, but rather a borrowing rate for a credit facility that is only accessible to investment trusts for the specific purpose of funding physical investment projects, it can temporarily become negative without any practical problems.<sup>9</sup> In other words, a zero lower bound does not apply to this rate. This makes it feasible to keep steady state inflation at zero without worrying about the fact that nominal policy rates are in that case more likely to reach zero or negative values.<sup>10</sup> Furthermore, our model simulations will show that near-zero inflation can be reached almost immediately upon the implementation of the Chicago Plan, not just in the new steady state.

The critical feature of our theoretical model is that it exhibits the key function of banks in modern economies, which is not their largely incidental function as financial intermediaries between depositors and borrowers, but rather their central function as creators (and destroyers) of money for use by its borrowers. The “loanable funds” model of banking that still dominates virtually the entire macroeconomic literature on the subject misses the fact that under the present system banks categorically do not have to wait for depositors to appear and make funds available before they can on-lend, or intermediate, those funds. Rather, they create their own funds, deposits, in the act of lending.<sup>11</sup> We will

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<sup>9</sup>Of course this requires the assumption that diversion of funds to non-investment uses can be effectively prevented. There is no reason why this should be difficult.

<sup>10</sup>Zero steady state inflation has been found to be desirable in a number of recent models of the monetary business cycle (Schmitt-Grohé and Uribe (2004)). However, see Akerlof et al. (1996) for a contrary view that advocates moderate positive inflation due to downward nominal wage rigidity.

<sup>11</sup>Another common terminology in the macroeconomic literature on banking, namely that banks *collect*

show that, once a correct model of banks as money creators rather than intermediaries is adopted, the implications for the ability of banks to create credit cycles are profound.

The fact that banks create their own funds in the act of lending can be verified in the description of the money creation process in many central bank statements<sup>12</sup> and in the older economics literature, particularly of the first half of the twentieth century.<sup>13</sup> It is also obvious to anybody who has ever lent money and created the resulting book entries.<sup>14</sup> In other words, new bank liabilities are not macroeconomic savings that have been withdrawn from other uses. Savings are a state variable, so that by relying entirely on intermediating slow-moving savings, banks would be unable to engineer the rapid lending booms and busts that are frequently observed in practice. Rather, bank liabilities are money that can be created and destroyed at a moment's notice. The critical importance of this fact only appears in the modern macroeconomics literature in Werner (2005), and to some extent in Christiano et al. (2011).<sup>15</sup> Our model generates this feature in a number of ways. First, it introduces agents who have to borrow for the sole purpose of generating sufficient deposits for their transactions purposes. This means that they simultaneously borrow from and deposit with banks. This is true for many households and firms in the real world, as we will discuss in Section VI on model calibration.<sup>16</sup> Second, the model introduces financially unconstrained agents who do not borrow from banks. Their savings consist of multiple assets including a fixed asset referred to as land, government bonds and deposits. This means that a sale of mortgageable fixed assets from these agents to credit-constrained agents (or of government bonds to banks) results in new bank credit, and thus in the creation of new deposits that are created for the purpose of paying for those assets. Instantly, and in arbitrarily large amounts, so long as banks are satisfied with borrowers' creditworthiness. Third, even for conventional deposit-financed

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deposits, is also misleading. Individual banks do indeed collect deposits, in the form of various instruments drawn on accounts at other banks, in their daily business. But the aggregate banking system, with the quantitatively insignificant exception of cash deposits, does not collect deposits from non-banks. Rather, it *creates* (and destroys) deposits for non-banks. To understand how problematic the notion of the aggregate banking system collecting deposits from non-banks is, it helps to ask the following question: When a customer walks into a bank to "make" a non-cash deposit, what is it, exactly, that the bank "collects" from him/her? If it appears that there is no good answer to that question, it is because there is none.

<sup>12</sup>Berry et al. (2007), which was written by a team from the Monetary Analysis Division of the Bank of England, states: "When banks make loans, they *create* additional deposits for those that have borrowed the money." Keister and McAndrews (2009), staff economists at the Federal Reserve Bank of New York, write: "Suppose that Bank A gives a new loan of \$20 to Firm X, which continues to hold a deposit account with Bank A. Bank A does this by crediting Firm X's account by \$20. The bank now has a new asset (the loan to Firm X) and an offsetting liability (the increase in Firm X's deposit at the bank). Importantly, Bank A still has [unchanged] reserves in its account. In other words, the loan to Firm X does not decrease Bank A's reserve holdings at all." Putting this differently, the bank does not lend out reserves (money) that it already owns, rather it creates new deposit money ex nihilo. See Ryan-Collins et al. (2012) for an excellent overview of the modern money creation system.

<sup>13</sup>A particularly clear statement is due to Schumpeter (1994): "But this ... makes it highly inadvisable to construe bank credit on the model of existing funds' being withdrawn from previous uses by an entirely imaginary act of saving and then lent out by their owners. It is much more realistic to say that the banks ... *create deposits in their act of lending*, than to say that they lend the deposits that have been entrusted to them." (p. 1114)

<sup>14</sup>This includes one of the authors of this paper.

<sup>15</sup>We emphasize that this exception is partial, because while bank deposits in Christiano et al. (2011) are modelled as money, they are also, with the empirically insignificant exception of a possible substitution into cash, modelled as representing household savings. The latter is not true in our model.

<sup>16</sup>It would in fact be perfectly feasible to construct a model that features no intermediation whatsoever. We have verified that such a model economy works very similarly to the one presented in this paper.

investment loans the transmission is from lending to investment to savings and not the reverse. When banks decide to lend more for investment purposes, say due to increased optimism about business conditions, they create additional purchasing power for investors in plant and machinery by crediting their accounts. It is this new purchasing power that makes the actual investment possible. And it is the transfer of the deposit account balance from the investor in plant and machinery to the seller of plant and machinery that generates the corresponding saving, which is therefore a *consequence* of the creation of purchasing power and of physical investment activity. This issue is in fact of much broader policy significance. Because it implies that, at least to the extent that investment is bank-financed, the often heard prescription that in order to generate adequate levels of investment the economy first needs to generate sufficient savings is fundamentally mistaken. Because the credit system will generate the saving along with the investment.

Finally, the issue can be further illuminated by looking at it from the vantage point of depositors. We will assume, based on empirical evidence, that the interest rate sensitivity of deposit demand is high at the margin. Therefore, if depositors decided, for a given deposit interest rate, that they wanted to start depositing additional funds in banks, without bankers wanting to make additional loans, the end result would be virtually unchanged deposits and loans. The reason is that banks would start to pay a slightly lower deposit interest rate, and this would be sufficient to reduce deposit demand without materially affecting funding costs and therefore the volume of lending. For a given credit demand, the final decision on the quantity of lending and therefore of money in the economy is therefore almost exclusively made by banks, and is based on their optimism about business conditions and thus about borrowers' creditworthiness.

Our model completely omits two other monetary magnitudes, cash outside banks and bank reserves held at the central bank. This is because it is privately created deposit money that plays the central role in the current U.S. monetary system, while government-issued money plays a quantitatively and conceptually negligible role. In this context it should be mentioned that both private and government-issued monies are fiat monies, because the acceptability of bank deposits for commercial and official transactions has had to first be decreed by law. As we will argue in Section III, virtually all monies throughout history, including precious metals, have derived most or all of their value from government fiat rather than from their intrinsic value.

Rogoff (1998) examines U.S. dollar currency outside banks for the late 1990s. He concludes that it was equal to around 5% of GDP for the United States, but that 95% of this was held either by foreigners and/or by the underground economy. This means that currency outside banks circulating in the formal U.S. economy equalled only around 0.25% of GDP, while we will find that the current transactions-related liabilities of the U.S. financial system, including the shadow banking system, are equal to around 200% of GDP.

Bank reserves held at the central bank have also generally been negligible in size, except of course after the onset of the 2008 financial crisis and quantitative easing. But this quantitative point is far less important than the recognition that they do not play any meaningful role in the determination of wider monetary aggregates. The reason is that the "deposit multiplier" of the undergraduate economics textbook, where monetary aggregates are created at the initiative of the central bank, through an initial injection of high-powered money into the banking system that gets multiplied through bank lending,

turns the actual operation of the monetary transmission mechanism on its head. This should be clear under the current inflation targeting regime, where the central bank controls an interest rate and must be willing to supply as many reserves as banks demand at that rate.<sup>17</sup> But as shown by Kydland and Prescott (1990), the availability of central bank reserves did not even constrain banks during the period, in the 1970s and 1980s, when the central bank did in fact officially target monetary aggregates. These authors show that broad monetary aggregates, which are driven by banks' lending decisions, led the economic cycle, while narrow monetary aggregates, most importantly reserves, lagged the cycle. In other words, banks ask for reserves after they have decided to lend more, and the central bank obliges. Reserves therefore impose no constraint, they are a consequence rather than a cause of bank credit and money creation. The deposit multiplier is simply, in the words of Kydland and Prescott (1990), a myth.<sup>18</sup> And because of this, private banks are almost fully in control of the money creation process.<sup>19</sup>

The one qualification to this is that the central bank does have some effect on the money supply through the policy rate. However, that control is quite weak and indirect.<sup>20</sup> The policy rate works through its effects, by arbitrage, on the deposit rate and thereby on bank lending rates. But in order to have a significant effect on credit and therefore on money by using this price instrument, the central bank has to literally raise the price of credit to the point where it makes significant numbers of potential borrowers not creditworthy. This makes the policy rate a very blunt and indiscriminate tool for affecting the money supply, and one that is not likely to be frequently used for this purpose. By contrast with the policy rate, banks' decisions on lending standards have a much stronger and direct effect on the availability and cost of credit, and therefore on the quantity of money.

Apart from the central role of bank-based money creation, other features of our banking model are based on Benes and Kumhof (2011). This work differs from other recent papers on banking along the following dimensions: First, banks have their own balance sheet and net worth, and their profits and net worth are exposed to non-diversifiable aggregate risk determined endogenously on the basis of optimal debt contracts.<sup>21</sup> Second, banks are lenders rather than holders of risky equity.<sup>22</sup> Third, bank lending is based on the loan contract of Bernanke, Gertler and Gilchrist (1999), but with the crucial difference that lending is risky due to non-contingent lending interest rates. This implies that banks can

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<sup>17</sup>The absence of a deposit multiplier channel in the current U.S. financial system has been confirmed empirically by Carpenter and Demiralp (2010), in a Federal Reserve Board working paper. It is also stated very clearly in ECB (2012), which explains that the ECB's reserve requirements are backward-looking, and therefore only apply after banks have made a loan decision. Furthermore, "The Eurosystem ... always provides the banking system with the liquidity required to meet the aggregate reserve requirement."

<sup>18</sup>This is of course the reason why quantitative easing, at least the kind that is intended to work by making greater reserves available to banks and not to the public, can be ineffective if banks decide that lending remains too risky.

<sup>19</sup>Incidentally, we do not refer to the money created by banks as "endogenous money" precisely because that term is associated with the deposit multiplier, where the exogenous shock is the central bank injection of high-powered money. Bank-based money creation is partly endogenous, but only with respect to standard business cycle shocks. If on the other hand the shock is to bank sentiment about borrower riskiness, which then leads to changes in lending conditions, bank-based money creation is more properly classified as exogenous.

<sup>20</sup>See Altunbas et al. (2009) for empirical evidence that confirms this for Europe.

<sup>21</sup>Christiano, Motto and Rostagno (2010) and Curdia and Woodford (2010) focus exclusively on how the price of credit affects real activity.

<sup>22</sup>Gertler and Karadi (2010) and Angeloni and Faia (2009) make the latter assumption.

make losses if a larger number of loans defaults than was expected at the time of setting the lending rate. Fourth, bank capital is subject to regulation that closely replicates the features of the Basel regulatory framework, including costs of violating minimum capital adequacy regulations. Capital buffers arise as an optimal equilibrium phenomenon resulting from the interaction of optimal debt contracts, endogenous losses and regulation.<sup>23</sup> To maintain capital buffers, banks respond to loan losses by raising their lending rate in order to rebuild their net worth, with adverse effects for the real economy. Fifth, acquiring fresh capital is subject to market imperfections. This is a necessary condition for capital adequacy regulation to have non-trivial effects, and for the capital buffers to exist. We use the “extended family” approach of Gertler and Karadi (2010), whereby bankers (and also non-financial manufacturers and entrepreneurs) transfer part of their accumulated equity positions to the household budget constraint at an exogenously fixed rate. This is closely related to the original approach of Bernanke, Gertler and Gilchrist (1999), and to the dividend policy function of Aoki, Proudman and Vlieghe (2004).

The rest of the paper is organized as follows. Section II discusses answers to some common questions concerning the Chicago Plan. Section III contains a survey of the literature on monetary history and monetary thought leading up to the Chicago Plan. Section IV presents the model under the current monetary system. Section V presents the model under the Chicago Plan. Section VI discusses model calibration. Section VII studies impulse responses that simulate a dynamic transition between the current monetary system and the Chicago Plan, which allows us to analyze all but one of the above-mentioned claims in favor of the Chicago Plan. The remaining claim, regarding the more effective stabilization of bank-driven business cycles, is studied in Section VIII. Section IX concludes.

## II. Answers to Common Questions

Since this paper was first published as IMF Working Paper 12/202 in August 2012, we have received an enormous amount of feedback from around the world. Nobody has so far challenged our economic model or the model simulations. But there were many questions concerning the feasibility and/or desirability of implementing a modern version of the Chicago Plan. We have therefore added this new section, which covers the major issues raised in these questions in a small number of subsections.

The questions can be divided into two groups, those that concern the difficulties of correctly designing a different monetary and financial system, and those that argue that such a system, even if designed as intended, could have major shortcomings. The first set of questions, which is covered in subsections II.A – II.B, is of course entirely justified. Any major monetary reform requires very careful attention to detail, and the Chicago Plan would be no exception. The critiques underlying the second set of questions, which is covered in subsections II.C – II.J, have mostly turned out to be based either on misconceptions of what the Chicago Plan proposes, or on insufficient attention to the

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<sup>23</sup>Van den Heuvel (2008) models capital adequacy as a continuously binding constraint. Gerali et al. (2010) use a quadratic cost short-cut.

historical evidence. Responding to these questions has in many cases helped us to further illuminate the advantages of the Chicago Plan.

### **A. The Transition Period**

The key question in any major monetary reform is whether the risks of transitioning to a different monetary system are justified by the benefits once that transition is complete. We have already discussed that the benefits of the Chicago Plan, in terms of output, output volatility, and debt levels would be very large, and will demonstrate this quantitatively in the second half of the paper. The risks and uncertainties of the transition period would therefore have to be extreme to counsel against attempting a transition. But there is no reason for thinking that they would be extreme. In fact, both Fisher (1935) and Friedman (1960) express the view that the transition would be a simple matter. The very first stage of the Chicago Plan, the implementation of full reserve backing for all existing deposits, is quite straightforward to implement. It would of course have to be designed with careful attention to detail, given the complexity of today's financial markets and financial products. The subsequent steps, including the citizens' dividend and the gradual transition to a low-inflation, low-interest-rate and low-tax environment, can be spread out over time to minimize potential disruptive effects. In the process, from a position of formidable fiscal strength, the authorities would gain the experience necessary to fine-tune the details of the new monetary system.

### **B. Debt-Financed Investment Trusts and Near-Monies**

The question is whether and how the creation of money substitutes, or near-monies, by the investment trust sector can be prevented, given that a proliferation of near-monies could make the control of money and thus inflation very difficult. Henry Simons and Irving Fisher were very aware of this problem, but did not think of it as prohibitive. Nor did the other advocates of full reserve banking. The obvious solution is to insist on equity-funded or treasury-funded investment trusts, which would most directly prevent the emergence of near-monies. But even for debt-funded investment trusts it should be straightforward to design effective institutional and regulatory safeguards that accomplish the same objective. We will list five such safeguards, with the initial ones designed to create economic incentives against the creation of near-monies, and the later ones designed to outlaw them completely. A policymaker could choose any combination along this spectrum. Legal prohibitions may be more extreme than necessary, but this could only be finally decided in the light of experience with lighter-touch alternatives.

The first and most important safeguard would be that none of the liabilities of the investment trusts should be protected by any kind of government-backed deposit insurance, either explicitly or implicitly, so that from the point of view of the investor they would represent risky investments rather than money. Incidentally, any objection that the removal of deposit insurance would severely increase systemic risk misses one of the most important points of the Chicago Plan, namely that under the new system, completely unlike the present one, large-scale loan defaults would have no implications whatsoever for

the money supply and the safety of the payments system, which remains fully insulated from the credit system.

The second safeguard against the emergence of near-monies would be a legal requirement that all remaining short-term lending, of which there will be much less under the Chicago Plan, must be financed exclusively through equity-funded investment trusts, while longer-term lending can be financed by debt, but with strict regulations on maturity mismatches, and with very high penalties for early withdrawal.

The third safeguard would be the complete removal of any tax advantages for debt relative to equity, or even the creation of tax disadvantages for debt. This would make equity-funded investment trusts more attractive than their debt-funded competitors.

The fourth safeguard would be incentive-compatible penalties against institutions issuing near-monies. Particularly effective would be laws whereby the penalty would not be payable to the government but rather to the parties receiving a payment (or collateral) in something other than government-issued money, as this would ensure cooperation from such parties in the enforcement process.

Finally, the fifth and most extreme safeguard would be to simply outlaw the creation of near-monies, and to confiscate the assets of all institutions in violation of that law.

### C. Maturity Transformation

A very common question concerning the Chicago Plan is whether it would destroy the benefits of maturity transformation that are currently provided by banks. Diamond and Dybvig (1986), which is still frequently cited in defense of the status quo, argue that it would. A careful analysis of what we propose shows that it would not. We begin that analysis by pointing out that the existence of maturity transformation is clearly not an end in itself. Rather, what matters are the benefits derived from it, and whether these benefits would be lost under the Chicago Plan.<sup>24</sup> These benefits have two relevant aspects, cost of borrowing and access to desired maturity profiles of assets and liabilities.

The Chicago Plan clearly imposes no additional constraints on the latter. Investors have access to an undiminished range of generally shorter maturities on safe monetary deposits, plus to longer-term maturities on non-monetary, risky investment trust liabilities. Borrowers, especially but not only physical investors, can access long-term funding through investment trusts without any problems. If the government wants to maintain low interest rates in the investment trust sector while longer-term financial investors prefer to switch to safe monetary investments at those rates, treasury credit can be used to supply additional funds. Otherwise interest rates can be allowed to rise to attract sufficient funding for investment trusts.

This takes us to the second aspect of maturity transformation, cost of borrowing. In Section VI we estimate, based on U.S. data, that the average interest cost on bank

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<sup>24</sup>Incidentally, maturity transformation between highly liquid transactions balances and valuable long-term assets clearly also takes place when the government, as under the Chicago Plan, uses the proceeds of money creation to finance spending on long-term physical and human capital such as infrastructure, education and public health.



deposits, broadly defined, is around 100 basis points below the rate on short-term government securities. If, as assumed in our model, banks currently pass this cost advantage on to borrowers, the adoption of the Chicago Plan would, *ceteris paribus*, raise lending rates by 100 basis points, by removing cheap deposits as a source of funding loans. But this misses several more important considerations. First, based on empirical studies that are also cited in Section VI, we estimate that the large debt-equity swap of the Chicago Plan would lower real interest rates on government securities themselves by around 200 basis points, and this is under the conservative assumption that the government decides not to completely repay all previously outstanding government debt, but rather to leave separate gross positions of government debt and treasury credit outstanding. Because private lending rates would follow rates on government securities, the 200 basis points reduction in government borrowing rates far outweighs the cost of losing low-cost deposit funding. Second, because under the Chicago Plan money no longer needs to be created through debt, debt levels throughout the economy would be very much lower, so that households and firms would be far less affected by borrowing costs than before. Third, if banks, instead of passing their funding cost advantage on to borrowers, were currently appropriating this profit by exploiting market power, then the implementation of the Chicago Plan would simply transfer these monopoly profits from banks' shareholders to the taxpayer.<sup>25</sup>

#### **D. Competitiveness of the Banking System**

Some have questioned whether the dramatic benefits of the Chicago Plan would come at the expense of diminishing some of the other core useful functions of a private financial system. We would argue that the exact opposite is true. Under the Chicago Plan private financial institutions would continue to play a key and in fact a much more effective role in providing a state-of-the-art payments system, facilitating the efficient allocation of capital to its most productive uses, and facilitating intertemporal smoothing by households and firms. The payments system could be operated highly efficiently without having to worry about asset quality risks, while the credit system could be operated with a long-run focus, with far fewer reasons to worry about liability management risks, including the risk of bank runs. Credit, especially socially useful credit that supports real physical investment activity, would continue to exist, and would in addition be significantly cheaper. What would cease to exist however is the proliferation of credit created, at the almost exclusive initiative of private institutions, for the purpose of creating an adequate money supply that can easily be created debt-free.

#### **E. Deflation**

The question here is whether the Chicago Plan would cause massive deflation by causing financial institutions to stop lending.<sup>26</sup> This involves two issues. One of them, deflation, clearly confuses matters by applying the logic of our current debt-based monetary system, where a reduction in bank lending does indeed lead to a reduction in the money supply, to

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<sup>25</sup>We thank Olivier Blanchard for pointing this possibility out to us.

<sup>26</sup>See the remarks by Timothy Congdon cited in Evans-Pritchard (2012).

a completely different system where the money supply, and therefore the risk of deflation, is completely under the control of monetary policy, and completely independent of lending. Deflation can therefore never become a problem.

The question of whether financial institutions would stop lending therefore has no bearing on the size of the overall money supply, but rather on its efficient allocation among non-bank agents via intermediation. Sufficient lending however is surely only a question of the right price and, as discussed in subsection II.C, we estimate that equilibrium funding rates under the Chicago Plan would drop so much that lending rates could drop while still allowing investment trusts to make an adequate return on their capital.<sup>27</sup>

## F. Inflation

Interestingly, others have raised precisely the opposite concern, by questioning whether the Chicago Plan could avoid being highly inflationary. Two different arguments are made in this context. One is based on theory and is dealt with in this subsection, while the other is based on economic history and is dealt with in the next subsection. The brief answer is that neither theory nor history support this claim.

In our model of the Chicago Plan steady state inflation is determined by the money growth rate, and as we have already argued zero *steady state* inflation can be achieved without complications, due to the absence of liquidity trap problems. Inflation along the *transition path* is determined by the relative supplies of money (deposits) and goods. The Chicago Plan, as Figure 1 shows very clearly, involves no significant initial changes in the supply of money, which starts and ends the single transition period at 184% of GDP, and thereafter remains tightly controlled by a money growth rule. This cannot be inflationary.<sup>28</sup>

A critical misinterpretation in some arguments against the Chicago Plan concerns the creation of a large new stock of reserves at the outset. The point is that this is not at all a case of printing new money, but rather one of changing what the existing stock of money represents. Under the present system money needs to be created through debt, and fluctuations in the recovery of that debt, or in banks' willingness to create debt, must lead to fluctuations in the supply of money. In that sense money is highly "destructible". Under the Chicago Plan money is created independently of debt to satisfy the demand for a stable medium of exchange, with no risk at all from the credit sector of the economy. This money is therefore "indestructible". This critical and highly beneficial change in the nature of money is what happens along the transition path, not inflation.

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<sup>27</sup>On this, see Admati and Hellwig (2013), who argue against the notion that policymakers should be concerned with banks' return on equity on welfare grounds.

<sup>28</sup>Any short-term inflationary concerns could furthermore be very effectively dealt with through a combination of a slow disbursement of the citizens' dividend, an initially more conservative money growth rate, a very gradual lowering of the interest rate on treasury credit, and licensing requirements for investment trusts that mandate conservative lending policies such as high downpayments.

## **G. Government Control over Money**

A frequently-raised question is whether government can be trusted with control of the money supply, given the historical record. The very common claim that it cannot will be comprehensively refuted in Section III, which shows that, both in ancient societies and in Western nations, it was periods of private control over money issuance that have been plagued by financial crises, while periods of government control have exhibited much more stability.

This wealth of historical evidence for comparatively responsible government money issuance dates back several centuries in many (but not all) cases. As an argument in favor of the Chicago Plan it is therefore commonly countered by pointing to the many examples of unsuccessful government monetary policy and inflation throughout the twentieth century. This however represents a serious logical error. The reason is that the Chicago Plan proposes, as in the much older experiences, government control of broad monetary aggregates and the complete elimination of all private debt-based money creation. This has not been the case, even approximately, in any twentieth century experience. To the contrary, private banks have had a great deal of monetary control, albeit not always to the extent of the United States today. This could in fact be used to turn the argument around, by concluding that recent episodes of monetary instability must have been caused to a very significant extent by private banks, not by governments. As we will show in Section III, the German hyperinflation of 1923 is completely consistent with this alternative interpretation. One really does have to look centuries into the past to find examples of the type of government monetary control advocated in this paper. This is what we do in Section III, and that record undeniably supports the Chicago Plan.

This leaves the question of how precisely, in our modern monetary environment, to best ensure responsible government money issuance. Here we suggest that the management of money growth should ideally be entrusted to a fourth power of government, with a constitutional independence similar to that of the Supreme Court. This would insulate the issuance of money not only from government pressures, but also from pressures that come from private financial interests.

## **H. Government Control over Credit**

One aspect of the balance sheet changes illustrated in Figure 1 frequently gives rise to concerned questions, namely the fact that the government appears to end up funding and therefore indirectly controlling all private credit, with the quantitatively small exception of investment trust equity. This is seen as undesirable. There are four responses to this.

First, we already discussed that investment trusts that intermediate between private net savers and borrowers would continue to exist under the Chicago Plan, but are omitted from the model, and from Figure 1, because of the representative agent assumption.

Second, the investment trusts shown in Figure 1 do not have to be predominantly financed by treasury credit. A perfectly feasible alternative assumption is that the government spends a further 60% of GDP of its treasury credit balance to redeem all remaining government debt held outside the financial system. The final result would be investment

trusts that are financed by equity equal to 9% of GDP, treasury credit equal to 11% of GDP, and private non-monetary debts equal to 60% of GDP. This has a potential drawback in that government debt has been a very important benchmark asset for financial markets, so that full repayment of all government debt could be inferior to having separate gross debt and gross treasury credit positions outstanding.<sup>29</sup> However, it is not clear that this benchmark role could not be played by government-issued money under the Chicago Plan.

Third, even the sizeable treasury credit funding in Figure 1 does not need to imply that the government must have a major influence on the quantity of private credit. We will show that if the government made treasury credit available at an interest rate that follows a conventionally-calibrated Taylor-type rule, this would allow for money creation that is almost as elastic as under the present system. The volume of credit would still be mostly controlled by private financial institutions, and the allocation of that credit would be completely controlled by them.

However, and this takes us to the fourth point, in light of the historical experience with private credit creation, presented in much more detail in Section III, we argue that this is not a desirable outcome, and that greater government control over credit can be highly beneficial. In our model simulations we will in fact be able to demonstrate that an additional tool, quantitative lending guidance, can be used very effectively. Specifically, highly countercyclical capital adequacy requirements, as permitted under the new Basel-III regulations, can dramatically smooth business cycle fluctuations driven by bank sentiment concerning the creditworthiness of potential borrowers.

Policies of quantitative lending guidance have historically for the most part been highly successful. Quantitative and qualitative guidance of bank credit was at some stage used by almost all central banks in the world (Goodhart (1989)). The experience that has been documented in greatest detail, using econometric and qualitative primary data and institutional analysis, is that of Japan in the post-war era, known as ‘window guidance’ (Werner (1998, 2002, 2003a)). According to Werner (2003a), the Japanese system was the basis for the window guidance introduced in Korea, Taiwan (Wade (1990)), and China (Chen and Werner (2011)). In turn, the Japanese system was introduced from Germany’s Reichsbank, which pioneered the practice in 1912 (Werner (2003a, 2003c)). It was subsequently used by the Federal Reserve, the Bank of England, the Banque de France, and the central banks of Austria, Greece, Thailand, Malaysia and India, among others (Werner (2000a, 2000b, 2005)). According to Werner (2003b, 2005) historical experience shows that, provided sensible rules for the design of credit guidance were observed, the system was effective and garnered the support of the banking industry.

The principle of credit guidance is to ensure that bank credit creation is used mainly for sustainable purposes that do not impose unjustifiable costs on society. Hence bank credit for productive purposes would generally be encouraged (especially credit for the manufacturing and export industries), while unproductive credit would be discouraged (especially credit for financial and asset transactions, including many real estate transactions). On occasion quantitative lending guidance was misused, as in the case of Germany during the 1920s (Werner (2003a, 2003c)), Japan during the 1980s (Werner

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<sup>29</sup>The possibility of an insufficient stock of government debt was a significant concern in the United States at the end of the 1990s. See Reinhart et al. (2000).

(1998, 2002, 2003a)), and Thailand during the 1990s (Werner (2000a)). Werner (2005) argues that misuses were only made possible by excessive secrecy surrounding the use of this policy by central banks. The lesson from these episodes is therefore that quantitative lending guidance should be implemented in a transparent fashion, ensuring full accountability of the central banks involved. But there were many more highly successful episodes. According to Werner's quantity theory of credit, credit guidance has in fact been a very powerful policy tool for achieving high and sustainable growth in numerous countries. Specifically, he argues that it was the single most important factor in the 'East Asian economic miracle', and this argument is supported by a World Bank study on this topic (IBRD, 1993).

Quantitative lending guidance under a regime of full reserve banking can be thought of as the price that investment trusts have to pay for the much greater funding flexibility offered by treasury credit. In a world of pure financial intermediation, as opposed to the present world of private money creation, investment trusts would have to attract existing privately-held money balances in order to be able to lend them out. Compared to this, treasury credit gives them the option to have the government create additional money for them.<sup>30</sup> This is not dramatically different from being able to create money themselves, as long as it is subject only to an interest rate rule that is fairly elastic. Under quantitative lending guidance the government demands an additional price for the privilege of retaining this flexible access to money, namely the backing of above-trend loan creation by a greater amount of capital.

## I. Compromise Solutions

A commonly asked question is whether it would not be more pragmatic to advocate less comprehensive forms of monetary reform than the Chicago Plan, either because they would face less resistance, or because they are claimed to have advantages of their own.

One suggested alternative is the maintenance of the current monetary system with higher, but not 100%, reserve requirements. There are at least three problems with this suggestion. First, it unnecessarily foregoes a large part of the dramatic debt-reduction benefits of the Chicago Plan, while still leaving banks in charge of money creation at the margin, with all that that implies for macroeconomic volatility. Second, it is not clear at all how to combine a system of effective and substantial reserve requirements with an inflation targeting regime, because this would imply the simultaneous targeting of a price and a monetary quantity. Third, historically most regimes of limited reserve requirements have suffered from gradual attrition, as lobbies succeeded in having the ratios lowered. This would be much harder under a full reserve banking regime.

Another suggested alternative is a much greater use of complementary currencies that are not debt-based. Stodder (2009), Lietaer et al. (2010) and Ulanowicz et al. (2009) discuss that complementary currencies have been successfully used in systems of centralized exchange (like the Swiss WIR) that contribute to stabilizing the business cycle, and at the

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<sup>30</sup>Of course this would remain within the overall envelope of money creation envisaged by the money growth rule. Higher money demand by banks would therefore lead to less money being put into circulation through other budgetary channels such as government spending.

local level to accomplish specific socially valuable objectives. Their many examples of complementary currencies are persuasive, and there may be scope for more of the local schemes. Economy-wide systems, as shown by Stodder (2009), can stabilize the money supply under a system of fractional reserve banking. But under a system of full reserve banking alternative currencies, if they were to become large, could potentially pose problems with national monetary and thus inflation control.<sup>31</sup> More importantly, complementary currencies could become a distraction if they were proposed as the main solution to the problems identified by Fisher and his contemporaries, because this would very likely leave bank-based money creation at the core of the financial system. Finally, the great democratic potential of national rather than private control over money issuance means that full reserve banking may be able to accomplish many of the desirable social objectives outlined in Lietaer et al. (2010) without the use of complementary currencies.

The third suggested alternative is not really a monetary reform at all. We nevertheless mention it here because it is currently much discussed. This is the proposal of the trillion dollar platinum coin, to be deposited in the Federal Reserve against cancellation of an equal amount of government debt, thereby avoiding the U.S. debt ceiling. The one positive aspect of this solution is that it does reflect an understanding that a government does not need to be in stifling debt if it exercises its sovereign right to create money. But, apart from perhaps permitting the government to dodge the debt ceiling<sup>32</sup>, this device would not accomplish anything of substance. The reason is that the implications for the consolidated government and central bank balance sheet, and also the flow budgetary implications, are zero. For stocks, the transaction does not change either government or central bank liabilities vis-a-vis the public. For flows, the Federal Reserve already remits its profits, which include interest earnings on government debt, back to the government, therefore a transaction that remains purely between the Federal Reserve and the treasury has no significant budgetary implications. The key shortcoming of this approach relative to the Chicago Plan is therefore that it does not recognize the central importance of private debt-based money creation for public (and private) debt levels.

## J. Open Economy Considerations

The final question is whether the existence of globalized financial markets would make it dangerous for one country to “go it alone”, by implementing full reserve banking while others retain the present system.

If the concern is only with speculative attacks on a country’s currency due to weak economic fundamentals, the answer to this question is clearly no. The traditional first-generation, or fundamentals-based literature on balance of payments crises<sup>33</sup> stressed weak fiscal fundamentals as the key reason for an attack on a currency. But following the implementation of the Chicago Plan, particularly if the initial disbursement of the citizens’ dividend was implemented very gradually rather than instantaneously, the government’s fiscal position would become extremely strong compared to that of virtually

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<sup>31</sup>This is a question that needs further research.

<sup>32</sup>This is a legal question on which the authors do not claim any expertise.

<sup>33</sup>See Krugman (1979) and Calvo (1987). Balance of payments crises under inflation targeting are analyzed in Kumhof et al. (2007).

any other country. The same is true of prospects for the real economy. In addition, especially if the implementation were to take place during global financial market turmoil, the indestructible and completely safe money offered by the country's banks would become highly attractive as a safe haven asset that is virtually immune to credit risks.

However, the concern may not be with economic fundamentals, but rather with an irrational speculative attack on a new and therefore unfamiliar monetary system. This type of speculative attack also turns out to be much less of a concern under full reserve banking. As shown by the experience of the German hyperinflation of 1923, which will be recounted in some detail in Section III, a determined central bank can quickly crush speculators if the latter do not have access to a private banking system that creates local currency on demand, and more so if the government is in a much stronger fiscal position than that of Germany in 1923.

If this should not be enough, it is always possible to implement temporary capital controls<sup>34</sup> until the system has had time to start proving its many advantages.

### III. The Chicago Plan in the History of Monetary Thought

#### A. Government versus Private Control over Money Issuance

The monetary historian Alexander Del Mar (1895) writes: “As a rule political economists do not take the trouble to study the history of money; it is much easier to imagine it and to deduce the principles of this imaginary knowledge.” Del Mar wrote more than a century ago, but this statement still applies today. An excellent example is the textbook explanation for the origins of money, which holds that money arose in private trading transactions, to overcome the double coincidence of wants problem of barter.<sup>35</sup> As shown by Graeber (2011), on the basis of extensive anthropological and historical evidence that goes back millennia, there is not a shred of evidence to support this story. Barter was virtually nonexistent in primitive and ancient societies, and instead the first commercial transactions took place on the basis of elaborate credit systems whose denomination was typically in agricultural commodities, including cattle, grain by weight, and tools. Furthermore, Graeber (2011), Zarlenga (2002) and the references cited therein provide plenty of evidence that these credit systems, and the much later money systems, had their origins in the needs of the state (Ridgeway (1892)), of religious/temple institutions (Einzig (1966), Laum (1924)) and of social ceremony (Quiggin (1949)), and not in the needs of private trading relationships.<sup>36</sup>

Any debate on the *origins* of money is not of merely academic interest, because it leads directly to a debate on the *nature* of money, which in turn has a critical bearing on arguments as to who should *control* the issuance of money. Specifically, the private trading story for the origins of money has time and again, starting at least with Adam Smith (1776), been used as an argument for the private issuance and control of money.

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<sup>34</sup>On this topic, see the IMF Staff Position Note by Ostry et al. (2010).

<sup>35</sup>A typical early example of this claim is found in Menger (1892).

<sup>36</sup>See Goodhart (1998) for a very similar argument.

Until recent times this has mainly taken the form of monetary systems based on precious metals, especially under free coinage of bullion into coins. Even though there can at times be heavy government involvement in such systems, the fact is that in practice precious metals tended to accumulate privately in the hands of the wealthy, who would then lend them out at interest. Since the thirteenth century this precious-metals-based system has, in Europe, been accompanied, and increasingly supplanted, by the private issuance of bank money, more properly called credit. On the other hand, the historically and anthropologically correct state/institutional story for the origins of money is one of the arguments supporting the government issuance and control of money under the rule of law. In practice this has mainly taken the form of interest-free issuance of notes or coins, although it could equally take the form of electronic deposits.

There is another issue that tends to get confused with the much more fundamental debate concerning the control over the issuance of money, namely the debate over “real” precious-metals-backed money versus fiat money. As documented in Zarlenga (2002), this debate is mostly a diversion, because even during historical regimes based on precious metals the main reason for the high relative value of precious metals was precisely their role as money, which derives from government fiat and not from the intrinsic qualities of the metals.<sup>37</sup> These matters are especially confused in Smith (1776), who takes a primitive commodity view of money despite the fact that at his time the then private Bank of England had long since started to issue a fiat currency whose value was essentially unrelated to the production cost of precious metals. Furthermore, as Smith certainly knew, both the Bank of England and private banks were creating checkable book credits in accounts for borrowing customers who had not made any deposits of coin (or even of bank notes).

The historical debate concerning the nature and control of money is the subject of Zarlenga (2002), a masterful work that traces this debate back to ancient Mesopotamia, Greece and Rome. Like Graeber (2011), he shows that private issuance of money has repeatedly led to major societal problems throughout recorded history, due to usury associated with private debts.<sup>38</sup> Zarlenga does not adopt the common but simplistic definition of usury as the charging of “excessive interest”, but rather as “taking something for nothing” through the calculated misuse of a nation’s money system for private gain. Historically this has taken two forms. The first form of usury is the private appropriation of the convenience yield of a society’s money. Private money has to be borrowed into existence at a positive interest rate, while the holders of that money, due to the non-pecuniary benefits of its liquidity, are content to receive no or very low interest. Therefore, while part of the interest difference between lending rates and rates on money is due to a lending risk premium, another large part is due to the benefits of the liquidity services of money. This difference is privately appropriated by the small group that owns the privilege to privately create money. This is a privilege that, due to its enormous benefits, is often originally acquired as a result of intense rent-seeking behavior. Zarlenga

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<sup>37</sup>For example, in many of the ancient Greek societies gold was not intrinsically valuable due to scarcity, as temples had accumulated vast amounts of gold over centuries. But gold coins were nevertheless highly valued, due to government fiat declaring them to be money. A more recent example is the collapse of the price of silver relative to gold following the widespread demonetization of silver that started in the 1870s.

<sup>38</sup>Reinhart and Rogoff (2009) contains an even more extensive compilation of historical financial crises. However, unlike Zarlenga (2002) and Del Mar (1895), these authors do not focus on the role of private versus public monetary control, the central concern of this paper.



(2002) documents this for multiple historical episodes. We will return to the issue of the interest difference between lending and deposit rates in calibrating our theoretical model. The second form of usury is the ability of private creators of money to manipulate the money supply to their benefit, by creating an abundance of credit and thus money at times of economic expansion and thus high goods prices, followed by a contraction of credit and thus money at times of economic contraction and thus low goods prices. A typical example is the harvest cycle in ancient farming societies, but Zarlenga (2002), Del Mar (1895), and the works cited therein contain numerous other historical examples where this mechanism was at work. It repeatedly led to systemic borrower defaults, forfeiture of collateral, and therefore the concentration of wealth in the hands of lenders. For the macroeconomic consequences it matters little whether this represents deliberate and malicious manipulation, or whether it is an inherent feature of a system based on private money creation. We will return to this in our theoretical model, too.

A discussion of the crises brought on by excessive debt in ancient Mesopotamia is contained in Hudson and van de Mierop (2002). It was this experience, acquired over millennia, that led to the prohibition of usury and/or to periodic debt forgiveness (“wiping the slate clean”) in the sacred texts of the main Middle Eastern religions. The earliest known example of such debt crises in Greek history are the 594 BC reforms of Solon, which were a response to a severe debt crisis of small farmers, brought on by the charging of interest on coinage by a wealthy oligarchy. It is extremely illuminating to realize that Solon’s reforms, at this very early time, already contained many elements of what Henry Simons (1948), a principal proponent of the Chicago Plan, would later refer to as the “financial good society”. First, there was widespread debt cancellation, and the restitution of lands that had been seized by creditors. Second, agricultural commodities were monetized by setting official monetary floor prices for them. Because the source of loan repayments for agricultural debtors was their output of these commodities, this turned debt finance into something closer to equity finance. Third, Solon provided much more plentiful government-issued, debt-free coinage that reduced the need for private debts. Solon’s reforms were so successful that, 150 years later, the early Roman republic sent a delegation to Greece to study them. They became the foundation of the Roman monetary system from 454 BC (Lex Aternia) until the time of the Punic wars (Peruzzi (1985)). It is also at this time that a link was established between these ancient understandings of money and more modern interpretations. This happened through the teachings of Aristotle that were to have such a crucial influence on early Western thought. In *Ethics*, Aristotle clearly states the state/institutional theory of money, and rejects any commodity-based or trading concept of money, by saying “Money exists not by nature but by law.” The *Dialogues* of Plato contain similar views (Jowett (1937)). This insight was reflected in many monetary systems of the time, which contrary to a popular prejudice among monetary historians were based on state-backed fiat currencies rather than commodity monies. Examples include the extremely successful Spartan system (approx. 750-415 BC), introduced by Lycurgus, which was based on iron disks of low intrinsic value, the 390-350 BC Athenian system, based on copper, and most importantly the early Roman system (approx. 700-150 BC), which was based on bronze tablets, and later coins, whose material value was far below their face value.

Many historians have attributed the eventual collapse of the Roman republic to the emergence of a plutocracy that accumulated immense private wealth at the expense of the

general citizenry.<sup>39</sup> Their ascendancy was facilitated by the introduction of privately controlled silver money, and later gold money, at prices that far exceeded their earlier commodity value prices, during the emergency period of the Punic wars. With the collapse of Rome much of the ancient monetary knowledge and experience was lost in the West. But the teachings of Aristotle remained important through their influence on the scholastics, including St. Thomas Aquinas (1225-1274). This may be part of the reason why, until the Industrial Revolution, monetary control in the West remained generally either in government or religious hands, and was inseparable from ultimate sovereignty in society. However, this was to change eventually, and the beginnings can be traced to the first emergence of private banking after the fall of Byzantium in 1204, with rulers increasingly relying on loans from private bankers to finance wars. But ultimate monetary control remained in sovereign hands for several more centuries. The Bank of Amsterdam (1609-1820) in the Netherlands was still government-owned and maintained a 100% reserve backing for deposits. And the *Mixt Moneys of Ireland* (1601) legal case in England confirmed the right of the sovereign to issue intrinsically worthless base metal coinage as legal tender. It was the English Free Coinage Act of 1666, which placed control of the money supply into private hands, and the founding of the privately controlled Bank of England in 1694, that first saw a major sovereign relinquishing monetary control, not only to the central bank but also to the private banking interests behind it. The following centuries would provide ample opportunities to compare the results of government and private control over money issuance.

The results for the United Kingdom are quite clear. Shaw (1896) examined the record of monarchs throughout English history, and found that, with one exception (Henry VIII), the king had used his monetary prerogative responsibly for the benefit of the nation, with no major financial crises. On the other hand, Del Mar (1895) finds that the Free Coinage Act inaugurated a series of commercial panics and disasters which to that time were completely unknown, and that between 1694 and 1890 twenty-five years never passed without a financial crisis in England.

The principal advocates of this system of private money issuance were Adam Smith (1776) and Jeremy Bentham (1818), whose arguments were based on a fallacious notion of commodity money. But a long line of distinguished thinkers argued in favor of a return to (or, depending on the country and the time, a maintenance of) a system of government money issuance, with the intrinsic value of the monetary metal (or material) being of no consequence. The list of their names, over the centuries, includes John Locke (1692, 1718), Benjamin Franklin (1729), George Berkeley (1735), Charles de Montesquieu (1748, in Montague (1952)), Thomas Paine (1796), Thomas Jefferson (1803), David Ricardo (1824), Benjamin Butler (1869), Henry George (1884), Georg Friedrich Knapp (1924), Frederick Soddy (1926, 1933, 1943), Pope Pius XI (1931) and the Archbishop of Canterbury (1942, in Dempsey (1948)).

The United States monetary experience provides similar lessons to that of the United Kingdom. Colonial paper monies issued by individual states were of the greatest economic advantage to the country (Franklin (1729)), and English suppression of such monies was one of the major reasons for the revolution (Del Mar (1895)). The Continental Currency

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<sup>39</sup>See Del Mar (1895), Toynbee (1965) and Hudson (2010). Livy, Diodorus and Plutarch all attributed the Roman decline to this cause.

issued during the revolutionary war was crucial for allowing the Continental Congress to finance the war effort. There was no over-issuance by the colonies, and the only reason why inflation eventually took hold was massive British counterfeiting (Franklin (1786), Schuckers (1874)).<sup>40</sup> The government also managed the issuance of paper monies in the periods 1812-1817 and 1837-1857 conservatively and responsibly (Zarlenga (2002)). The Greenbacks issued by Lincoln during the Civil War were again a crucial tool for financing the war effort, and as documented by Randall (1937) and Studenski and Kroos (1952) their issuance was responsibly managed, resulting in comparatively less inflation than the financing of the war effort in World War I.<sup>41</sup> Finally, the Aldrich-Vreeland system of the 1907-1913 period, where money issuance was government controlled through the Comptroller of the Currency, was also very effectively administered (Friedman and Schwartz (1963), p. 150). The one blemish on the record of government money issuance was deflationary rather than inflationary in nature. The van Buren presidency triggered the 1837 depression by insisting that the government issuance of money had a 100% gold/silver backing. This completely unnecessary straitjacket meant that the money supply was inadequate for a growing economy. As for the U.S. experience with private money issuance, the record was much worse. Private banks and the privately-owned First and especially Second Bank of the United States repeatedly triggered disastrous business cycles due to initial monetary over-expansion accompanied by high debt levels, followed by monetary contraction and debt deflation, with bankers eventually collecting the collateral of defaulting debtors, thereby contributing to an increasing concentration of wealth. Massive losses were also caused by spurious private bank note issuance in the 1810-1820 period, and similar experiences continued throughout the century (Gouge (1833), Knox (1903)).<sup>42</sup> The large expansion of private credit in the period leading up to the Great Depression was another example of a bank-induced boom-bust cycle, although its severity was exacerbated by mistakes of the Federal Reserve (Friedman and Schwartz (1963)).<sup>43</sup>

Finally, a brief word on a favorite example of advocates of private control over money issuance, the German hyperinflation of 1923, which was supposedly caused by excessive government money printing. The Reichsbank president at the time, Hjalmar Schacht, put the record straight on the real causes of that episode in Schacht (1967). Specifically, in May 1922 the Allies insisted on granting total private control over the Reichsbank. This private institution then allowed private banks to issue massive amounts of currency, until half the money in circulation was private bank money that the Reichsbank readily exchanged for Reichsmarks on demand. The private Reichsbank also enabled speculators to short-sell the currency, which was already under severe pressure due to the transfer problem of the reparations payments pointed out by Keynes (1929).<sup>44</sup> It did so by granting lavish Reichsmark loans to speculators on demand, which they could exchange

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<sup>40</sup>The assignats of the French revolution also resulted in very high inflation partly due to British counterfeiting (Dillaye (1877)).

<sup>41</sup>Zarlenga (2002) documents very persistent attempts by the private banking industry, throughout the late 19th century, to have the Greenbacks withdrawn from circulation.

<sup>42</sup>The widespread financial fraud committed prior to the U.S. S&L crisis (Black (2005)) and prior to the Great Recession (Federal Bureau of Investigations (2007)) is the 20th- and 21st-century equivalent of fraudulent bank note issuance - of counterfeiting money.

<sup>43</sup>This interpretation of Friedman and Schwartz (1963) is not shared by all students of history. Keen (2011) argues that the main cause of the Great Depression was excessive prior credit expansion by banks.

<sup>44</sup>The transfer problem arises when a large foreign debt is denominated in foreign currency, but has to be serviced by raising revenue in domestic currency. As this leads to the domestic currency's rapid depreciation, it makes debt service harder.

for foreign currency when forward sales of Reichsmarks matured. When Schacht was appointed, in late 1923, he stopped converting private monies to Reichsmark on demand, he stopped granting Reichsmark loans on demand, and furthermore he made the new Rentenmark non-convertible against foreign currencies. The result was that speculators were crushed and the hyperinflation was stopped. Further support for the currency came from the Dawes plan that significantly reduced unrealistically high reparations payments. This episode can therefore clearly not be blamed on excessive money printing by a government-run central bank, but rather on a combination of excessive reparations claims and of massive money creation by private speculators, aided and abetted by a private central bank. It should be pointed out that many more recent hyperinflations in emerging markets also took place in the presence of large transfer problems and of intense private speculation against the currency. But a detailed evaluation of the historical experiences of emerging markets is beyond the scope of the present paper.

To be fair, there have of course been historical episodes where government-issued currencies collapsed amid high inflation. But the lessons from these episodes are so obvious, and so unrelated to the fact that monetary control was exercised by the government, that they need not concern us here. These lessons are: First, do not put a convicted murderer and gambler, or similar characters, in charge of your monetary system (the 1717-1720 John Law episode in France). Second, do not start a war, and if you do, do not lose it (wars, especially lost ones, can destroy any currency, irrespective of whether monetary control is exercised by the government or by private parties).

To summarize, the Great Depression was just the latest historical episode to suggest that privately controlled money creation has much more problematic consequences than government money creation. Many leading economists of the time were aware of this historical fact. They also clearly understood the specific problems of bank-based money creation, including the fact that high and potentially destabilizing debt levels become necessary just to create a sufficient money supply, and the fact that banks and their fickle optimism about business conditions effectively control broad monetary aggregates.<sup>45</sup> The formulation of the Chicago Plan was the logical consequence of these insights.

## B. The Chicago Plan

The Chicago Plan provides an outline for the transition from a system of privately-issued debt-based money to a system of government-issued debt-free money. The history of the Chicago Plan is explained in Phillips (1994). It was first formulated in the United Kingdom by the 1921 Nobel Prize winner in chemistry, Frederick Soddy, in Soddy (1926).<sup>46</sup> Professor Frank Knight of the University of Chicago picked up the idea almost immediately, in Knight (1927). The first, March 1933 version of the plan is a memorandum to President Roosevelt (Knight (1933)). Many of Knight's distinguished University of Chicago colleagues supported the plan and signed the memorandum,

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<sup>45</sup>This understanding is evident in statements by leading economists at the time, including Wicksell (1906), "The lending operations of the bank will consist rather in its entering in its books a fictitious deposit equal to the amount of the loan..." and Rogers (1929), "a large proportion of ... [deposits] under certain circumstances may be manufactured out of whole cloth by the banking institutions themselves."

<sup>46</sup>See Daly (1980) for an excellent review of Soddy's thought.

including especially Henry Simons, who was the author of the second, more detailed memorandum to Roosevelt in November 1933 (Simons et al. (1933)). The Chicago economists, and later Irving Fisher of Yale, were in constant contact with the Roosevelt administration, which seriously considered their proposals, as reflected for example in the government memoranda of Gardiner Means (1933) and Lauchlin Currie (1934), and the bill of Senator Bronson Cutting (see Cutting (1934)). Fisher supported the Chicago Plan for the same reason as the Chicago economists, but he had one additional concern not shared by them, the improved ability to use monetary policy to affect debtor-creditor relations through reflation, in an environment where, in his opinion, over-indebtedness had become a major source of crises for the economy.

Several of the signers of the Chicago Plan were later to become known as the founders of the Chicago School of Economics. Though they were strong proponents of laissez-faire in industry, they did not question the right of the federal government to have an exclusive monopoly on money issuance (Phillips (1994)).<sup>47</sup> The Chicago Plan was a strategy for establishing that monopoly. There was concern because it called for a major change in the structure of banking, but 1933 was a year of major financial crisis, and “...most of us suspect that measures at least as drastic as those described in our statement can hardly be avoided, except temporarily, in any event.” (Knight (1933)). Furthermore, in Fisher (1935) we find supportive statements from bankers arguing that the conversion to 100% reserve backing would be a simple matter. Friedman (1960) expresses the same view.

Many different versions of the Chicago Plan circulated in the 1930s and beyond. All of them were very similar in their prescriptions for money, but they differed significantly in their prescriptions for credit. For money, all of them envisaged 100% reserve backing for deposits, either immediately or over time, and all of them advocated monetary rules rather than discretion. For credit, the original plan advocated the replacement of traditional banks with investment trusts that issue equity, and that in addition sell their own private non-monetary interest-bearing securities to fund lending. But Simons was always acutely aware that such securities might over time develop into near-monies, thereby defeating the purpose of the Chicago Plan by turning the investment trusts into new creators of money. There are three alternatives that avoid this outcome. Simons himself, in Simons (1946), advocated a “financial good society” where all private property eventually takes the form of either government currency, government bonds, corporate stock, or real assets. The investment trusts that take over the credit function would therefore be both funded by equity and invest in corporate equity, as private debt disappears completely. The critical feature for avoiding the emergence of near-monies is of course that they must be funded by equity, there would be no problem if they invested in risky debt securities. The second alternative is to maintain private debt-financed investment trusts, but subject to strict institutional and regulatory constraints. These were discussed in Section II.B. The third alternative is for investment trusts to issue their debt instruments to the government rather than to the private sector. This option is considered in the government versions of the plan formulated by Means (1933) and Currie (1934), and also in the academic proposal by Angell (1935). Beyond preventing the emergence of new near-monies, this alternative has three major additional advantages. First, it makes it possible to effect an immediate and full transition to the Chicago Plan even if the deposits that need to be

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<sup>47</sup>Furthermore, unlike today’s free market economists, they argued for a strong government role in infrastructure provision and in regulation, see e.g. Simons (1948).

backed by reserves are very large relative to outstanding amounts of government debt that can be used to back them. This was the main concern of Angell (1935). The reason is that when government funding is available, banks can immediately borrow any amount of required reserves from the government. Second, switching to full government funding of credit can maximize the fiscal benefits of the Chicago Plan. This gives the government budgetary space to reduce tax distortions, which stimulates the economy during the crucial transition period. Third, when investment trusts need to switch their funding from cheap deposits to more expensive privately held debt liabilities, their cost of funding, and therefore the interest rate on loans, increases relative to the rate on risk-free government debt. While in our simulations this will be more than offset by a large drop in the rate on risk-free government debt itself, it is still true that, *ceteris paribus*, this tends to reduce any economic activity that continues to depend on lending. When the switch is to treasury-held debt liabilities, the government is free to set a lower funding interest rate that keeps interest rates on investment trust loans to private agents aligned with government borrowing costs. It is for all of these reasons, and for analytical simplicity, that we exclusively use this version of the Chicago Plan for the core of our theoretical model. Specifically, after the citizens' dividend that exactly repays all non-investment loans, the remaining credit function of the financial sector is carried out by private institutions that fund conventional investment loans with a combination of equity and treasury credit provided at a policy-determined rate.

In our formal model there is no need for Simons' privately-funded investment trusts. This would not be true in a real-world implementation if the government were to distribute an even larger share of its stock seigniorage gains to households by way of a citizens' dividend. This would leave households with surplus funds, which would then be converted to private non-monetary deposits in investment trusts. Nor would it be true if the different classes of private bank debtors did not have identical debt levels within each class. In our representative agent framework, a fair citizens' dividend, in the sense that the government makes equal per capita transfers to each debtor within a given group, leads to the exact repayment of the debts of every single agent that receives a citizens' dividend, which in our illustrative simulation means all agents except investors in physical capital. But if the same transfers were to be received by agents with highly heterogeneous debt levels, e.g. due to idiosyncratic income processes, some agents would end up with a residual debt while others would end up with a residual financial asset. In order to prevent the latter from adding to the money supply, by becoming near-monies, intermediating these assets by way of Simons' investment trusts would be the natural solution. Under the version of the Chicago Plan considered in this paper these trusts would be quantitatively less significant than originally envisaged by Simons, because treasury-funded investment trusts remain at the core of the financial system. But they retain a key function by facilitating intertemporal smoothing by households and firms.

In another respect our proposal remains very close to Simons: After the large-scale debt repayments made possible by the government's initial seigniorage gains, credit to households can in net aggregate terms be completely eliminated, as can short-term working capital credit to firms. This is because credit is no longer needed to create the economy's money supply, with both households and firms replacing debt-based private money with debt-free government-issued money. The only credit that remains is lending for productive investment purposes. In terms of the composition of financial institutions'

assets, our remaining banking system therefore ends up closely resembling the banking structures in pre-World-War-I/II France (advocated by the Saint-Simonians) and especially Germany. It should be remembered that prior to World War I Germany's industrial successes were widely viewed as reflecting the superior efficiency of its financial system, which was based on the notion that successful industrial development needed long-term stable financing and government support. This view was articulated in Naumann (1915), with subsequent support from both UK and U.S. economists (Foxwell (1917a,b), Veblen (1921)). Simons (1946) is essentially in the same tradition. The main reason why the more short-term-oriented Anglo-Saxon tradition of finance has come to dominate throughout the world is the victory of the United States, Britain and their allies in the two world wars.

The Chicago Plan was never adopted as law, due to strong resistance from the banking lobby. But it played a major role in the passage of the 1935 Banking Act, which also faced resistance but was considered more acceptable to banks. As documented in Phillips (1994), the 1935 Act was at the time not considered the final word on banking reform, and efforts by proponents of the Chicago Plan, especially by Irving Fisher, continued for many years afterwards. The long list of academic treatments in the 1930s, almost universally sympathetic, includes Whittlesey (1935), Douglas (1935), Angell (1935), Fisher (1936) and Graham (1936). Advocacy for full reserve banking continued after the war, with Allais (1947, 1984), Friedman (1960), who was a lifelong supporter, Tobin (1985), and more recently Zarlenga (2002) and Robertson (2012).<sup>48</sup>

The many contributions of Richard Werner<sup>49</sup> are in a very similar spirit. One of his arguments is that bad debt problems in a country's banking system can be effectively dealt with by central bank purchases of the bad debts against the issuance of new reserve money. If this is accompanied by a new reserve requirement on banks whereby the new reserves are permanently required to back certain types of deposits, this amounts to a small-scale version of the Chicago Plan.

The "narrow banking" literature is in the same tradition, but generally with a narrower focus on the safety of the deposit part of banks' business. See Phillips (1994) for references. The most prominent recent proponent is Kotlikoff (2012). His Limited Purpose Banking proposal has two principal components. The first is 100% reserve backing for transactions deposits. The second is conversion of all bank lending activity into mutual funds that continue to hold loans, but that are funded entirely by equity, a very similar proposal to Simons' equity-funded investment trusts. Limited Purpose Banking exhibits three sets of differences with the Chicago Plan that should be explored in future research. The first concerns the control of money and thus inflation. The key question is how the supply of transactions deposits would be managed under Limited Purpose Banking, because neither central bank policy nor the quantity of private bank lending imposes any obvious quantitative constraints. The second set of differences concerns the fact that Limited Purpose Banking rules out debt-funded investment trusts, while the Chicago Plan keeps them as an option. The reason is that under the Chicago Plan fluctuations in this sector, including through defaults, would have no effects on the broad money supply. This

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<sup>48</sup>See also Huerta de Soto (2012). His analysis of the problems with the contemporary monetary system is very similar to ours. His solution, while calling for full reserve banking, differs in some important details from ours.

<sup>49</sup>See for example Werner (2005).

greatly limits the effects of credit fluctuations on economic activity. The third set of differences between the Chicago Plan and Limited Purpose Banking is that under the latter system debts would remain unchanged, with no major conversion of private and government debt into equity as under the Chicago Plan. While Limited Purpose Banking dramatically reduces the systemic implications of debt defaults, the full benefits for economic activity and economic stability that come with lower debt levels could therefore not be realized.

Among the advocates of full reserve banking, Friedman’s work is especially important. In Friedman (1967) he explains that his support for the Chicago Plan is partly based on different arguments from those of Simons and Fisher. Simons’s and Fisher’s main concern was the instability of bank credit in a world where that credit determines the money supply. They therefore advocated more governmental control over the money creation process via more control over bank lending. Friedman was interested in precisely the opposite, his concern was with making the government commit to fixed rules in order to otherwise keep it from interfering with borrowing and lending relationships. This would become possible because under the Chicago Plan a fixed money growth rule would give the policymaker much more control over actual monetary aggregates than under the current monetary system. Simons and Fisher also advocated a fixed money growth rule, so in this respect the Chicago Plan would satisfy both sides. But the degree to which it otherwise approximates the ideals of these thinkers depends on details of the implementation on the credit side. Our proposed implementation is closer to Simons and Fisher than to Friedman, by limiting and regulating private debt funding (but not equity funding) of the financial system’s residual lending business, because of the multiple above-mentioned advantages of this approach.

## IV. The Model under the Current Monetary System

The model economy consists of two household sectors, a productive sector, a banking sector and a government. It features a number of nominal and real rigidities. A comprehensive model, with multiple sectors and multiple rigidities, has three major advantages for the task we set ourselves in this paper. First, it provides an integrated framework where all of the critical differences between the Chicago Plan and current monetary arrangements emerge simultaneously. Second, it generates an empirically realistic scenario for the transition to the Chicago Plan, based on an accurate (as far as possible) estimate of the balance sheet sizes of different types of bank borrowers. Third, it makes our model consistent with the findings of the empirical DSGE literature, which has identified a number of nominal and real rigidities that are critical for the ability of such models to generate reasonable impulse responses.

Four types of private agents interact directly with banks. Financially unconstrained households have large financially unencumbered investments that include not only bank deposits but also land and government debt. Financially constrained households own bank deposits and land that serve as collateral for consumer loans and mortgages. Manufacturers own bank deposits that serve as collateral for working capital loans. Capital investment funds own physical capital that serves as collateral for investment loans. Other sectors include capital goods producers, who produce the economy’s capital



stock subject to investment adjustment costs, and unions, who supply labor subject to nominal rigidities in wage setting.

The economy experiences a constant positive technology growth rate  $g = T_t/T_{t-1}$ , where  $T_t$  is the level of labor augmenting technology. When the model's nominal variables, say  $X_t$ , are expressed in real normalized terms, we divide by the price level  $P_t$  and the level of technology  $T_t$ . We use the notation  $\check{x}_t = X_t/(T_t P_t) = x_t/T_t$ , with the steady state of  $\check{x}_t$  denoted by  $\bar{x}$ . The population shares of unconstrained and constrained households are given by  $\omega$  and  $1 - \omega$ .

Our exposition of each agent's optimization problem is kept brief in the interest of space. A complete derivation is contained in the Technical Appendix. Because of their central role in the economy, we start our exposition with banks.

## A. Banks

Banks lend to constrained households by way of consumer loans secured on bank deposits (superscript  $c$ ) and of mortgages secured on land (superscript  $a$ ), to manufacturers by way of working capital loans secured on bank deposits (superscript  $m$ ), to capital investment funds by way of investment loans secured on fixed capital (superscript  $k$ ), and to the government by way of holding part of the outstanding stock of government bonds.

Banks maintain deposits for unconstrained households (superscript  $u$ ), constrained households and manufacturers. Bank deposits are modelled as a single asset type with a one-period maturity. We emphasize that in our calibration this will correspond to all bank liabilities, and therefore includes not just demand deposits but also all other near-monies. This will allow our model to address some of the concerns with near-monies stressed by Simons (1946, 1948), Angell (1935) and Allais (1947).

Apart from deposits, banks' own net worth is another important source of funds. The reason why banks maintain positive net worth is that the government imposes official minimum capital adequacy requirements (henceforth referred to as MCAR), to neutralize the moral hazard created by the fact that banks operate under limited liability. These regulations are modeled to closely resemble the current Basel regime, by requiring banks to pay penalties if they violate the MCAR.<sup>50</sup> Banks' total equity exceeds the minimum requirements in equilibrium, in order to provide a buffer against adverse shocks that could cause equity to drop below the MCAR and trigger penalties.

Moral hazard creates an incentive for banks to not protect themselves against negative shocks to profits that are larger than their existing equity base. In the absence of regulation, banks therefore have an incentive to take on large amounts of lending risk and to minimize their own equity base. As this would mean that depositors would be exposed to significant risks of capital losses, one solution is for deposit contracts to reflect that risk, and to thereby discipline bankers. But this solution is impractical, as it requires depositors to engage in costly monitoring, and also because it may leave the financial system prone to bank runs. The preferred policy solution has therefore generally been

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<sup>50</sup>Furfine (2001) and van den Heuvel (2005) contain a list of such penalties, according to the Basel rules or to national legislation, such as the U.S. Federal Deposit Insurance Corporation Improvement Act of 1991.

some form of deposit insurance that obviates the need for complicated deposit contracts, and that minimizes the probability of bank runs. But in that case, given that deposit insurance schemes are generally not sufficiently funded to insure against systemic crises, the risks of large capital losses accrue to taxpayers rather than depositors. Deposit insurance therefore has to be accompanied by direct capital adequacy regulations that penalize banks for maintaining an insufficient equity buffer, and thereby exposing taxpayers to the risk of capital losses. That is the environment assumed in this paper, and the calibration of these regulations will be such that the probability of banks becoming insolvent and having to call on deposit insurance is vanishingly small.

Banks are assumed to face heterogeneous realizations of credit and non-credit risks, and are therefore indexed by  $j$ . We sometimes use the general notation  $x \in \{c, a, m, k, u\}$  to represent the different groups of agents with which banks interact. Banks' nominal and real normalized loan stocks between periods  $t$  and  $t + 1$  are given by  $L_t^x(j)$  and  $\check{\ell}_t^x(j)$ , while their deposit stocks are  $D_t^x(j)$  and  $\check{d}_t^x(j)$ , holdings of government bonds are  $B_t^b(j)$  and  $\check{b}_t^b(j)$ , and net worth is  $N_t^b(j)$  and  $\check{n}_t^b(j)$ . Banks' nominal and ex-post real deposit rates are given by  $i_{d,t}$  and  $r_{d,t}$ , where  $r_{d,t} = i_{d,t-1}/\pi_t$ , and where  $\pi_t = P_t/P_{t-1}$ . Their wholesale cost of funding loans is given by  $i_{\ell,t}$  and  $r_{\ell,t}$  for all loans except mortgage loans, and by  $i_{\ell,t}^h$  and  $r_{\ell,t}^h$  for mortgage loans. Banks' retail nominal and real lending rates, which add a credit risk spread to the wholesale rates, are given by  $i_{r,t}^x$  and  $r_{r,t}^x$ . Finally, nominal and real interest rates on government debt are denoted by  $i_t$  and  $r_t$ . Bank  $j$ 's balance sheet in real normalized terms is given by

$$(1 - \omega) (\check{\ell}_t^c(j) + \check{\ell}_t^a(j)) + \check{\ell}_t^m(j) + \check{\ell}_t^k(j) + \check{b}_t^b(j) = \omega \check{d}_t^u(j) + (1 - \omega) \check{d}_t^c(j) + \check{d}_t^m(j) + \check{n}_t^b(j) \quad , \quad (1)$$

where for future reference we define  $\check{\ell}_t(j) = (1 - \omega) \check{\ell}_t^c(j) + \check{\ell}_t^m(j) + \check{\ell}_t^k(j)$ ,  $\check{\ell}_t^h(j) = (1 - \omega) \check{\ell}_t^a(j)$ ,  $\check{\ell}_t^\ell(j) = \check{\ell}_t(j) + \check{\ell}_t^h(j)$ , and  $\check{d}_t(j) = \omega \check{d}_t^u(j) + (1 - \omega) \check{d}_t^c(j) + \check{d}_t^m(j)$ . Banks can make losses on each of their four loan categories. Losses are given by  $\check{\Delta}_t^b(j) = (1 - \omega) (\check{\Delta}_t^c(j) + \check{\Delta}_t^a(j)) + \check{\Delta}_t^m(j) + \check{\Delta}_t^k(j)$ . The stock of government bonds on banks' balance sheets is assumed to equal a fixed share of the total balance sheet,  $\check{b}_t^b(j) = s_b (\check{d}_t(j) + \check{n}_t^b(j))$ . This cash constraint specification is based on the fact that banks, on a daily basis, require government bonds as collateral in order to be able to make payments to other financial market participants. This is therefore a financial markets equivalent to the usual goods market rationale for cash constraints. We assume a cash constraint rather than a cash-in-advance constraint because this simplifies the analysis without losing any important insights.

Our model focuses on bank solvency considerations and ignores liquidity management problems. Banks are therefore modeled as having no incentive, either regulatory or precautionary, to maintain cash reserves at the central bank. Because, furthermore, for households cash is dominated in return by bank deposits, in this economy there is no demand for government-provided real cash balances. Empirically, as discussed in the introduction, such balances are vanishingly small relative to the size of bank deposits.

Banks are assumed to face pecuniary costs of falling short of official minimum capital adequacy ratios. The regulatory framework we assume introduces a discontinuity in outcomes for banks. In any given period, a bank either remains sufficiently well capitalized, or it falls short of capital requirements and must pay a penalty. In the latter case, bank net worth suddenly drops further. The cost of such an event, weighted by the appropriate probability, is incorporated into the bank's optimal capital choice. Modeling

this regulatory framework under the assumption of homogenous banks would lead to outcomes where all banks simultaneously either pay or do not pay the penalty. A more realistic specification therefore requires a continuum of banks, each of which is exposed to idiosyncratic shocks, so that there is a continuum of ex-post capital adequacy ratios across banks, and a time-varying small fraction of banks that have to pay penalties in each period.

Specifically, banks are assumed to be heterogeneous in that the return on their loan book is subject to an idiosyncratic shock  $\omega_{t+1}^b$  that is lognormally distributed, with  $E(\omega_{t+1}^b) = 1$  and  $Var(\ln(\omega_{t+1}^b)) = (\sigma_{t+1}^b)^2$ , and with the density function and cumulative density function of  $\omega_{t+1}^b$  denoted by  $f_t^b(\omega_{t+1}^b)$  and  $F_t^b(\omega_{t+1}^b)$ . This risk can reflect a number of individual bank characteristics, such as differing loan recovery rates, and differing success at raising non-interest income and minimizing non-interest expenses, where the sum of the last two categories would have to sum to zero over all banks.

The regulatory framework stipulates that banks have to pay a real penalty of  $\chi (\check{\ell}_t(j) + \check{b}_t(j))$  at time  $t + 1$  if the sum of the gross returns on their loan book, net of gross deposit interest expenses and loan losses, is less than a fraction  $\gamma_t$  of the gross risk-weighted returns on their loan book. Different risk-weights will be one of the critical determinants of equilibrium interest rate spreads. We assume that the risk-weight on all non-mortgage loans is 100%, the risk-weight on mortgage loans is  $\zeta$ , and the risk weight on government debt is zero. Then the penalty cutoff condition is given by

$$\begin{aligned} & \left( r_{\ell,t+1} \check{\ell}_t(j) + r_{\ell,t+1}^h \check{\ell}_t^h(j) + r_{t+1} \check{b}_t(j) \right) \omega_{t+1}^b - r_{d,t+1} \check{d}_t(j) - \check{\Lambda}_{t+1}^b(j) \\ & < \gamma_t \left( r_{\ell,t+1} \check{\ell}_t(j) + \zeta r_{\ell,t+1}^h \check{\ell}_t^h(j) \right) \omega_{t+1}^b . \end{aligned} \quad (2)$$

Because the left-hand side equals pre-dividend (and pre-penalty) net worth in  $t + 1$ , while the term multiplying  $\gamma_t$  equals the value of risk-weighted assets in  $t + 1$ ,  $\gamma_t$  represents the minimum capital adequacy ratio of the Basel regulatory framework. We denote the cutoff idiosyncratic shock to loan returns below which the MCAR is breached by  $\bar{\omega}_t^b$ . It is given by

$$\bar{\omega}_t^b \equiv \frac{r_{d,t} \check{d}_{t-1} + x \check{\Lambda}_t^b}{(1 - \gamma_{t-1}) r_{\ell,t} \check{\ell}_{t-1} + (1 - \gamma_{t-1} \zeta) r_{\ell,t}^h \check{\ell}_{t-1}^h + r_t \check{b}_{t-1}^b} . \quad (3)$$

Banks choose their loan volumes to maximize their pre-dividend net worth, which equals the sum of gross returns on the loan book minus gross interest charges on deposits, loan losses, and penalties:

$$\begin{aligned} & \underset{\check{\ell}_t(j), \check{\ell}_t^h(j)}{Max} E_t \left[ \left( r_{\ell,t+1} \check{\ell}_t(j) + r_{\ell,t+1}^h \check{\ell}_t^h(j) + r_{t+1} \check{b}_t(j) \right) \omega_{t+1}^b - r_{d,t+1} \check{d}_t(j) \right. \\ & \quad \left. - \check{\Lambda}_{t+1}^b(j) - \chi \left( \check{\ell}_t(j) + \check{\ell}_t^h(j) + \check{b}_t(j) \right) F_t^b(\bar{\omega}_{t+1}^b) \right] . \end{aligned}$$

The optimality conditions are shown in full in the Technical Appendix.<sup>51</sup> They state that banks' wholesale lending rates  $i_{\ell,t}$  and  $i_{\ell,t}^h$  are at a premium over the deposit rate  $i_{d,t}$  by magnitudes that depend on the size of the MCAR  $\gamma_t$ , the penalty coefficient  $\chi$  for

<sup>51</sup> While the optimality conditions are in terms of expected real interest rates, which are subject to uncertainty in inflation, our discussion is in terms of the unconditional (except for default) nominal interest rates actually set by banks. Our course inflation affects all real rates in the same fashion.

breaching the MCAR, and expressions  $F_t^b(\bar{\omega}_{t+1}^b)$  and  $f_t^b(\bar{\omega}_{t+1}^b)$  that reflect the expected riskiness of banks  $\sigma_{t+1}^b$  and therefore the likelihood of a breach. Banks' retail rates  $i_{r,t}^x$  on the other hand, whose determination is discussed in the next subsection, are at another premium over  $i_{\ell,t}$  and  $i_{\ell,t}^h$ , to compensate for the bankruptcy risks of the four different borrower types. A sensible interpretation of the wholesale rate is therefore as the rate a bank would charge to a hypothetical borrower (not present in the model) with zero default risk. Note that the policy rate  $i_t$  does not enter these optimality conditions as the marginal cost of funds, because the marginal cost of funds is given by the rate at which banks can create their own funds, which is  $i_{d,t}$ .<sup>52</sup>

Another outcome of this optimization problem is banks' actually maintained Basel capital adequacy ratio  $\gamma_t^a$ . This will be considerably above the minimum requirement  $\gamma_t$ , because by maintaining an optimally chosen buffer banks protect themselves against the risk of penalties while minimizing the cost of excess capital. There is no simple formula for  $\gamma_t^a$ , which in general depends nonlinearly on a number of parameters. We will however calibrate its steady state value  $\bar{\gamma}^a$  below.

Given the linearity of banks' technology, balance sheet items can be easily aggregated over all banks, and we can therefore drop bank-specific indices. Banks' aggregate net worth  $\tilde{n}_t^b$  represents an additional state variable of the model, and is given by the gross return on loans, minus the sum of gross interest on deposits, loan losses, penalties incurred, and dividends. The cost of penalties, which is partly a lump-sum transfer to households and partly a real resource cost, is  $\tilde{\mathcal{M}}_t^b = \frac{x}{x}(\tilde{\ell}_{t-1} + \tilde{\ell}_{t-1}^h + \tilde{b}_{t-1}^b) F_t^b(\bar{\omega}_t^b)$ . Dividends, which will be discussed in more detail below, are given by  $\delta^b \tilde{n}_t^b$ . Then we have

$$\tilde{n}_t^b = \frac{1}{x} \left( r_{\ell,t} \tilde{\ell}_{t-1} + r_{\ell,t}^h \tilde{\ell}_{t-1}^h + r_t \tilde{b}_{t-1}^b - r_{d,t} \tilde{d}_{t-1} \right) - \tilde{\Lambda}_t^b - \tilde{\mathcal{M}}_t^b - \delta^b \tilde{n}_t^b . \quad (4)$$

## B. Lending Technologies

Almost identical forms of the borrowing problem are solved by constrained households (for consumer and mortgage loans), manufacturers and capital investment funds. In this subsection we again use general notation, with  $x \in \{c, a, m, k\}$  representing the four different types of loans. Borrowers use an optimally chosen combination of nominal/real bank loans  $L_t^x(j)/\ell_t^x(j)$  and internal funds to purchase nominal/real assets  $X_t/x_t$ . The ex-post nominal/real returns on the latter are denoted by  $Ret_{x,t}$  and  $ret_{x,t}$ .

After the asset purchase each borrower of type  $x$  draws an idiosyncratic shock which changes  $x_t(j)$  to  $\omega_{t+1}^x x_t(j)$  at the beginning of period  $t+1$ , where  $\omega_{t+1}^x$  is a unit mean lognormal random variable distributed independently over time and across borrowers of type  $x$ . The standard deviation of  $\ln(\omega_{t+1}^x)$ ,  $S_{t+1}^z \sigma_{t+1}^x$ , is itself a stochastic process that will play a key role in our analysis. We will refer to this as the borrower riskiness shock. It has an aggregate component  $S_{t+1}^z$  that is common across borrower types, and a type-specific component  $\sigma_{t+1}^x$ . The density function and cumulative density function of  $\omega_{t+1}^x$  are given by  $f_t^x(\omega_{t+1}^x)$  and  $F_t^x(\omega_{t+1}^x)$ .

<sup>52</sup>The policy rate would equal the marginal cost of funds if banks were able to appropriate the funding cost advantage of cheap deposits as a monopoly profit.

We assume that each borrower receives a standard debt contract from the bank. This specifies a nominal loan amount  $L_t^x(j)$  and a gross nominal retail rate of interest  $i_{r,t}^x$  to be paid if  $\omega_{t+1}^x$  is sufficiently high to rule out default. The critical difference between our model and those of Bernanke et al. (1999) and Christiano et al. (2011) is that the interest rate  $i_{r,t}^x$  is assumed to be pre-committed in period  $t$ , rather than being determined in period  $t+1$  after the realization of time  $t+1$  aggregate shocks. The latter, conventional assumption ensures zero ex-post profits for banks at all times, while under our debt contract banks make zero expected profits, but realized ex-post profits generally differ from zero. Borrowers who draw  $\omega_{t+1}^x$  below a cutoff level  $\bar{\omega}_{t+1}^x$  cannot pay this interest rate and go bankrupt. They must hand over all their assets to the bank, but the bank can only recover a fraction  $(1 - \xi^x)$  of the asset value of such borrowers. The remaining fraction represents monitoring costs, which are assumed to be partially paid out to households in a lump-sum fashion, with the remainder representing a real resource cost. Banks' ex-ante zero profit condition for borrower group  $x$ , in real terms, is given by

$$E_t \left\{ r_{\ell,t+1} \check{\ell}_t^x(j) - \left[ (1 - F_t^x(\bar{\omega}_{t+1}^x)) r_{r,t+1}^x \check{\ell}_t^x(j) + (1 - \xi^x) \int_0^{\bar{\omega}_{t+1}^x} x_t(j) \text{ret}_{x,t+1} \omega^x f_t^x(\omega^x) d\omega^x \right] \right\} = 0 .$$

This states that the payoff to lending must equal wholesale interest charges  $r_{\ell,t+1} \check{\ell}_t^x(j)$ .<sup>53</sup> The first term in square brackets is the gross real interest income on loans to borrowers whose idiosyncratic shock exceeds the cutoff level,  $\omega_{t+1}^x \geq \bar{\omega}_{t+1}^x$ . The second term is the amount collected by the bank in case of the borrower's bankruptcy, where  $\omega_{t+1}^x < \bar{\omega}_{t+1}^x$ . This cash flow is based on the return  $\text{ret}_{x,t+1} \omega$  on the asset  $x_t(j)$ , but multiplied by the factor  $(1 - \xi^x)$  to reflect a proportional bankruptcy cost  $\xi^x$ . The ex-post cutoff productivity level is determined by equating, at  $\omega_t^x = \bar{\omega}_t^x$ , the gross interest charges due in the event of continuing operations  $r_{r,t}^x \check{\ell}_{t-1}^x(j)$  to the gross idiosyncratic return on the borrower's asset  $\text{ret}_{x,t} x_{t-1}(j) \bar{\omega}_t^x$ . Using this equation, we can replace the previous equation by the zero-profit condition

$$E_t \{ r_{\ell,t+1} \check{\ell}_t^x - \check{x}_t \text{ret}_{x,t+1} (\Gamma_{x,t+1} - \xi^x G_{x,t+1}) \} = 0 , \quad (5)$$

where  $\Gamma_{x,t+1}$  is the bank's gross share in the earnings of the underlying asset

$$\Gamma_{x,t+1} = \int_0^{\bar{\omega}_{t+1}^x} \omega_{t+1}^x f_t^x(\omega_{t+1}^x) d\omega_{t+1}^x + \bar{\omega}_{t+1}^x \int_{\bar{\omega}_{t+1}^x}^{\infty} f_t^x(\omega_{t+1}^x) d\omega_{t+1}^x ,$$

and  $\xi^x G_{x,t+1}$  is the proportion of earnings of the asset that the lender has to spend on monitoring costs

$$\xi^x G_{x,t+1} = \xi^x \int_0^{\bar{\omega}_{t+1}^x} \omega_{t+1}^x f_t^x(\omega_{t+1}^x) d\omega_{t+1}^x .$$

In other words, the bank will set the terms of the lending contract, in particular the unconditional nominal lending rate  $i_{r,t}^x$ , such that its expected gross share in the earnings of the underlying assets is sufficient to cover monitoring costs and the opportunity cost of the loan. The borrower is left with a share  $1 - \Gamma_{x,t+1}$  of the asset's earnings.

The remainder of the analysis is very similar to Bernanke et al. (1999). Specifically, the borrower selects the optimal level of investment in the respective assets by maximizing

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<sup>53</sup>For mortgage loans, due to a lower Basel risk-weighting, the wholesale interest rate  $r_{\ell,t+1}^h$  is lower than  $r_{\ell,t+1}$ .

$E_t \{(1 - \Gamma_{x,t+1}) \tilde{x}_t \text{ret}_{x,t+1}\}$  subject to (5). Borrower-specific indices can in each case be dropped because the problems are linear in balance sheet quantities. For the case of capital investment funds, whose owners will be referred to as entrepreneurs, the condition for the optimal loan contract is identical to Bernanke et al. (1999),

$$E_t \left\{ (1 - \Gamma_{k,t+1}) \frac{\text{ret}_{k,t+1}}{r_{\ell,t+1}} + \tilde{\lambda}_{t+1}^k \left[ \frac{\text{ret}_{k,t+1}}{r_{\ell,t+1}} \left( \Gamma_{k,t+1} - \xi^k G_{k,t+1} \right) - 1 \right] \right\} = 0, \quad (6)$$

with  $\tilde{\lambda}_{t+1}^k = \Gamma_{k,t+1}^\omega / \left( \Gamma_{k,t+1}^\omega - \xi^k G_{k,t+1}^\omega \right)$ , and where  $\Gamma_{k,t+1}^\omega$  and  $G_{k,t+1}^\omega$  are the derivatives of  $\Gamma_{k,t+1}$  and  $G_{k,t+1}$  with respect to  $\bar{\omega}_{t+1}^k$ .

For the remaining three types of loan contract there are some small differences to (6). First, the nature of the asset is different. For capital investment funds the value of the asset equals  $x_t = q_t k_t$ , where  $k_t$  is the real capital stock and  $q_t$  is the shadow value of installed capital (Tobin's  $q$ ). For mortgages this is replaced by the value of constrained households' land  $p_t^a a_t^c$ , where  $a_t^c$  is holdings of land and  $p_t^a$  is the price of land. For consumer loans and working capital loans it is replaced by the value of deposit balances  $d_t^c$  and  $d_t^m$ . Second, for these last two cases deposit balances enter a transactions cost technology, so that in the conditions for the optimal loan contracts of those two agents there will be additional terms due to monetary wedges. Similarly, land enters the utility function of constrained households, which means that the condition for the optimal mortgage loan contract contains an additional utility-related term.

The net worth evolution of each borrower group is affected by banks' net loan losses. These are positive if wholesale interest expenses, which are the opportunity cost of banks' retail lending, exceed banks' net (of monitoring costs) share in borrowers' gross earnings on their assets. This will be the case if a larger than anticipated number of borrowers defaults, so that, ex-post, banks find that they have set their pre-committed retail lending rate at an insufficient level to compensate for lending losses. Of course, if losses are positive for banks, this corresponds to a gain for their borrowers.

According to Fisher (1936), banks' optimism about business conditions is a key driver of business cycle volatility. We evaluate this claim by studying, in both the current monetary environment and under the Chicago Plan, a standardized shock  $S_t^z$  that multiplies each standard deviation of borrower riskiness,  $\sigma_t^x$ ,  $x \in \{c, a, m, k\}$ . Similar to Christiano et al. (2011) and Christiano et al. (2010), this shock captures the notion of a generalized change in banks' perception of borrower riskiness. We assume that it consists of two components,  $S_t^z = S_t^{z1} S_t^{z2}$ . We specify the first component as consisting of the sum of news shocks  $\varepsilon_t^{\text{news}}$  received over the current and the preceding 12 quarters,  $\ln S_t^{z1} = \sum_{j=0}^{12} \varepsilon_{t-j}^{\text{news}}$ , while the second component is autoregressive and given by  $\ln S_t^{z2} = \rho_z \ln S_{t-1}^{z2} + \varepsilon_t^{z2}$ .

### C. Transactions Cost Technologies

Unconstrained households, constrained households and manufacturers (with superscripts  $x \in \{u, c, m\}$ ), require bank deposits for transactions purposes. Our specification of the transactions cost technologies follows Schmitt-Grohé and Uribe (2004), with a nonnegative transactions cost term  $s_t^x$  that is increasing in velocity  $v_t^x$ , or in other words decreasing in

the amount of deposits held by the respective agent,

$$s_t^x = A_x v_t^x + \frac{B_x}{v_t^x} - 2\sqrt{A_x B_x} . \quad (7)$$

The velocity term  $v_t^x$  is different for different agents. For households, total consumption expenditures equal  $c_t^x (1 + \tau_{c,t}) (1 + s_t^x)$ , where  $c_t^x$  is the consumption level,  $\tau_{c,t}$  is the consumption tax rate, and velocity is given by

$$v_t^x = \frac{c_t^x (1 + \tau_{c,t})}{d_t^x} . \quad (8)$$

For manufacturers, total expenditures on inputs equal  $(w_t h_t + r_{k,t} k_{t-1}) (1 + s_t^m)$ , where  $w_t$  is the real wage,  $h_t$  is aggregate hours,  $r_{k,t}$  is the return to capital, and velocity  $v_t^m$  is given by

$$v_t^m = \frac{w_t h_t + r_{k,t} k_{t-1}}{d_t^m} . \quad (9)$$

## D. Equity Ownership and Dividends

In our model the acquisition of fresh capital by banks, manufacturers and entrepreneurs is subject to market imperfections. This is a necessary condition for capital adequacy regulations to have non-trivial effects on banks, and for external finance premia to arise in the interactions between banks and their borrowers. We use the “extended family” approach of Gertler and Karadi (2010), whereby bankers, manufacturers and entrepreneurs transfer part of their accumulated equity positions to the household budget constraint at an exogenously fixed rate.

Each unconstrained and constrained household represents an extended family that consists of four types of members, workers, manufacturers, entrepreneurs and bankers. Manufacturers, entrepreneurs and bankers enter their occupations for random lengths of time, after which they revert to being workers. There is perfect consumption insurance within each household. Workers supply labor, and their wages are returned to the household each period. Each manufacturer (entrepreneur, banker) manages a firm (capital investment fund, bank) and transfers earnings back to the household at the time when his period as a manufacturer (entrepreneur, banker) ends. Before that time he retains accumulated earnings within the firm (capital investment fund, bank). This means that while the household ultimately owns firms (capital investment funds, banks), equity cannot be freely injected into or withdrawn from these entities. That in turn means that equity and leverage matter for the decisions of firms (capital investment funds, banks).

Specifically, at a given point in time a fraction  $(1 - f)$  of the representative household’s members are workers, a fraction  $f(1 - b)m$  are manufacturers, a fraction  $f(1 - b)(1 - m)$  are entrepreneurs, and a fraction  $fb$  are bankers. Manufacturers (entrepreneurs, bankers) stay in their occupations for one further period with unconditional probability  $p^m$  ( $p^k$ ,  $p^b$ ). This means that in each period  $(1 - p^m)f(1 - b)m$  manufacturers,  $(1 - p^k)f(1 - b)(1 - m)$  entrepreneurs, and  $(1 - p^b)fb$  bankers, exit to become workers, and the same number of workers is assumed to randomly become manufacturers (entrepreneurs, bankers). The shares of workers, manufacturers, entrepreneurs and bankers within the representative

household therefore remain constant over time. Distribution of net worth by manufacturers (entrepreneurs, bankers), at the time they revert to being workers, ensures that the aggregate net worth of the corporate and banking sectors does not grow to the point where debt financing (deposit financing in the case of banks) becomes unnecessary. Finally, the representative household supplies startup funds to its new manufacturers (entrepreneurs, bankers), and we assume that these represent small fractions  $\iota^m$  ( $\iota^k$ ,  $\iota^b$ ) of the existing stocks of aggregate net worth in these three sectors. Each existing manufacturer (entrepreneur, banker) makes identical decisions that are proportional to his existing stock of accumulated earnings, so that aggregate decision rules for these three sectors are straightforward to derive. Therefore, the parameters that matter for aggregate dynamics are the shares of aggregate firm net worth  $n_t^m$ , capital investment fund net worth  $n_t^k$ , and banking sector net worth  $n_t^b$  paid out to households each period,  $(1 - p^m)\mathfrak{f}(1 - \mathfrak{b})\mathfrak{m}n_t^m$ ,  $(1 - p^k)\mathfrak{f}(1 - \mathfrak{b})(1 - \mathfrak{m})n_t^k$ , and  $(1 - p^b)\mathfrak{f}\mathfrak{b}n_t^b$ , net of startup funds  $\iota^m n_t^m$ ,  $\iota^k n_t^k$  and  $\iota^b n_t^b$ . As all of these terms are proportional to the aggregate stocks of net worth, their net effects can be denoted by  $\delta^m n_t^m$ ,  $\delta^k n_t^k$  and  $\delta^b n_t^b$ , and our calibration is therefore simply in terms of  $\delta^m$ ,  $\delta^k$  and  $\delta^b$ . These parameters can alternatively be thought of as fixed dividend policies of the firm, capital investment fund and banking sectors, and for simplicity we will utilize this terminology in the remainder of the paper.

## E. Unconstrained Households

The utility of a financially unconstrained household, indexed by  $i$ , at time  $t$  depends on an external consumption habit  $c_t^u(i) - \nu c_{t-1}^u$ , where  $c_t^u(i)$  is individual per capita consumption and  $c_t^u$  is aggregate per capita consumption, and where consumption is a CES aggregate over goods varieties supplied by manufacturers, with elasticity of substitution  $\theta$ . Utility also depends on labor hours,  $h_t^u(i)$ , and on the real quantity of land held,  $a_t^u(i)$ . Lifetime expected utility at time 0 of an individual household is given by

$$Max \quad E_0 \sum_{t=0}^{\infty} \beta_u^t \left\{ \left(1 - \frac{v}{x}\right) \log(c_t^u(i) - \nu c_{t-1}^u) - \psi \frac{h_t^u(i)^{1+\frac{1}{\eta}}}{1 + \frac{1}{\eta}} + \kappa \log(a_t^u(i)) \right\}, \quad (10)$$

where  $\beta_u$  is the discount factor,  $v$  indexes the degree of habit persistence,  $\eta$  is the labor supply elasticity, and  $\psi$  and  $\kappa$  fix the utility weights of labor and land. All unconstrained households have identical initial endowments and behave identically. The household index  $i$  is therefore only required for the distinction between  $c_t(i)$  and  $c_{t-1}$ , and can henceforth be dropped.

The assets held by unconstrained households include land  $a_t^u$ , whose real normalized price is given by  $\check{p}_t^a$ , real domestic government debt  $\check{b}_t^u$ , and real bank deposits  $\check{d}_t^u$ . The time subscript  $t$  denotes financial claims held from period  $t$  to period  $t + 1$ . The recent empirical literature has found that equilibrium real interest rates exhibit a small but positive elasticity with respect to the level of government debt (see section VI). The model replicates this feature by assuming that the holding of financial assets requires a small transactions cost  $(\check{b}_t^u + \check{d}_t^u) \phi_b (\check{b}_t^{rat} - \bar{b}^{rat})$ , where  $\check{b}_t^{rat} = \check{b}_t^g / (4g\check{d}p_t)$  is the government debt-to-GDP ratio, and  $\bar{b}^{rat}$  is its initial steady state value.<sup>54</sup> This cost is taken as

<sup>54</sup>The assumption of transaction costs that are quadratic in the debt-to-output ratio is commonly used in



exogenous by unconstrained households, and is redistributed back to them by way of a lump-sum transfer  $\check{\Psi}_t^u$ .

Unconstrained households receive after-tax labor income  $\check{w}_t^h h_t^u (1 - \tau_{L,t})$ , where  $\check{w}_t^h$  is the real wage received from unions and  $\tau_{L,t}$  is the proportional labor income tax rate, and they pay net lump-sum taxes  $\check{\tau}_t^{uu}$  to the government. They also receive, in a lump-sum fashion, the profits and investment adjustment costs of the capital goods producing sector,  $\check{\Pi}_t^k + \check{\mathfrak{C}}_{I,t}$ , price adjustment costs  $\check{\mathfrak{C}}_{P,t}$ , and a share  $(1 - \iota)/\omega$  of other income  $\check{o}_t$ . The latter includes total dividends distributed by manufacturers, entrepreneurs and banks, plus a portion of overall monitoring costs  $\check{\mathcal{M}}_t$  and transactions costs  $\check{\mathcal{T}}_t$ . The remaining portion of  $\check{\mathcal{M}}_t$  and  $\check{\mathcal{T}}_t$  is a real cost that enters the aggregate resource constraint. Monitoring costs arise in connection with the bankruptcy monitoring costs payable by bank borrowers, and also with the capital adequacy penalties payable by the banking sector itself, while transactions costs arise due to the monetary wedges  $s_t^x$  mentioned above.

We have the overall budget constraint

$$\begin{aligned} & (\check{b}_t^u + \check{d}_t^u) (1 + \phi_b (\bar{b}_t^{rat} - \bar{b}^{rat})) + \check{p}_t^a a_t^u \\ = & \frac{r_t}{x} \check{b}_{t-1}^u + \frac{r_{d,t}}{x} \check{d}_{t-1}^u + \check{p}_t^a a_{t-1}^u + \check{\Psi}_t^u \\ & - \check{c}_t^u (1 + s_t^u) (1 + \tau_{c,t}) - \check{\tau}_t^{uu} + \check{w}_t^h h_t^u (1 - \tau_{L,t}) \\ & + \check{\Pi}_t^k + \check{\mathfrak{C}}_{I,t} + \check{\mathfrak{C}}_{P,t} + \frac{1 - \iota}{\omega} \check{o}_t . \end{aligned} \quad (11)$$

The unconstrained household maximizes (10) subject to (11). We obtain a set of standard optimality conditions that are listed in full in the Technical Appendix.

## F. Constrained Households

The lifetime utility function of a financially constrained household is identical to that of an unconstrained household, with the sole exception that the discount factor  $\beta_c$  is allowed to differ from  $\beta_u$ . We have

$$Max \quad E_0 \sum_{t=0}^{\infty} \beta_c^t \left\{ S_t^c (1 - \frac{v}{x}) \log(c_t^c(i) - \nu c_{t-1}^c) - \psi \frac{h_t^c(i)^{1+\frac{1}{\eta}}}{1 + \frac{1}{\eta}} + \kappa \log(a_t^c(i)) \right\} . \quad (12)$$

Constrained households can invest in bank deposits  $\check{d}_t^c$  and land  $a_t^c$ . However, unlike unconstrained households they cannot finance the desired levels of these assets completely out of their own resources, and therefore have to borrow from banks. The associated consumption and mortgage loans are denoted by  $\check{\ell}_t^c$  and  $\check{\ell}_t^a$ . Constrained households' budget constraint in period  $t$ , in real normalized terms, is given by

$$\begin{aligned} & \check{d}_t^c (1 + \phi_b (\bar{b}_t^{rat} - \bar{b}^{rat})) + \check{p}_t^a a_t^c - \check{\ell}_t^c - \check{\ell}_t^a \\ = & \frac{r_{d,t}}{x} \check{d}_{t-1}^c (1 - \xi^c G_{c,t}) + \check{\Lambda}_t^c - \frac{r_{\ell,t}}{x} \check{\ell}_{t-1}^c + \check{p}_t^a a_{t-1}^c (1 - \xi^a G_{a,t}) + \check{\Lambda}_t^a - \frac{r_{\ell,t}^h}{x} \check{\ell}_{t-1}^a \\ & - \check{c}_t^c (1 + s_t^c) (1 + \tau_{c,t}) - \check{\tau}_t^{cc} + \check{w}_t^h h_t^c (1 - \tau_{L,t}) + \check{\Psi}_t^c + \frac{\iota}{1 - \omega} \check{o}_t + \delta^u \check{n}_t^u . \end{aligned}$$

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other literatures. The main example is the open economy literature with incomplete asset markets (Schmitt-Grohé and Uribe (2003), Neumeyer and Perri (2005)). In the closed economy literature, Heaton and Lucas (1996) have used the same device.

The terms on the second line represent the net cash flows from debt-financed investments in bank deposits and land, with  $\xi^c G_{c,t}$  and  $\xi^a G_{a,t}$  denoting the shares of gross asset returns spent on monitoring costs, and  $\tilde{\Lambda}_t^c$  and  $\tilde{\Lambda}_t^a$  representing banks' net losses (and thus borrowers' gains) on the respective loans. All other terms are familiar, with an appropriate change of notation, from the cash flow of unconstrained households, except for the dividends of unions  $\delta^u \tilde{n}_t^u$ , which are assumed to be received only by constrained households. For utility maximization we also need to consider the budget constraint in period  $t + 1$ , which is identical in form to the time  $t$  budget constraint, except that the terms on the second row become

$$(1 - \Gamma_{c,t+1}) \frac{r_{d,t+1}}{x} \tilde{d}_t^c + (1 - \Gamma_{a,t+1}) \tilde{p}_{t+1}^a a_t^c ,$$

where  $(1 - \Gamma_{c,t+1})$  and  $(1 - \Gamma_{a,t+1})$  denote the expected shares of gross returns on deposits and land retained by households, that is after either repaying bank loans or going bankrupt. These terms are familiar from the description of the optimal loan contract studied in subsection IV.B. Most of the optimality conditions for constrained households are standard and shown in the Technical Appendix. We list here only the conditions for the optimal consumer loan contracts,

$$\begin{aligned} & \tilde{\lambda}_t^c (1 + \phi_b (b_t^{rat} - \bar{b}^{rat})) (1 - s_t^{c'} (v_t^c)^2) \\ = & E_t \frac{\beta_c}{x} \tilde{\lambda}_{t+1}^c r_{d,t+1} \left[ (1 - \Gamma_{c,t+1}) + \tilde{\lambda}_{t+1}^c (\Gamma_{c,t+1} - \xi^c G_{c,t+1}) \right] , \\ & \tilde{\lambda}_t^c = E_t \frac{\beta_c}{x} \tilde{\lambda}_{t+1}^c \tilde{\lambda}_{t+1}^c r_{\ell,t+1} , \end{aligned} \tag{13}$$

and for optimal mortgage loan contracts,

$$\begin{aligned} & \tilde{\lambda}_t^c - \frac{\kappa}{\tilde{p}_t^a a_t^c} \\ = & E_t \beta_c \tilde{\lambda}_{t+1}^c \frac{\tilde{p}_{t+1}^a}{\tilde{p}_t^a} \left[ (1 - \Gamma_{a,t+1}) + \tilde{\lambda}_{t+1}^a (\Gamma_{a,t+1} - \xi^a G_{a,t+1}) \right] , \\ & \tilde{\lambda}_t^c = E_t \frac{\beta_c}{x} \tilde{\lambda}_{t+1}^c \tilde{\lambda}_{t+1}^a r_{\ell,t+1}^h . \end{aligned} \tag{14}$$

We observe that these take a very similar form to the optimal loan contract for capital investment funds in (6), except for the presence of a monetary wedge in (13), and of a utility wedge in (14).

## G. Unions

Unions have unit mass and are indexed by  $i$ . Each union buys homogenous labor from households at the nominal household wage  $W_t^h$ , and sells labor variety  $i$  to manufacturers at the nominal producer wage  $W_t(i)$ . Each manufacturer demands a CES composite of labor varieties, with elasticity of substitution  $\theta_w$ , so that unions' steady state gross markup of  $W_t(i)$  over  $W_t^h$  equals  $\mu_w = \theta_w / (\theta_w - 1)$ . The aggregate nominal producer wage is given by  $W_t$ . Unions face wage adjustment costs  $\mathfrak{C}_{W,t}(i)$  that, as in Ireland (2001), make it costly to change the rate of wage inflation:  $\mathfrak{C}_{W,t}(i) = \frac{\phi_w}{2} h_t T_t \left( \frac{W_t(i)}{W_{t-1}(i)} / \frac{W_{t-1}}{W_{t-2}} - 1 \right)^2$ . Their optimization problem yields a familiar New Keynesian Phillips curve for wages. Unions are owned by constrained households, who receive the full value of the union's cash flow as a dividend in each period.

## H. Manufacturers

Manufacturers have unit mass and are indexed by  $j$ . Each buyer of manufacturing output demands a CES composite of goods varieties with elasticity of substitution  $\theta$ , so that manufacturers' gross steady state markup of their nominal price  $P_t(j)$  over nominal marginal cost  $MC_t$  equals  $\mu = \theta/(\theta - 1)$ . Manufacturers face price adjustment costs  $\mathfrak{C}_{P,t}(i)$  that, as in Ireland (2001), make it costly to change the rate of price inflation:  $\mathfrak{C}_{P,t}(i) = \frac{\phi_p}{2} y_t \left( \frac{P_t(j)}{P_{t-1}(j)} / \frac{P_{t-1}}{P_{t-2}} - 1 \right)^2$ . Demand for manufacturers' output is given by  $y_t(j) = y_t (P_t(j)/P_t)^{-\theta}$ , while their technology is given by a standard Cobb-Douglas production function in labor and capital  $y_t(j) = (T_t h_t(j))^{1-\alpha} k_{t-1}(j)^\alpha$ . Manufacturers need to maintain bank deposits to reduce the transactions costs associated with payments for their inputs. They finance deposits  $\check{d}_t^m$  partly out of their own net worth  $\check{n}_t^m$ , and partly by borrowing from banks  $\check{\ell}_t^m$ , with their balance sheet constraint given by

$$\check{d}_t^m = \check{\ell}_t^m + \check{n}_t^m \quad . \quad (15)$$

Manufacturers' time  $t$  optimization problem, in nominal terms, is

$$\begin{aligned} \underset{P_t(j), h_t(j), k_t(j), D_t^m(j), \bar{\omega}_{t+1}^m(j), \bar{\lambda}_{t+1}^m(j)}{Max} \quad & E_t \left\{ \left[ P_t(j) y_t \left( \frac{P_t(j)}{P_t} \right)^{-\theta} + (1 - \Gamma_{m,t+1}) i_{d,t} D_t^m(j) \right. \right. \\ & + MC_t \left( (T_t S_t^a h_t(j))^{1-\alpha} k_{t-1}(j)^\alpha - y_t \left( \frac{P_t(j)}{P_t} \right)^{-\theta} \right) \\ & - (W_t h_t(j) + R_{k,t} k_{t-1}(j)) (1 + s_t^m(j)) \\ & - P_t T_t \mathfrak{F} - P_t \mathfrak{C}_{P,t}(i) \Big] - \frac{1}{i_t} P_{t+1} \mathfrak{C}_{P,t+1}(i) \\ & \left. + \bar{\lambda}_{t+1}^m(j) [(\Gamma_{m,t+1}(j) - \xi^m G_{m,t+1}(j)) D_t^m(j) i_{d,t} - i_{\ell,t} D_t^m(j) + i_{\ell,t} N_t^m(j)] + \dots \right\} \end{aligned}$$

The first line shows sales revenues plus earnings on deposits net of the share going to banks. This latter expression is familiar from our general exposition of the optimal loan contract in subsection IV.B. The second line imposes the constraint that supply equals demand for good  $j$ . The term on the third line is the input cost of labor and capital, with an added transaction costs term that depends on the amount of deposits held. The first term on the fourth line is a fixed cost, and the remaining terms are inflation adjustment costs. The fifth line is the bank participation constraint.

We assume that all manufacturers have identical initial stocks of bank deposits, loans and net worth. In that case all manufacturers make identical choices in equilibrium, and we can drop the index  $j$  in what follows. The optimality conditions for price setting and input choice are standard, except for the presence of a monetary wedge in marginal cost terms. They are shown in the Technical Appendix. We list here only the condition for the optimal loan contract for working capital loans:

$$E_t \left\{ \left[ (1 - \Gamma_{m,t+1}) i_{d,t} + s_t^{m'} (v_t^m)^2 \right] + \bar{\lambda}_{t+1}^m [(\Gamma_{m,t+1} - S_{t+1}^x \xi_{t+1}^m G_{m,t+1}) i_{d,t} - i_{\ell,t}] \right\} = 0 \quad . \quad (16)$$

Similar to the condition for the optimal consumer loan contract, this features a monetary wedge, but it is otherwise identical to the optimality condition for investment loans (6).

Finally, the net worth accumulation of manufacturers is given by

$$\begin{aligned} \check{n}_t^m = & \frac{r_{d,t}}{x} \check{d}_{t-1}^m (1 - \xi^m G_{m,t}) + \check{\Lambda}_t^m - \frac{r_{\ell,t}}{x} \check{\ell}_{t-1}^m \\ & + \check{y}_t - \left( \check{w}_t h_t + r_{k,t} \frac{\check{k}_{t-1}}{x} \right) (1 + s_t^m) - \check{\mathfrak{C}}_{P,t} - \check{\mathfrak{F}} - \delta^m \check{n}_t^m . \end{aligned} \quad (17)$$

The terms on the first line represent the net cash flow from debt-financed investment in bank deposits, with  $\xi^m G_{m,t}$  denoting the share of gross returns spent on monitoring costs, and  $\check{\Lambda}_t^m$  representing banks' net losses (and thus borrowers' gains) on the loan. The terms on the second line represent the net cash flow from goods production, including a fixed cost  $\check{\mathfrak{F}}$ , minus the dividend payment.

## I. Capital Goods Producers

As in Bernanke et al. (1999), the production of the capital good  $k_t$  is performed by a separate agent that is subject to investment adjustment costs

$\mathfrak{C}_{I,t} = (\phi_I/2) I_t (I_t / (I_{t-1}x) - 1)^2$ , where  $I_t$  is investment. We obtain a standard Euler equation for optimal investment over time. Capital accumulation is given by  $k_t = (1 - \Delta)k_{t-1} + I_t$ , where  $\Delta$  is the depreciation rate.

## J. Capital Investment Funds

The balance sheet constraint of capital investment funds is given by

$$q_t \check{k}_t = \check{n}_t^k + \check{\ell}_t^k . \quad (18)$$

The ex-post return to capital is  $ret_{k,t} = (r_{k,t} + (1 - \Delta)q_t - \tau_{k,t}(r_{k,t} - \Delta q_t)) / q_{t-1}$ , where  $\tau_{k,t}$  is the tax rate on capital income. The condition for the optimal loan contract of capital investment funds was shown in (6). Their net worth accumulation takes the by now familiar form

$$\check{n}_t^k = \frac{ret_{k,t}}{x} q_{t-1} \check{k}_{t-1} \left( 1 - \xi^k G_{k,t} \right) + \check{\Lambda}_t^k - \frac{r_{\ell,t}}{x} \check{\ell}_{t-1}^k - \delta^k \check{n}_t^k . \quad (19)$$

## K. Government

### 1. Monetary Policy

Monetary policy is given by a conventional inflation forecast-based interest rate rule

$$i_t = (i_{t-1})^{m_i} \left( \frac{x}{\beta_u} \bar{\pi} (1 + \phi_b (b_t^{rat} - \bar{b}^{rat})) \right)^{(1-m_i)} \left( \frac{\pi_{4,t+3}}{(\bar{\pi})^4} \right)^{\frac{(1-m_i)m_\pi}{4}} , \quad (20)$$

where the second term on the right-hand side is the steady state nominal interest rate, which takes into account that the steady state nominal interest rate is increasing in the government debt-to-GDP ratio, and where  $\pi_{4,t} = \pi_t \pi_{t-1} \pi_{t-2} \pi_{t-3}$ .

## 2. Prudential Policy

We assume that prudential policy under the current monetary regime follows a fixed Basel rule that sets a constant minimum capital adequacy ratio,  $\gamma_t = \bar{\gamma}$ .

## 3. Fiscal Policy

Fiscal policy follows a structural deficit rule. Specifically, the government's long-run target for the deficit-to-GDP ratio  $gd_t^{rat} = (\check{b}_t^g - \check{b}_{t-1}^g / (x\pi_t)) / g\check{d}p_t$  is fixed at  $\overline{gd^{rat}}$ . But because of automatic stabilizers the deficit is allowed to fluctuate with the output gap  $\ln(g\check{d}p_t / gdp_{ss})$ ,

$$gd_t^{rat} = \overline{gd^{rat}} - d^{gdp} \ln \left( \frac{g\check{d}p_t}{gdp_{ss}} \right) . \quad (21)$$

We assume that the labor income tax rate  $\tau_{L,t}$  is endogenized to make this rule hold over the business cycle, with the other two distortionary tax rates following labor income tax rates in proportional fashion. This requires the auxiliary rules  $(\tau_{c,t} - \bar{\tau}_c) / \bar{\tau}_c = (\tau_{L,t} - \bar{\tau}_L) / \bar{\tau}_L$  and  $(\tau_{k,t} - \bar{\tau}_k) / \bar{\tau}_k = (\tau_{L,t} - \bar{\tau}_L) / \bar{\tau}_L$ . Lump-sum taxes are given by  $\check{\tau}_{ls,t} = \omega \check{\tau}_t^{uu} + (1 - \omega) \check{\tau}_t^{cc}$ , and we assume that the portion payable by constrained agents is determined by the parameter  $f_{cc}$  in  $\check{\tau}_t^{cc} = f_{cc} \check{\tau}_t^{ls} / (1 - \omega)$ . Government spending  $\check{g}_t$  is assumed to equal a fixed fraction  $s_g$  of GDP.

## 4. Government Budget Constraint

The government budget constraint is given by

$$\check{b}_t^g = \frac{r_t}{x} \check{b}_{t-1}^g + \check{g}_t - \check{\tau}_t , \quad (22)$$

where tax revenue is given by

$$\check{\tau}_t = \tau_{c,t} \check{c}_t + \tau_{L,t} \check{w}_t^h h_t + \tau_{k,t} (r_{k,t} - \Delta q_t) \frac{\check{k}_{t-1}}{x} + \check{\tau}_{ls,t} . \quad (23)$$

For future reference we note that the steady state relationship between debt- and deficit-to-GDP ratios is given by the accounting relationship  $\overline{b^{rat}} = \left( \overline{gd^{rat}} / 4 \right) \frac{x\bar{\pi}}{x\bar{\pi}-1}$ , where the factor of proportionality  $1/4$  is due to the fact that our model is quarterly.

## L. Market Clearing

The goods market clearing condition is given by  $\check{y}_t = \check{c}_t + \check{I}_t + \check{g}_t + \mathfrak{F} + \mathfrak{r} (\check{\mathcal{M}}_t + \check{\mathcal{T}}_t)$ , where  $\mathfrak{r}$  is the fraction of monitoring and transactions costs that represents a real resource cost, and where the remaining fraction  $1 - \mathfrak{r}$  is a lump-sum transfer to households. The labor market clearing condition is given by  $h_t = \omega h_t^u + (1 - \omega) h_t^c$ , land market clearing by  $a = \omega a_t^u + (1 - \omega) a_t^c$ , where  $a$  is the fixed and exogenous supply of land, and bonds market clearing is given by  $\omega \check{b}_t^u + \check{b}_t^b = \check{b}_t^g$ . Finally, aggregate consumption is defined as  $c_t = \omega c_t^u + (1 - \omega) c_t^c$ , and GDP as  $g\check{d}p_t = \check{c}_t + \check{I}_t + \check{g}_t$ .

## V. The Model under the Chicago Plan

We now describe the model economy under the Chicago Plan. We will refer to this as the post-transition economy, while the economy under the current monetary regime will be referred to as the pre-transition economy. Except when specifically mentioned in this section, the preferences, technologies and calibration of the two economies are identical. The transition is assumed to take place in exactly one period, and in this period budget constraints contain additional terms that relate to large one-off stock changes on balance sheets. We therefore introduce a dummy parameter that will be set to  $\mathfrak{d} = 1$  in the transition period, and to  $\mathfrak{d} = 0$  in all subsequent periods. Banks, households, manufacturers, and the government exhibit differences under the Chicago Plan, and we now deal with each in turn. As before, we start with banks.

### A. Banks

The key requirement of the Chicago Plan is that banks are required to back 100% of their deposits  $\check{d}_t$  by government-issued reserves  $\check{m}_t$ :

$$\check{d}_t = \check{m}_t . \quad (24)$$

This implies that financial institutions are split into two groups with entirely different functions, and with neither of them being able to lend by creating new deposits. *Deposit banks* administer government-issued money and provide payments services. They are (for simplicity) assumed to have no equity, and their balance sheet is given by (24).

*Investment trusts* inherit a stock of investment loans that has to be backed by a combination of its own equity and non-monetary liabilities  $\check{f}_t$ . For the reasons discussed in section III.B, we assume that this funding  $\check{f}_t$  is supplied exclusively by the government treasury. We will therefore refer to  $\check{f}_t$  as treasury credit. Private agents are limited to holding either investment trust equity or monetary bank deposits  $\check{d}_t$  that do not fund any lending.<sup>55</sup> Under this funding scheme the government separately influences the aggregate volumes of credit and the money supply.

The transition to these new balance sheets conceptually takes place in two stages that both happen in a single transition period. In the first stage, banks instantaneously increase their reserve backing for deposits from 0% to 100%, by borrowing from the treasury, so that  $\check{f}_t = \check{m}_t = \check{d}_t$ . In the second stage, the government can independently control money  $\check{m}_t$  and treasury credit  $\check{f}_t$ . It exercises this ability by cancelling all government debt on financial institutions' balance sheets against treasury credit, and by transferring part of the remaining treasury credit claims against banks to constrained households and manufacturers, by way of a citizens' dividend paid into restricted accounts that must be used to repay outstanding loans. This second stage leaves only investment loans  $\check{\ell}_t^k$  outstanding, with money  $\check{m}_t$  unchanged and treasury credit  $\check{f}_t$  much reduced. Net interest charges from the previous period remain the responsibility of the respective borrowers. With this, the overall financial sector balance sheet becomes

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<sup>55</sup>We reiterate that alternative assumptions, with a much more substantial role for private funding of credit, are perfectly feasible. Of course private agents can also hold real assets and government debt.

$\check{\ell}_t^k + \check{m}_t = \check{f}_t + \check{d}_t + \check{n}_t^b$ , while the balance sheet of investment trusts is simply given by

$$\check{\ell}_t^k = \check{f}_t + \check{n}_t^b . \quad (25)$$

The government affects the price of lending through its control of the interest rate on treasury credit  $i_{f,t}$ . It can also affect the volume of lending through capital adequacy regulations. But unless those regulations are tight, investment trusts retain considerable power to determine the aggregate quantity of credit. And of course they remain completely in charge of choosing the allocation of that credit. There is therefore nothing in the monetary arrangements of the Chicago Plan that interferes with the ability of the private financial sector to facilitate the allocation of capital to its most productive uses.

Other important details change for the financial sector. First, the government sets the nominal interest rate on reserves  $i_{m,t}$ . We assume that the deposit function of banks is perfectly competitive, and that deposit banks face zero marginal costs in providing deposit services. This means that deposit banks pass  $i_{m,t}$  on to depositors one for one,  $i_{m,t} = i_{d,t}$ . We will therefore describe policy in terms of the government directly setting  $i_{d,t}$ . Given that private credit is now only extended to capital investment funds, the expression for total loan losses simplifies to  $\check{\Delta}_t^b = \check{\Delta}_t^k$ . Capital adequacy regulation now only applies to investment trusts, but otherwise takes an identical form to the current arrangements. Details are shown in the Technical Appendix. Investment trusts' optimality condition for the optimal volume of loans takes the same form as before, but in this case it determines the spread between the wholesale rate  $i_{\ell,t}$  and the government-determined treasury credit rate  $i_{f,t}$ , rather than between  $i_{\ell,t}$  and the privately determined deposit rate  $i_{d,t}$ .

The net worth accumulation of the overall financial system is given by<sup>56</sup>

$$\begin{aligned} \check{n}_t^b = & \frac{1}{x} \left( r_{\ell,t} \check{\ell}_{t-1} + r_{\ell,t}^h \check{\ell}_{t-1}^h + r_t \check{b}_{t-1}^b - r_{d,t} \check{d}_{t-1} \right) - \check{\Delta}_t^b - \check{\mathcal{M}}_t^b - \delta^b \check{n}_t^b \\ & + \frac{1}{x} \left( r_{d,t} \check{m}_{t-1} - r_{f,t} \check{f}_{t-1} \right) - \mathfrak{d} \check{\Delta}_t^{nw} . \end{aligned} \quad (26)$$

The first line is identical to the pre-transition economy, although several of the lagged entries remain at zero after the transition period. The second line is new. The first item is gross interest on the reserve backing of deposits paid by the government to deposit banks. The second item is gross interest on treasury credit paid by investment trusts to the government. The third item is a one-off equity payout in the transition period. The reason for the latter is that, after a large portion of loans is repaid at an unchanged MCAR, equity requirements of investment trusts drop significantly, so that they would ordinarily respond by temporarily reducing their lending margin to run down their equity. An instantaneous equity payout of appropriate size ensures that the loan repayment has no significant effect on the pricing of the remaining loans. We assume that the excess equity is paid out to shareholders according to the formula

$$\check{\Delta}_t^{nw} = \check{n}_{t-1}^b - \bar{\gamma}^a \check{\ell}_t^k ,$$

where  $\bar{\gamma}^a$  is the unchanged steady state capital adequacy ratio.

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<sup>56</sup>We note that this reduces to the net worth accumulation of investment trusts, as deposit banks are assumed to have zero equity to start with, and their subsequent receipts  $r_{d,t} \check{m}_{t-1}/x$  and payments  $r_{d,t} \check{d}_{t-1}/x$  are equal and can be cancelled.

In the above analysis we make the simplifying assumption, common in macroeconomic models, that there is no heterogeneity in debt levels across constrained households, or across manufacturers. This is certainly not true in the real world. But it is straightforward to understand the implications of this additional complication. If we make the reasonable assumption that a government would not want to penalize low-debt individuals in a debt repayment, then the repayment would take the form of a flat per capita transfer  $\check{d}_t^{new}$  into the above-mentioned restricted private accounts.<sup>57</sup> For individuals whose outstanding bank debt  $\check{\ell}_t^{old}$  equals  $\check{d}_t^{new}$  this would exactly cancel the debt as before. But individuals that started out without debt would be left with the full new balance  $\check{d}_t^{new}$ , while individuals with debt that exceeds  $\check{d}_t^{new}$  would be left with the residual debt. To make sure that the balances of net savers do not add to the money supply, they could then be converted into the equity shares or non-monetary debt instruments of the investment trusts envisaged by Simons. Because treasury-funded investment trusts remain at the core of the financial system, the privately-funded trusts would be less important than envisaged by Simons. But their presence ensures that there is nothing in the monetary arrangements of the Chicago Plan that prevents households and firms from intertemporal smoothing.

## B. Households

Upon the announcement of the transition, due to the complete repayment of household debt by the government, all households become unconstrained. We model previously distinct households as identical post-transition by setting the population share parameter to  $\omega_t = 1$  from the transition period onwards. The new overall budget constraint correctly reflects the inherited assets and liabilities of both household groups. In the transition period households only pay the net interest charges on past debts incurred by constrained households to the banking sector. The principal is instantaneously repaid through the citizens' dividend. From that moment onwards the household sector has zero net debt to the financial sector<sup>58</sup>, while its financial assets consist of government bonds and deposits, the latter now being 100% reserve backed. The new household budget constraint is

$$\begin{aligned}
 & (\check{b}_t^u + \check{d}_t^u) (1 + \phi_b (\check{b}_{net,t}^{rat} - \bar{b}^{rat})) + \check{p}_t^a a \\
 = & \frac{r_t}{x} \omega_{t-1} \check{b}_{t-1}^u + \frac{r_{d,t}}{x} (\omega_{t-1} \check{d}_{t-1}^u + (1 - \omega_{t-1}) \check{d}_{t-1}^c) + \check{p}_t^a a + \check{\Psi}_t^u \\
 & - \check{c}_t^u (1 + s_t^u) (1 + \tau_{c,t}) - \check{\tau}_t^{ls} + \check{w}_t^h h_t^u (1 - \tau_{L,t}) \\
 & - \mathfrak{d} (1 - \omega_{t-1}) \left( \frac{r_{\ell,t}}{x} - 1 \right) \check{\ell}_{t-1}^c - \mathfrak{d} (1 - \omega_{t-1}) \left( \frac{r_{\ell,t}^h}{x} - 1 \right) \check{\ell}_{t-1}^a + \check{o}_t - \mathfrak{d} \tau_t^{once} .
 \end{aligned} \tag{27}$$

The transition-period-only terms on the last line are new relative to the pre-transition period. The first two terms state that households pay the net interest due on consumer loans and mortgages in the transition period. The dividend portion of other income  $\check{o}_t$

<sup>57</sup> A flat per capita transfer is a natural starting point for this thought experiment. But it should be clear that the transition to the Chicago Plan would represent a unique opportunity to address some of the serious income inequality problems that have developed over recent decades, by making larger transfers to lower-income households. As shown in Kumhof and Ranci  re (2010) and Kumhof et al. (2012), inequalities can make economies more vulnerable to financial crises, and they can contribute to current account imbalances.

<sup>58</sup> Again, with heterogeneity within household groups gross asset and liability positions would continue to exist.



now includes one additional term,  $\vartheta \Delta_t^{nw}$ . This represents the above-mentioned one-off equity distribution (share buyback) from financial institutions to households in the transition period. The final item on the last line,  $\tau_t^{once}$ , is a one-off lump-sum tax levied by the government in the transition period. We set  $\tau_t^{once} = \Delta_t^{nw}$ , so that the government can finance the additional treasury credit to investment trusts that is necessary to replace the lost equity, without having to resort to temporarily higher distortionary taxation.

The government-debt-related interest rate premium on financial assets is now determined by  $b_{net,t}^{rat}$  rather than  $b_t^{rat}$ , where

$$b_{net,t}^{rat} = \frac{(\check{b}_t^g - \vartheta \check{f}_t)}{4g\check{d}p_t} . \quad (28)$$

Here  $\vartheta$  indicates the weight that investors attach to treasury credit, that is to government assets vis-à-vis the private sector, in computing net government debt. That weight, in our calibration, will be determined by the relative interest burdens of these two financial instruments. Other changes to the budget constraint reflect the fact that all lump-sum transfers and other income are now received by one household group. Also, the monitoring cost term in other income is much reduced due to the repayment of a large stock of bank loans.

### C. Manufacturers

For manufacturers, the equations describing the technology, optimal input choice, and inflation dynamics remain unchanged. In the transition period manufacturers only pay the net interest charges on past debt incurred to the banking sector. The principal is instantaneously repaid through the citizens' dividend, which is paid to both households and manufacturers. From that moment onwards the manufacturing sector has zero debt to the financial sector. Manufacturers' main financial asset remains bank deposits, which are now fully backed by reserves and thus debt-free. The debt repayment therefore implies a large increase in the net worth of this sector, which from this moment onwards is financed almost exclusively by equity.

We assume that, post-transition, manufacturers can still smooth business cycle fluctuations through borrowing and lending. But given their much lower credit risk after the debt repayment, they can now access the market for riskless debt, in the same way as the government. The net steady state level of this borrowing is however zero.<sup>59</sup> We denote manufacturers' net holdings of riskless debt by  $\check{b}_t^m$ . Their post-transition balance sheet is given by

$$\check{d}_t^m + \check{b}_t^m = \check{n}_t^m . \quad (29)$$

Manufacturers' opportunity cost of holding bank deposits is therefore now given by the spread between the rate on riskless debt and the deposit rate, with optimal money holdings determined by

$$i_t = i_t^d + s_t^{m'} (v_t^m)^2 . \quad (30)$$

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<sup>59</sup>Similar to the case of households, non-bank investment trusts could accommodate the credit needs of heterogeneous manufacturers.

Finally, manufacturers' net worth accumulation is now given by

$$\begin{aligned} \tilde{n}_t^m = & \frac{r_{d,t}}{x} \check{d}_{t-1}^m + \frac{r_t}{x} \check{b}_{t-1}^m - \mathfrak{d} \left( \frac{r_{\ell,t}}{x} - 1 \right) \check{\ell}_{t-1}^m - \delta^m \tilde{n}_t^m \\ & + \check{y}_t - \left( \check{w}_t h_t + r_{k,t} \frac{\check{k}_{t-1}}{x} \right) (1 + s_t^m) - \check{\mathfrak{C}}_{P,t} - \check{\mathfrak{F}} . \end{aligned}$$

This reflects the absence of a bank lending relationship, and of associated monitoring costs.

## D. Government

### 1. Monetary Policy

In the pre-transition environment the government only has a single policy instrument, the nominal interest rate on short-term government bonds, to affect the quantities of both money and credit. As we have discussed, the effect on each is indirect and generally weak. In the post-transition environment the government directly controls the quantity of money. Its control over credit is still indirect but if desired it can be made stronger than before.

#### Money

For money, the government follows a Friedman money growth rule whereby the nominal quantity of money grows at the constant (gross) rate  $\pi_m$ ,

$$\check{d}_t = \pi_m \frac{\check{d}_{t-1}}{x\pi_t} . \quad (31)$$

The main reason why monetarism had to be abandoned in the 1980s is the fact that under the present monetary system the government can only pursue a rule such as (31) for the narrow monetary aggregates under its direct control. This is only effective if there is a stable deposit multiplier that relates broad to narrow monetary aggregates. However, as discussed in Section I, the deposit multiplier is a myth.

Under the current monetary system, broad monetary aggregates are created by banks as a function, almost exclusively, of their attitude towards credit risk, without narrow aggregates imposing any effective constraint. On the other hand, under the Chicago Plan the rule (31) directly controls the broadest monetary aggregate. In other words, monetarism can become highly effective at achieving its main objective of controlling price inflation by controlling the money supply. This is a key reason why Friedman (1967) was in favor of the 100% reserve solution.

Furthermore the government, as the sole issuer of money, can directly control the nominal interest rate on reserves, and given our assumptions about deposit banks' technology, this rate is passed on to depositors one for one. We assume, without loss of generality, that the government's long-run deposit rate equals  $\bar{r}_d = 1$ , in other words the government eventually pays zero interest on money. However, during a brief period following the implementation of the Chicago Plan real interest rates can become excessively volatile if the deposit rate is lowered too fast. For the immediate post-transition period we therefore assume a fixed autoregressive path for the nominal deposit interest rate, with an initial

value that equals the privately determined deposit interest rate of the last pre-transition period:

$$i_{d,t} = (1 - \rho_d) \bar{i}_d + \rho_d i_{d,t-1} . \quad (32)$$

## Credit

To control credit growth, policy is assumed to control the nominal interest rate on treasury credit  $i_{f,t}$  and, if desired, a countercyclical component of capital adequacy requirements  $\gamma_t$ . As the latter falls under prudential policy, it is discussed in the next subsection.

Because inflation is controlled by the money growth rule, control of the nominal interest rate on treasury credit is equivalent to control of the real interest rate on treasury credit, which then affects the real interest rate on credit from investment trusts.

The zero lower bound on the policy interest rate in the present monetary environment binds because at a less than zero nominal interest rate on bonds private agents can switch their investment to cash. This is not a relevant consideration for treasury credit, which is not an investment asset but a strictly limited funding source that is only accessible to investment trusts for the specific purpose of funding investment loans. The policy rate  $i_{f,t}$  is therefore not constrained by a zero lower bound. The government thus has the ability to charge investment trusts a negative nominal/real interest rate on treasury credit during severe downturns, and thereby to offset the higher spreads (due to higher lending risk) during such periods. The absence of a zero lower bound implies that policy can switch to an environment with both zero inflation and very low steady state treasury credit rates, without running the risk of losing the ability to lower rates further during a downturn.

For the purpose of our simulations we again distinguish between two different environments for the policy rate  $i_{f,t}$ . In the first environment the economy has reached its new post-transition steady state, while in the second we describe the immediate post-transition period. Around the new post-transition steady state we assume a feedback rule

$$i_{f,t} = (\bar{i}_f)^{1-m_i} (i_{f,t-1})^{m_i} \left( \frac{\pi_{4,t+3}}{(\bar{\pi})^4} \right)^{(1-m_i)m_\pi} . \quad (33)$$

This has an identical functional form to the pre-transition policy rule (20) for  $i_t$ . But apart from this there are major differences. First, there is no “natural rate” for this policy rate, so that the government is free to choose the steady state rate  $\bar{i}_f$ . Second, there is no zero lower bound for  $i_{f,t}$ . Third, this rate, through the financial system, only affects decisions on physical investment directly, with no direct effect on decisions on land purchases, consumption, or working capital purchases. It is therefore easier to use this rate in a targeted fashion if the nature of shocks is known.

The immediate post-transition period is characterized by a fixed autoregressive path that gradually lowers the treasury credit rate from the pre-transition deposit rate  $i_{d,t-1}$  to the long-run target  $\bar{i}_f$ :

$$i_{f,t} = (1 - \rho_f) \bar{i}_f + \rho_f (\mathfrak{d} i_{d,t-1} + (1 - \mathfrak{d}) i_{f,t-1}) . \quad (34)$$

For the simulation of this transition, we are less concerned with the business cycle stabilizing properties of the new policy rate, and therefore ignore policy feedback to

inflation. Reintroducing this feature would make only a minimal difference to our results. We assume that the policymaker sets the steady state rate  $\bar{i}_f$  so that in the long-run the steady state rate on wholesale lending  $\bar{i}_\ell$  (before risk spreads) equals the steady state rate on government bonds  $\bar{i}$ . In other words, by providing relatively cheap credit the government subsidizes investment trusts to equalize the average funding costs of the government and of the lowest-risk private corporations.

We have found that if the transition to  $\bar{i}_f$  was modelled as taking place very rapidly, the result would be an immediate explosion in investment demand, with destabilizing effects, through inflation and real interest rates, on the rest of the economy. We therefore calibrate the speed of the reduction in this interest rate to be fairly slow, by choosing a high value for  $\rho_f$ .

## 2. Prudential Policy

We recall that in the pre-transition economy we had assumed a Basel regime with a constant MCAR,  $\gamma_t = \bar{\gamma}$ . We retain this assumption when simulating the transition to the new steady state of the Chicago Plan. However, when describing the economy's behavior in response to business cycle shocks under the Chicago Plan, we will assume that prudential policy can have a strong countercyclical component, as permitted under the new Basel-III rules.

As shown in Benes and Kumhof (2011), a Basel regime can be made more flexible, and increase welfare, by responding to the state of banks' balance sheet. However, when banks lend to a variety of different borrowers, and when a variety of different shocks hit the economy, it may become hard to efficiently calibrate the response of a prudential rule to an appropriate target variable. This problem is very much reduced under the version of the Chicago Plan simulated in this paper, because investment trusts that have access to treasury credit exclusively finance physical investment projects.<sup>60</sup> In this case prudential policy can focus on limiting volatility in the amount of investment financed by investment trusts. Because the level of investment can be affected by both the price and the quantity of credit, it is preferable to target neither of those variables through the prudential rule, but rather to target the quantity of investment directly. The rule we postulate is

$$\gamma_t = \bar{\gamma} \left( \frac{\check{I}_t}{\bar{I}} \right)^{p_\ell}, \quad (35)$$

where  $p_\ell > 0$ . In other words, the minimum reserve requirement is raised when the quantity of investment is at a cyclical high, thereby forcing investment trusts to hold more equity per unit of loans if they decide to approve an exceptionally large volume of investment loans. The result is a combination of reduced lending and higher lending rates on the remaining loans.

This means that policy can, if desired, control credit not only through the interest rate on treasury credit, but also through a policy that resembles the quantitative lending guidance discussed in Section II.H. While lending guidance is assumed to be flexible in that investment trusts make the ultimate decision on the volume of investment loans, policy

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<sup>60</sup>Recall that all other lending is carried out by privately-funded investment trusts.

can nevertheless impose very costly penalties on excessively volatile lending. As we will see, this can be an extremely effective way to limit the business cycle effects of lenders' attitudes towards credit risk.

### 3. Fiscal Policy

The fiscal policy rule under the Chicago Plan remains unchanged, as do the rules endogenizing tax rates, and the exogenous process for government spending. But because the fiscal rule targets the government deficit, which equals the change in the stock of government debt, it needs to be modified for the transition period. The reason is that at that time there is a large discontinuous change in the stock of government debt, due to the repayment of the government debt held by the banking system. We therefore have

$$gd_t^{rat} = (1 - \mathfrak{d}) \left( \overline{gd^{rat}} - d^{gdp} \ln \left( \frac{g\check{d}p_t}{g\check{d}p_{ss}} \right) \right) + \mathfrak{d}\Delta_t^{bg} , \quad (36)$$

$$\Delta_t^{bg} = 4 \left( \bar{b}_t^{rat} - \frac{\bar{b}_{t-1}^{rat}}{x\pi_t (g\check{d}p_t/g\check{d}p_{t-1})} \right) , \quad (37)$$

where the last expression follows directly from the long-run relationship between debt and deficits. Note that the steady state debt-to-GDP ratios are here shown with time subscripts, because in the transition period there is an instantaneous and permanent reduction in the steady state debt-to-GDP ratio, due to the repayment of bank-held government debt against the cancellation of treasury credit.

### 4. Government Budget Constraint

Relative to the pre-transition government budget constraint (22), the post-transition budget constraint features two new flow terms related to money issuance and treasury credit issuance, as well as one-off stock adjustment terms in the transition period. We have

$$\check{b}_t^g + \check{m}_t - \check{f}_t - \mathfrak{d}\Delta_t^{comp} = \frac{r_t}{x}\check{b}_{t-1}^g + \frac{r_{d,t}}{x}\check{m}_{t-1} - \frac{r_{f,t}}{x}\check{f}_{t-1} + \check{g}_t - \check{\tau}_t , \quad (38)$$

$$\check{\tau}_t = \tau_{c,t}\check{c}_t + \tau_{L,t}\check{w}_t^h h_t + \tau_{k,t}(r_{k,t} - \Delta q_t) \frac{\check{k}_{t-1}}{x} + \check{\tau}_{ls,t} + \mathfrak{d}\tau_t^{once} . \quad (39)$$

The first new flow term is net seigniorage from government money provision  $\check{m}_t - \frac{r_{d,t}}{x}\check{m}_{t-1}$ . In a steady state with  $\bar{r}_d = 1$  and a positive growth rate  $x$  this represents a cash inflow that is equal to the real money stock multiplied by the real economic growth rate. The second new flow term is net cash flow from treasury credit provision  $-\check{f}_t + \frac{r_{f,t}}{x}\check{f}_{t-1}$ . In steady state this represents a cash outflow when, as we will assume, the government keeps the real interest rate on treasury credit below the growth rate,  $\bar{r}_f < x$ .

The new stock items in the transition period need to be discussed carefully. On impact there is a one-off cash flow  $\check{m}_t - \check{f}_t$ . At the moment when banks purchase their new reserve backing, this cash flow is exactly equal to zero. But we assume that this is

instantaneously followed by another set of transactions whereby the government, directly or indirectly, repays a number of government and private debts by cancelling them against  $\check{f}_t$ , thereby reducing  $\check{f}_t$ . First, there is a one-off negative cash flow  $\check{b}_t^g - \frac{r_t}{x}\check{b}_{t-1}^g$  that is exactly balanced by a commensurate reduction in  $\check{f}_t$ . This is the repayment of government debt held by banks, where  $\check{b}_t^g$  is significantly smaller than  $\check{b}_{t-1}^g$ . Second, there is a one-off negative cash-flow from the payout of the citizens' dividend for the purpose of repaying the principal of private debts. This again represents a reduction in  $\check{f}_t$ :

$$\Delta_t^{comp} = (1 - \omega_{t-1}) (\check{\ell}_{t-1}^c + \check{\ell}_{t-1}^a) + \check{\ell}_{t-1}^m . \quad (40)$$

Third, without an additional tax the government's cash flow in the transition period would suffer from the fact that financial institutions distribute part of their stock of equity  $\Delta_t^{nw}$  to households in that period, and need to make up the lost funding by borrowing additional funds from the government, thereby raising the required  $\check{f}_t$ . By raising a one-off lump-sum tax  $\tau_t^{once} = \Delta_t^{nw}$ , the government's cash flow remains smooth and does not require a large spike in distortionary taxes in the transition period in order to procure the additional funds. A maintained assumption in this argument is of course that the government maintains its fiscal rule at all times. With this set of assumptions the regular flow items of the government's budget constraint remain insulated from the large one-off stock effects of the transition.

In terms of stock items, the government and the private sector share the benefits of replacing debt-based private money with debt-free government-issued money. The government swaps debt for equity. First, the large new stock of irredeemable government-issued money represents government equity rather than government debt. This is not traded equity that pays dividends, but rather equity in the commonwealth, whose return comes in the form of lower government interest costs, lower distortionary taxes, and lower financial market monitoring costs. Second, treasury credit to investment trusts dramatically reduces the government's overall net debt. The non-bank private sector also swaps debt for equity. In this case this is due to the citizens' dividend, which increases private sector net worth by reducing debt levels.

## 5. Controlling Boom-Bust Cycles - Additional Considerations

Two additional considerations suggest that the effectiveness of countercyclical policy would be further enhanced under the Chicago Plan relative to the present monetary system. We mention them in a separate subsection because, unlike the other arguments in favor of the Chicago Plan, they cannot be analyzed using our formal model.

First, financial institutions that are subject to a 100% reserve requirement know that they cannot create their own funds to fuel a lending boom. Instead, they have to either attract existing money balances from private agents, who hold them both for their safety and for transactions needs and who will therefore need an incentive to part with them, or they have to borrow money from the government at rates that increase in a lending boom, and where the additional lending could furthermore be subject to much higher capital requirements. Arguably this knowledge makes it much less likely that financial institutions will develop their intermittent bouts of optimism and pessimism in the first place.

Second, under the present monetary regime, especially during a boom, capital adequacy requirements impose virtually no effective constraint, because the money that is injected as equity does not need to represent other agents' savings. Instead, any additional funds required as equity by Bank A can simply be created by Bank B as credit to a household, who then injects those funds as equity into Bank A.<sup>61</sup> This is impossible under the Chicago Plan, because the financial system is unable to create its own funds through credit, while any government credit is specifically earmarked for investment projects. Therefore, just like in the case of the money growth rule, a prudential MCAR rule becomes far more effective under the Chicago Plan.

## VI. Calibration

We calibrate the steady state of our model economy, for the period prior to the transition to the Chicago Plan, based on U.S. data for the period 1990-2006, where available. The reason is that 2006 is the last full year before the onset of the Great Recession, which led to massive fluctuations in many of the data required for our calibration, particularly in balance sheet data. For most of our calibration of the real economy we use data for the full 1990-2006 period to compute averages. However, for balance sheet data, including balance sheets of banks, firms, households and the government, we use a calibration based on the final years preceding the crisis. This is because balance sheets, unlike most key ratios in the real economy, have changed dramatically since the early 1990s, so that earlier data are no longer representative as a starting point when trying to evaluate the effects of policies whose immediate impact is on balance sheets. In the interest of space we do not display the data underlying our calibration choices. Detailed figures are shown in the Technical Appendix. One period corresponds to one quarter.

The trend real growth rate  $x$  is calibrated at 2% per annum and the average inflation rate  $\bar{\pi}$  at 3% per annum. The historical average for the real interest rate on short-term U.S. government debt is around 2.5%-3.0% per annum. We calibrate it at 3% per annum. The population share of unconstrained households is assumed to be 10%, or  $\omega = 0.1$ . The parameter  $\iota$ , which determines the relative income and therefore consumption levels of unconstrained and constrained household, is fixed to obtain a steady ratio of unconstrained to constrained households' per capita consumption of 4:1, in line with evidence from the U.S. Survey of Consumer Finance. The parameter  $\tau$ , which determines the share of monitoring and transactions costs that represent real resource costs rather than lump-sum payments back to households, is fixed at  $\tau = 0.25$ .

The labor income share is calibrated at 61% by fixing  $\alpha$ . This is in line with recent BLS data for the U.S. business sector. This share has exhibited a declining trend over recent decades, and we therefore base our calibration on the more recent values. The private investment to GDP ratio is set to 19% of GDP, roughly its average in U.S. data. The implied depreciation rate, at close to 10% per annum, is in line with much of the literature. The investment adjustment cost parameter, at  $\phi_I = 2.5$ , follows Christiano et al. (2005). The price and wage markups of monopolistically competitive manufacturers and unions are fixed, in line with much of the New Keynesian literature, at 10%, or

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<sup>61</sup>See Huber (2011).

$\mu_p = \mu_w = 1.1$ . Together with the assumptions for the price and wage inflation stickiness parameters of  $\phi_p = 200$  and  $\phi_w = 200$ , this implies an average duration of price and wage contracts of 5 quarters in an equivalent Calvo (1983) setup with full indexation to past inflation. This is consistent with the results of Christiano et al. (2005). Unions' dividends are assumed to be fully distributed to constrained households in each period,  $\delta_u = 1$ .

The government accounts are calibrated in considerable detail, because the effects of the Chicago plan include a substantial reduction in both gross and net government debt, and large effects on deficits coming from the previously non-existent items net seigniorage and net new treasury credit. To evaluate the desirability of such a development, it is critical to study its implications for interest rates and for different types of distortionary taxation, the latter starting from levels that are consistent with the data. The government spending to GDP ratio is set to its approximate historical average of 18% of GDP. Tax rates on labor, capital and consumption are fixed to reproduce the historical ratios of the respective tax revenues to GDP, which are 17.6% for labor income taxes, 3.2% for capital income taxes, and 4.6% for consumption taxes. The implied initial steady state tax rates are  $\tau_L = 0.317$ ,  $\tau_k = 0.259$  and  $\tau_c = 0.073$ . The implied steady state value for  $\tau_{ls}$  is a lump-sum transfer to households of 6.6% of GDP, of which constrained households are assumed to receive 95% by setting  $f_{cc} = 0.95$ . The calibrated value for the government debt-to-GDP ratio, at 80%, is based on the most recent available data. The elasticity of the real interest rate with respect to the level of government debt is calibrated at 3 basis points for each percentage point increase in the government debt-to-GDP ratio. This is consistent with the empirical estimates reported in Laubach (2009), Engen and Hubbard (2004) and Gale and Orszag (2004). Fiscal policy can be characterized by the degree to which automatic stabilizers work, in other words by the size of  $d^{gdp}$ . This has been quantified by the OECD (Girouard and André (2005)), whose estimate for the United States is  $d^{gdp} = 0.34$ . We adopt this for the business cycle comparison of the pre-transition and post-transition economies, but for the illustration of the transition dynamics without business cycle shocks we simplify by assuming a balanced budget rule with  $d^{gdp} = 0$ .<sup>62</sup> All three distortionary tax rates are assumed to move in proportion. We assume a conventional calibration of the monetary policy rule, similar to what has for example been used in the Federal Reserve's SIGMA model, by setting  $m_i = 0.7$  and  $m_\pi = 2.0$ . For the prudential rule, we set  $p_\ell = 0$  except for one of the simulations of business cycle shocks in the post-transition economy.

In household preferences, all parameters except for the discount factors are identical across unconstrained and constrained households. We set the labor supply elasticity  $1/\eta$  to one, a common choice in the business cycle literature. The degree of habit persistence is  $v = 0.7$ .

For banks, the parameter  $\bar{\gamma}$  determining the Basel minimum capital adequacy ratio is set to 8% of risk-weighted assets, as under both the Basel-II and the new Basel-III regulations.<sup>63</sup> Both Basel-II and -III regulations feature a 35% risk weight for residential property and a 100% risk weight for commercial real estate. We therefore set the parameter  $\zeta$ , which represents the risk weight for mortgages in the model, to an intermediate value of  $\zeta = 0.5$ . Other parameters are calibrated to be consistent with the assumption that banks maintain an average actual capital adequacy ratio of 10.5%, which

<sup>62</sup>The effects of this simplification on the results are minor.

<sup>63</sup>Details on the Basel III regulations are available at <http://www.bis.org/bcbs/basel3.htm>.



means that they maintain a buffer of 2.5%, as envisaged under Basel-III. The percentage of banks violating the minimum capital adequacy ratio is set to 2.5% of all banks per quarter.

Our calibration of the interest rate margin between the policy rate  $i_t$  and banks' deposit rate  $i_{d,t}$  is based on Ashcraft and Steindel (2008), who find a margin of 1.34%, in 2006, between the average rate of commercial banks' portfolio of treasury and agency securities on the one hand, and their overall portfolio of liabilities on the other hand. We have repeated their computations for a longer time span, and found similar spreads in the 1990s and more recently, but lower spreads from 2001-2004. During that period the policy rate was lowered to unprecedented levels while interest rates on bank liabilities, of which a significant portion is of longer duration, did not drop to the same extent. This in fact suggests that during times of steady policy rates the margin of Ashcraft and Steindel (2008) may be biased downwards because banks' portfolio of liabilities has a longer average duration, and thus a larger term premium, than their portfolio of government securities. On the other hand, our paper uses a broader concept of deposit-like liabilities than Ashcraft and Steindel (2008), who focus only on commercial banks, while we include all financial institutions that offer liquid liabilities, including the shadow banking system. The liabilities of non-bank financial institutions are less liquid on average than those of commercial banks, and therefore need to offer a larger interest rate. Our compromise calibration is to choose a steady state interest rate margin between  $i_t$  and  $i_{d,t}$  of 1%. Finally, the steady state interest rate margin between the deposit rate  $i_{d,t}$  and the rate that banks would charge on riskless private loans  $i_{\ell,t}$  is fixed at 1.5% per annum in steady state.<sup>64</sup> This means that the margin of the riskless private lending rate over the policy rate is 0.5%, which is roughly equal to the historical spread of the 3-month US\$ LIBOR over the 3-month treasury bill rate. The implied value for penalty costs  $\chi$  equals around 0.7% of the value of assets. This is not an unrealistically large number, because it only applies to the small fraction of banks that do violate the minimum capital adequacy requirement in any given period. As a fraction of the value of total assets of the banking system the penalty only equals 0.02% per period in steady state.

The overall size of the financial system's balance sheet is calibrated at 200% of GDP, with liabilities at 184.25% of GDP and bank equity at 15.75% of GDP. The figure for liabilities is a compromise, in that it exceeds the 100% of GDP reported for 2006 by the Federal Financial Institutions Examination Council (2007), while it is well below the almost 350% of GDP reported for safe or information-insensitive financial assets by Gorton et al. (2012). Federal Financial Institutions Examination Council (2007) includes U.S. commercial banks, U.S. branches and agencies of foreign banks, thrift institutions, and credit unions, but it excludes the shadow banking system, while Gorton et al. (2012) include shadow banks. Similar numbers to Gorton et al. (2012) are provided by Pozsar et al. (2010), who use the Flow of Funds database to show that, just prior to the onset of the 2007 crisis, total liabilities of the U.S. commercial banking sector equalled around 100% of GDP, while the size of the shadow banking sector was around 150% of GDP, and despite a large subsequent contraction it still exceeded the size of the commercial banking sector in 2010. Gorton (2010) emphasizes that a key component of the shadow banking system is the repo market, but that its size is very hard to estimate reliably due to a lack of

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<sup>64</sup>While in the model no borrower is charged the rate  $i_{\ell,t}$ , it is important as the base lending rate to which different risk-based spreads are added.

comprehensive data coverage. Nevertheless, available estimates for the most recent period range between U.S.\$ 10 trillion (gross) according to Hördahl and King (2008) and U.S.\$ 12 trillion according to Gorton (2010). Our reason for including at least a conservative estimate of the liabilities of the shadow banking system is that these liabilities perform money-like functions that must not be omitted from a model of the modern U.S. financial system. This is also emphasized by Gorton et al. (2012), who describe the functions of safe or information-insensitive financial sector liabilities as follows: “To the extent that debt is information-insensitive, it can be used efficiently as collateral in financial transactions, a role in finance that is analogous to the role of money in commerce.” A large share, and perhaps by now the majority, of financial system debt can therefore command an interest rate discount below the policy rate by yielding these financial, rather than purely goods market, transactions services. Because, in terms of our model, the full menu of safe assets considered by Gorton et al. (2012)<sup>65</sup>, and also by Pozsar et al. (2010), includes items not always intermediated by the financial system (e.g. treasuries) and items that would represent double-counting in a model with a single aggregated banking system (e.g. interbank loans), we adopt the compromise calibration of approximately 185% of GDP<sup>66</sup>, with a total balance sheet size of 200% of GDP.

This figure also turns out to be approximately consistent with Flow of Funds information on the size of borrowing exposures of the U.S. corporate and household sectors. Just before the onset of the recent crisis, the total amount of credit market debt outstanding for non-financial businesses reached 80% of GDP. Ueda and Brooks (2011) show that around 20%-25% of this was short-term debt with a maturity of up to one year. We therefore set the steady state values of short-term or working capital loans  $\check{\ell}_t^m$  equal to 20% of GDP.<sup>67</sup> We allocate the remaining 60% of GDP to long-term or investment loans  $\check{\ell}_t^k$ . Similarly, just prior to the crisis the ratio of residential mortgages to GDP reached around 80% of GDP. Our model does not feature housing investment, but rather a fixed factor referred to as land. A significant portion of housing investment does of course represent the acquisition of the underlying land, and a significant portion of the remainder represents purchases of pre-existing houses where additional investment is only a minor consideration. We find that very important insights can be gained by representing such investment as investment in a fixed factor. On the other hand, housing construction does of course play an important role, and in fact in the official U.S. statistics it is included as part of private investment. Out of the stock of residential mortgages, we therefore allocate one quarter or 20% of GDP to  $\check{\ell}_t^k$ , to represent the housing component of investment loans, taking the total to 80% of GDP. We allocate the remaining 60% of GDP to mortgage loans  $\check{\ell}_t^a$ . The Flow of Funds data show that short-term consumer loans reached just under 20% of GDP prior to the onset of the crisis, and we therefore set  $\check{\ell}_t^c$  to equal 20% of GDP in steady state.<sup>68</sup> Finally, the financial system also holds significant amounts

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<sup>65</sup>The asset categories included in safe assets by Gorton et al. (2012), who use the Federal Reserve’s Flow of Funds database, include bank deposits, money market mutual fund shares, commercial paper, federal funds, repurchase agreements, short-term interbank loans, treasuries, agency debt, municipal bonds, securitized debt and high-grade financial sector corporate debt.

<sup>66</sup>Primarily due to the inclusion of the shadow banking system, this figure is much larger than traditional measures of the money supply such as M2, MZM or M3 (discontinued in 2006), with even M3 only reaching around 80 percent of GDP in 2006.

<sup>67</sup>Bates et al. (2008) show that, as in our model, nonfinancial firms simultaneously borrow and hold large amounts of cash, reaching a cash-to-assets ratio of 23.2% in 2006.

<sup>68</sup>Laibson et al. (2001) mention that, as in our model, typical U.S. households simultaneously borrow and

of government debt, but, unlike at the time of the Chicago Plan in the 1930s, the majority of U.S. government debt is nowadays held outside the banking system. We therefore calibrate the model so that the domestic financial system holds, and therefore intermediates, government debt equal to 20% of steady state GDP. This is equal to around 25% of total outstanding marketable debt.

The composition of the liability side of various borrowers' balance sheets is mainly determined by our assumptions about their leverage, on which we comment next. Ueda and Brooks (2011) contain information on the leverage or debt-to-equity ratio of all listed U.S. companies. For the overall non-financials group this has fluctuated around 140% since the early 1990s, while for the core manufacturing and services sectors it has fluctuated around 110%. Leverage for unlisted companies is likely to have been lower on average due to more constrained access to external financing. We therefore choose a steady state leverage ratio of 100% for both working capital loans and investment loans. For consumer loans, data are not readily available to make a similar determination. We fix leverage for these loans at the same 100% level as for working capital loans. For mortgages we use data from the Flow of Funds and Fannie Mae to decompose the total value of the U.S. housing stock into its equity and mortgage-debt components. We then deduct one third of the value of the housing stock from the equity component, to account for the fact that one third of U.S. residential property is owned free and clear, based on the 2005 U.S. census.<sup>69</sup> In our model this mortgage-free component of the housing stock is owned by unconstrained households, and therefore needs to be removed in computing the leverage of constrained households. The ratio of mortgages to the remaining equity equalled around 200% in the two decades prior to the crisis (since then it has risen dramatically), and we use this to calibrate our steady state.

Steady state interest rate spreads over the policy rate  $i_t$  are computed from average margins between different corporate and household borrowing rates over 3-month U.S. treasury bill rates. Ashcraft and Steindel (2008) compute, for 2006, a 2% spread for real estate loans, a 3% spread for commercial and industrial loans, and a 5% spread for credit card and other consumption loans. We therefore fix the following steady state spreads: 2% for mortgage loans, 5% for consumer loans, 3% for working capital loans, and 1.5% for investment loans. Only the latter deviates from Ashcraft and Steindel (2008), principally because these authors only consider the commercial banking sector, while long-term corporate funding, to the extent that it does not come directly from capital markets, comes to a significant extent from the shadow banking system where spreads tend to be lower. For example, in the commercial paper market average spreads prior to the crisis averaged less than 0.5%.

We calibrate additional parameters by fixing steady state loan default rates at levels that are consistent with the data. Ueda and Brooks (2011) show that the default rate for non-financial listed U.S. companies has averaged around 1.5% since the early 1990s. Default rates for smaller, non-listed companies are known to be higher. We therefore set the steady state default rate for investment loans to 1.5% of all firms per period, and the default rate for working capital loans to 3%. As for household loans, the average personal bankruptcy rate has been just under 1% over the last two decades. But, as discussed in

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hold cash balances.

<sup>69</sup>This information is available at <http://www.census.gov/hhes/www/housing/ahs/ahs05/tab3-15.pdf>.

White (1998), only a fraction of households who default file for bankruptcy, even though in her estimation 15% of households would benefit financially from doing so. For banks it is often more cost-efficient to simply write off the debt, especially for smaller personal loans. And even for mortgage loans, lenders may be willing to incur significant costs in restructuring the loan before forcing the borrower to resort to the protection of bankruptcy. In our model such plans and associated costs, and not only outright bankruptcy, do represent default events. We therefore fix the steady default rate on mortgages at 2.5%, and on short-term household loans at 4%. These high rates can also be justified by appealing to the U.S. credit score distribution and associated delinquency rates, where delinquency is a 90+ days late payment on any type of debt. In the United States, 15% of households fall into a score range that exhibits a delinquency rate of 50% or more, and another 12% into a range that exhibits a delinquency rate of around one third.

The interest semi-elasticity of money demand is the percent change in money demand in response to a one percentage point increase in the opportunity cost of holding money. Traditional empirical studies have estimated money demand equations separately rather than as part of an overall general equilibrium model, and have found interest semi-elasticities of -0.05 (Ball (2001)) or even lower (Ireland (2007), O'Brien (2000)). We find that when such elasticities are adopted for a general equilibrium model where money is a very broad aggregate representing all transactions-related (goods *and* financial markets transactions) liabilities of the financial system, the implications are highly counterfactual. Specifically, a bank lending boom triggered by greater optimism about the creditworthiness of borrowers raises the volume of lending and therefore of deposits. However, despite the fact that lending spreads over the deposit rate fall, with a low interest semi-elasticity the overall cost of lending would rise dramatically, because the increase in deposits would require a much larger increase of deposit interest rates relative to the policy rate. This has not been a feature of interest rate data during lending booms. To the contrary, the data suggest that the marginal depositor is willing to increase his holdings of deposits with little increase in deposit rates relative to policy rates. In other words, the marginal depositor's money demand exhibits a high interest semi-elasticity. We accommodate this by assuming that unconstrained households have an interest semi-elasticity of -1.00. Their money demand can be thought of as representing the demand for liquidity in financial transactions stressed in the recent literature. On the other hand, the money demand of constrained households and of manufacturers represents a more traditional demand for goods and factor market transactions, and for this group we therefore adopt the conventional semi-elasticity of -0.05.

The combination of the above assumptions about capital adequacy, interest margins, leverage and money demand implies the composition of the liability side of the financial system's balance sheet, with equity equal to 15.75% of GDP<sup>70</sup>, constrained households' and manufacturers' deposits each equal to 40% of GDP, and unconstrained households' deposits equal to 104.25% of GDP. The overall initial steady state balance sheet is shown as the leftmost of three balance sheets in Figure 3.

We now proceed to discuss the calibration of the post-transition economy that operates under the monetary arrangements of the Chicago Plan. Most importantly, we assume that

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<sup>70</sup>This is below the 21% suggested by a simple-minded application of the 10.5% steady state Basel ratio. The reason is the less than 100% risk weighting of government bonds and mortgages.

all the main structural parameters are identical to those of the pre-transition economy. The exceptions are mainly due to the fact that the size of post-transition balance sheets is very different. There are also some new policy parameters.

We start with the latter. The nominal growth rate of money  $\pi_m$  is set equal to the real growth rate of output  $x$ , which ensures zero inflation in steady state. The steady state net nominal interest rate paid on reserves is set equal to zero,  $\bar{i}_d = 1$ . The interest rate charged by the government on treasury loans to the banking system is set to ensure that banks' wholesale rate equals the rate on government bonds in steady state,  $\bar{i}_\ell = \bar{i}$ . The rates at which the deposit and treasury credit rates converge to their new steady state values during the transition period are determined by  $\rho_d = 0.25$  and  $\rho_f = 0.9$ . The steady state value of the gross government debt-to-GDP ratio is, following the permanent repayment of the government debt held by the banking system, reduced from 80% to 60%. The coefficient  $\vartheta$  that is used to determine the net government debt-to-GDP ratio, which in turn determines long-run equilibrium real interest rates, is set equal to  $\vartheta = 0.5$ . This takes into account the approximate ratio between the real interest cost on government bonds  $\check{b}_t^g$  and on treasury credit  $\check{f}_t$ . Specifically, steady state nominal (and real) interest rates in the Chicago Plan economy are 1.07% on government bonds, 0.49% on treasury credit, and 0% on deposits.

The monetary policy rule for the treasury credit rate is calibrated identically to the pre-transition rule for the policy rate,  $m_i = 0.7$  and  $m_\pi = 2.0$ . For the prudential rule, we set  $p_\ell = 0$  as in the pre-transition economy, but when discussing countercyclical policies we also consider an alternative calibration with  $p_\ell = 8$ .

Under our chosen money demand specification, it can be shown that the average interest semi-elasticity of money demand across unconstrained and constrained households in the pre-transition economy is equal to a simple weighted average of their individual semi-elasticities. We set the post-transition money demand coefficients of unconstrained households such that their interest semi-elasticity equals that pre-transition average.

Finally, the balance sheets of the financial sector and of manufacturers change dramatically following the stock transactions in the transition period. Our calibration ensures that investment trusts' steady state Basel ratio continues to equal 10.5%, and that the steady state leverage ratio of manufacturers remains at the 0% reached immediately after the debt repayment of the transition period.

## VII. Transition to the Chicago Plan

In this section we study the response of the model economy to the implementation of the Chicago Plan, including its effects in the single implementation period itself, and the subsequent adjustment towards a new steady state. This will allow us to study all but the first claim of Irving Fisher (1936) mentioned in the abstract and in Section I. The first claim relates to the business cycle properties of the model, and is studied in the next section.

Figure 3 shows bank balance sheets in the transition period. It repeats Figure 1, which is discussed in Section I, but contains more details concerning the composition of loans and

deposits. For continuity with the subsequent discussion, we repeat here the main points made in our discussion of Figure 1. The figure breaks the transition into two separate stages. First, the original balance sheet remains unchanged but banks have to borrow from the treasury to procure the reserves necessary to fully back their deposits. As a result both treasury credit and reserves increase by 184.25% of GDP. Second, the principal of all of banks' original loans to the government and the private sector, except investment loans, is cancelled against treasury credit, either directly, in the case of government debt, or indirectly through the citizens' dividend. Furthermore, banks pay out part of their equity to keep their net worth in line with the now much reduced capital adequacy requirements. The balance sheets on the right of Figure 3 show that the overall volume of deposits only drops very slightly, with a drop in household deposits nearly matched by an increase in manufacturer deposits. The split into two balance sheets represents the now strict separation between the monetary and credit functions of the banking system, between deposit banks and credit investment trusts. The credit function consists only of investment loans, which are financed by a reduced level of equity and by what is left of treasury credit after the repayments of other debts. The slight increase in investment loans reflects the beginning of a sustained increase in investment as the economy starts to move towards a new steady state.

Figure 4 shows the full dynamic adjustment of financial sector balance sheets to the Chicago Plan over the first 60 quarters. In this and all subsequent figures the dotted lines, which jump in the transition period, represent the pre- and post-transition steady states of the model, while the solid lines represent the dynamic adjustment paths. Loans to the private sector and to the government drop by 100% and 20% of GDP on impact, with bank net worth dropping by around 7% of GDP, and treasury credit rising from zero to initially just over 70% of GDP, to replace deposits and the paid-out equity as the funding source for investment loans. Investment loans subsequently increase by almost 20% of GDP, but due to the assumed very slow reduction of the cost of treasury credit this adjustment happens very gradually, and therefore does not lead to excessive short-run volatility. It is accompanied by an equally gradual increase in investment trust net worth that keeps the capital adequacy ratio within a fairly narrow range. The volume of household deposits falls, due to a slightly larger spread between bond and deposit rates, while manufacturers' deposits increase due to growing economic activity, with an overall long-run decline in deposits of around 4% of GDP. Reserves rise from zero to around 180% of GDP to back this level of deposits. The riskiness of financial institutions drops dramatically, with the share of investment trusts violating the MCAR dropping from 2.5% to around 0.8% per period. Finally, monitoring costs as a share of GDP drop from 2.0% to 0.7%. In the pre-transition economy extensive monitoring is required to facilitate the private creation of the economy's money stock at an acceptable risk to banks. When this is replaced by debt-free government money creation, a large share of these monitoring costs, which are costly both because they use significant real resources and because they lead to higher equilibrium real interest rates, becomes unnecessary. The only exception is the monitoring of productive investment projects, which represents a core function of the remaining financial system.

Figure 5 shows the macroeconomic effects of the balance sheet changes illustrated in Figure 4. The post-transition economy exhibits a very large output gain that eventually approaches 10% for GDP. This is mainly driven by a 27% increase in investment, and

accompanied by an eventually almost 5% increase in consumption. Over the first few years however consumption drops, because the very rapid increase in investment initially crowds out some consumption. The reason for the large output gain is a combination of lower real interest rates, lower distortionary taxes and lower monitoring costs. The latter has already been discussed, while the other two are illustrated in Figure 5.

The balance sheet changes in Figure 4 cause major drops in equilibrium real interest rates. Gross government debt drops from 80% to 60% of GDP, and with treasury credit jumping to around 70% of GDP on impact, and to 90% of GDP eventually, unadjusted net government debt immediately, and then increasingly, turns negative. But it is the adjusted net government debt  $b_{net,t}^{rat}$  that determines investors' desired real interest rates. Because this net debt applies a weight of  $\vartheta = 0.5$  to treasury credit, it drops from 80% of GDP to an eventually very much lower but still positive 16% of GDP. The consequence is a gradual 1.93% per annum reduction in real bond and deposit rates, with an additional 3% per annum reduction in the corresponding nominal rates due to the elimination of steady state inflation. The reduction in the nominal deposit rate is allowed to happen almost instantaneously, while the nominal treasury credit rate, which is shown in Figure 5 relative to the initial nominal deposit rate, is only allowed to fall very gradually. This cautious credit policy is desirable because of its effects on the dynamics of investment. An investment boom begins immediately upon the implementation of the Chicago Plan, due to much lower distortionary tax rates, most importantly capital income tax rates, made possible by the favorable fiscal effects of the plan (see below). An initial slight increase in the treasury credit rate, and therefore in the real lending rate on investment loans, followed by a gradual rate reduction, insures that this boom does not become too rapid and destabilizing. The extent of the ultimate drop in the treasury credit rate is determined by the government's objective to equalize the real wholesale rate and the real government bond rate. This requires an eventual drop in the real treasury credit rate of 1.51% per annum, to 0.49% per annum, which compares to a 2% per annum drop, to 0%, in the real deposit rate. Real wholesale lending rates eventually drop even further than bond and deposit rates, by 2.43% per annum. Retail real rates on investment loans on the other hand drop somewhat less, by 1.64% per annum, because corporate leverage increases in the new steady state, which calls for a higher external finance premium.

Figure 5 also illustrates the third reason for the output gains under the Chicago Plan, very large drops in distortionary tax rates, by almost 5 percentage points for the labor income tax rate, 4 percentage points for the capital income tax rate, and just over one percentage point for the consumption tax rate. The explanation requires a detailed analysis of the budgetary implications of the Chicago Plan.

Figure 6 illustrates the dramatic beneficial effect of the Chicago Plan on government finances.<sup>71</sup> Debt service, that is net nominal interest charges on government debt, drops by 4.2% of GDP. Only the smaller part of this is due to the 20 percentage point reduction in government debt, while the major part is due to a large drop in nominal interest rates from 6% per annum pre-transition to just over 1% per annum post-transition. More than half of this is in turn due to the 3% per annum reduction in inflation, with the remainder due to much lower real interest rates. The reduction in inflation is the main reason why

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<sup>71</sup>Several subplots of Figure 6 show a gap in the transition period. This concerns all flow variables that represent changes in financial stocks, given that the latter exhibit large jumps in the transition period. Showing these values in the transition period would render the remaining values unreadable.

the government is able to reduce its deficit ratio by 2.8% of GDP.<sup>72</sup> The reduction in real interest rates on the gross debt is sufficient to finance the government's issuance of net new treasury credit, which requires an ongoing budgetary expenditure of 1.3% of GDP because the 0.49% steady state real interest rate on treasury credit is below the economy's 2% growth rate. The two main remaining budget items, seigniorage and tax revenue, are equal but of opposite sign. Government issuance of a large stock of reserves allows it to collect flow seigniorage equal to 3.6% of GDP. This number is so large not because of an inflation tax, because inflation is zero in steady state. Rather, its size is due to the large size of the stock of reserves at over 180% of GDP, combined with the fact that 2% per annum economic growth exceeds the zero nominal and real rate paid on reserves.<sup>73</sup> The government is assumed to use this new source of revenue to finance a reduction in distortionary taxes equal to 3.6% of GDP. This is the reason for the above-mentioned drops in tax rates. It should be added that other ways of spending the additional seigniorage revenue could be considered, including spending on public infrastructure. Finally, government spending remains constant as a share of GDP, while transfers are kept constant in real terms and therefore decline by 0.6 percentage points relative to GDP.

We conclude that Fisher's (1936) claims (2) through (4) regarding the Chicago Plan, as listed in the abstract of this paper, are validated by our model:

First, bank runs can obviously be completely eliminated. Solvency considerations are no longer an issue in the safety of bank deposits, because money is now debt-free and "indestructible". A run on credit investment trusts is impossible to the extent that they are either financed by equity, or issue debt liabilities that are held by the government. A run on private-debt-financed investment trusts can be prevented through the regulations that we discussed above. Note however that even if a run on a debt-financed investment trust were to occur, this would have no implications whatsoever for the money supply and thus for the safety of the payments system.

Second, government debt net of treasury credit goes from being highly positive to highly negative if unadjusted for the real interest burden, and to a positive but much smaller fraction of GDP if adjusted for that burden. The large new stock of government-issued money is irredeemable, and represents equity in the commonwealth rather than debt.

Third, private debts can be dramatically reduced, because money creation no longer requires simultaneous debt creation. In principle, net private debts in our model could be reduced to almost zero if the government were to also repay investment loans through an even larger citizens' dividend. But the monitoring of industrial projects is a core and highly useful function of financial institutions in which they should continue to be involved, even though some authors, like Simons (1946), might argue that this could best be accomplished by equity-funded rather than debt-funded institutions. However, most other pre-transition lending activities of banks in our model served the main purpose of mortgaging various types of assets in order to be able to create a debt-based money supply at an acceptable risk to banks. This is not necessary, because providing a money

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<sup>72</sup>This follows mechanically from the fact that the factor of proportionality between long-run deficit- and debt-to-GDP ratios is the steady state nominal growth rate.

<sup>73</sup>A small positive steady state inflation rate, even if considered acceptable for non-budgetary purposes, would not generate additional fiscal revenue. In fact, due to the high interest elasticity of money demand at the margin, it would reduce seigniorage income unless the interest rate on deposits is raised accordingly.



supply does not need to involve risk. It can instead be done by the sovereign, debt-free, at much lower cost.

By validating these claims in a rigorous, microfounded model, we were able to establish that the advantages of the Chicago Plan go even beyond those identified by Fisher (1936). First, output gains are very large, approaching ten percent, due to a combination of lower real interest rates, lower distortionary tax rates, and lower monitoring costs in the financial system. Second, the model provides a compelling answer to those who claim that giving the government the power to issue such a large stock of money would be highly inflationary. The opposite is true. Not only does Fisher’s proposal not imply any initial increase in the stock of money held by the private sector, and therefore by construction no increase in initial nominal spending power and thus in inflation, but furthermore it allows the government to achieve much lower steady state inflation without any risk of falling into a liquidity trap, because the government controls a policy rate that is not subject to a zero lower bound.

## VIII. Credit Booms and Busts Pre-Transition and Post-Transition

Figure 7 illustrates how the pre-transition and post-transition monetary regimes cope with a credit boom-and-bust cycle driven by volatile financial sector sentiment concerning borrower risk. Specifically, we construct a standardized experiment whereby lenders receive a succession of “good news” shocks  $\varepsilon_t^{news}$  such that the standard deviation of the riskiness of all their borrowers falls gradually and cumulatively by 60% by the end of quarter 12. For the post-transition economy this only concerns  $\sigma_t^k$ , the riskiness of investment loans, while for the pre-transition economy we assume that all four standard deviations are reduced by a common factor. This shock leads to a very large three-year expansion in credit. We assume that in quarter 13 lenders suddenly reverse their assessment of borrower riskiness. They not only start to completely discount the “news” previously revealed, which otherwise would have continued to support strong lending until petering out after another 12 quarters, but they also now perceive an additional adverse autocorrelated shock to borrower riskiness  $\varepsilon_t^{z2}$ . The net effect is to make borrower riskiness jump from 40% of its steady state value to 125% of its steady state value in period 13, after which it gradually reverts back to its steady state value. This simulation, which uses borrower riskiness shocks in a very similar way to Christiano et al. (2011) and Christiano et al. (2010), captures a highly realistic phenomenon that has been repeatedly observed throughout history, as detailed in Section III. In a credit boom, financial institutions tend to compete with each other in providing easy credit and discounting lending risk, and the availability of credit and associated economic expansion create the very conditions that make optimism about borrower riskiness look justified. But there comes a point where the debt burdens of borrowers have become so widespread and so large that nervousness sets in about their ability to repay. At that point the perception of borrower riskiness can suddenly turn, and again this sharp contraction of credit creates the very conditions that justify the pessimism. This sudden change in the perception of borrower riskiness is the model’s simplified way of capturing the economy’s “Minsky moment” (Minsky (1986)).

But different monetary regimes cope with this shock in very different ways. The solid line in Figure 7 shows the response of the pre-transition economy. Bank loans grow very strongly over the initial boom period, by over 50% of GDP, and banks create the corresponding bank deposits to “fund” the additional lending. A decomposition shows that about 70% of the additional lending is due to higher mortgage loans, while the remaining three loan types account for approximately another 10% each. The reason why mortgages grow so strongly is the fact that the asset securing the loan is neither limited by the amount of the loan itself, as is the case for consumer and working capital loans that are backed by credit-based money, nor does the asset have to be produced first, subject to adjustment costs, as for investment loans. Rather, land already exists in unencumbered form on the balance sheet of unconstrained households, and easier credit terms simply enable constrained households to purchase this land from them, on credit created by banks against the security of that land. Unconstrained households instantaneously exchange their land against the additional bank deposits, while constrained households end up with additional land, of which they initially held a lower amount due to their borrowing constraint. Unconstrained households end up awash with liquidity, and therefore increase their consumption. This is the main reason why both consumption and investment increase strongly under the pre-transition monetary regime. But deposits increase more generally across the economy, albeit by smaller amounts than for unconstrained households, because the lending expansion across all borrower classes creates large amounts of additional money. During this boom phase investment grows by 2.5% relative to its trend, while consumption grows by 1.5%, with GDP ending up just under 2% higher at the end of quarter 12. At the peak of the boom the inflation rate exceeds its target by over 3% per annum, and the real policy rate has risen by 2% per annum.

The first feature to note about the credit contraction at the end of the third year is its massive size, with bank loans dropping by almost 70% of GDP in a single quarter. This discontinuous credit contraction is a feature that pure “loanable funds” models of banking are entirely unable to deliver, because they model banks as intermediaries of slow-moving savings. On the other hand, with a model of banks as creators or destroyers of money this feature emerges naturally, because money creation or destruction can happen instantaneously.

Compared to the cumulative gains of the boom phase, the credit contraction has much larger negative effects on activity, with output dropping by over 5%, consumption by around 3%, and investment by well over 10%. The main reason for this is not that the shock to creditworthiness at that point is around 30% larger than the cumulative shock over the first three years. Rather, what matters is the suddenness of the reversal. Households have no choice but to respond to the sudden destruction of money with an equally sudden contraction in consumption. More importantly, banks make very large lending losses, with capital adequacy ratios dropping by well over 2 percentage points, and more than 20% of all banks violating the MCAR. This leads to an approximately 2% per annum increase in the wholesale real lending rate as banks try to rebuild their capital base, and to an even larger 5% per annum increase in the average real retail lending rate as banks require compensation for higher lending risk. This increase in lending rates across all borrower categories is the main reason why aggregate activity contracts, with investment being more seriously affected than consumption.

The dashed blue line in Figure 7 illustrates the response of the economy under the

Chicago Plan, under the assumption that the government pursues an interest rate rule for the treasury credit rate, but that it does not pursue quantitative lending guidance through countercyclical capital adequacy regulations. The first important observation is that the quantities of credit and money now evolve completely independently of each other. Because debt is now much less pervasive throughout the economy, and especially because loans that create money on the security of land or deposits are no longer observed, the increase in credit is now much smaller as a share of GDP. Investment loans do rise, and continue rising until well after the negative shock hits in period 13, because the capital stock that requires continued financing only declines gradually thereafter. Investment trust net worth declines immediately after the negative shock due to lending losses, as in the pre-transition economy. The fluctuations in GDP in this economy are almost identical to those in the pre-transition economy, but the underlying fluctuations in consumption and investment are different. Because only investment is now subject to borrower riskiness shocks, an increase in investment trusts' optimism now has much larger effects on investment, while consumption is not directly affected by increased lending, and is crowded out by higher investment. The treasury credit rate responds to higher inflation with a similar behavior to the policy rate in the pre-transition economy, but with a large swing during the credit bust that takes it well into negative territory, in real but especially in nominal terms. As emphasized above, under the Chicago Plan this does not need to be problematic because there is no zero lower bound for the policy rate. Nevertheless, despite these large swings in the treasury credit rate, the economy remains volatile. The much larger increase in the capital stock relative to its long-run equilibrium value under this scenario implies that the reversal of lending optimism has a larger effect on the valuation of capital, and therefore leads to larger losses at that time. As this impairs investment trusts' capital adequacy more severely, it leads to a larger spike in the wholesale rate, but the main effect is a much larger spike in the retail lending rate to compensate investment trusts for temporarily elevated credit risk. The highly volatile investment under this scenario would likely be considered undesirable by policymakers. A much more aggressive interest rate response would make nominal treasury credit rates far more volatile, which may also be undesirable. The problem is that an exclusively price-based credit policy still gives investment trusts a great deal of discretion to choose the overall volume of lending. To avoid this and stabilize the economy more effectively, policy needs to avail itself of an additional quantitative tool. This however is readily available.

The red dotted line in Figure 7 illustrates this possibility. The government is now assumed to pursue flexible quantitative lending guidance via countercyclical adjustments of minimum capital adequacy requirements for investment trusts.<sup>74</sup> As stressed in Section V.D.5, MCAR are a far more effective tool under the Chicago Plan, because the financial system is unable to create its own equity. In this simulation, investment trusts have to raise their capital adequacy ratio from 10.5% to around 15% during the boom, so that the wholesale lending rate, and thus also the retail lending rate, remains very much higher during that time. As a result the increase in investment is only one third as large, with a commensurate reduction in the fluctuations in consumption. At the time of the reversal in lending optimism this makes the economy far more resilient, first because capital investment funds are now much less exposed to a collapse in their asset values, and second because they are far more resilient by being able to respond to the shock by reducing their

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<sup>74</sup>The lending volume of the aforementioned privately-funded investment trusts, which are not part of the formal model, could also be regulated by countercyclical capital adequacy requirements.

capital adequacy ratio from a very comfortable level. As a result the spike in lending rates under this scenario is also much milder, and smaller than in the pre-transition environment, while the treasury credit rate can be far less volatile. Finally, the amplitude of GDP fluctuations throughout the entire boom-bust cycle is about half that under the other two scenarios.

We conclude that Fisher's claim (1) regarding the advantages of the Chicago Plan can also be validated, provided policy avails itself of the appropriate tools. What that means is that policy does not just use a countercyclical policy for the interest rate at which the treasury makes credit available to lenders, but also uses direct targets for the quantity of lending, to prevent excessive volatility in the quantity of investment projects approved by lenders.

## IX. Conclusion

This paper revisits the Chicago Plan, a proposal for fundamental monetary reform that was put forward by many leading U.S. economists at the height of the Great Depression. Fisher (1936), in his brilliant summary, claimed that the Chicago Plan had four major advantages, ranging from greater macroeconomic stability to much lower debt levels throughout the economy. In this paper we are able to rigorously evaluate his claims, by applying the recommendations of the Chicago Plan to a state-of-the-art monetary DSGE model that contains a fully microfounded and carefully calibrated model of the current U.S. financial system. The critical feature of this model is that under the current monetary system the economy's money supply is created by banks, through debt, rather than being created debt-free by the government.

Our analytical and simulation results fully validate Fisher's (1936) claims. The Chicago Plan could significantly reduce business cycle volatility caused by rapid changes in banks' attitudes towards credit risk, it would eliminate bank runs, and it would lead to an instantaneous and large reduction in the levels of both government and private debt. It would accomplish the latter by making government-issued money, which represents equity in the commonwealth rather than debt, the central liquid asset of the economy, while financial institutions concentrate on their strength, the extension of credit to investment projects that require monitoring and risk management expertise. We find that the advantages of the Chicago Plan go even beyond those claimed by Fisher. One additional advantage is large steady state output gains due to the removal or reduction of multiple distortions, including interest rate risk spreads, distortionary taxes, and costly monitoring of macroeconomically unnecessary credit risks. Another advantage is the ability to drive steady state inflation to zero in an environment where liquidity traps do not exist, and where a growth rule for the broad money supply becomes desirable because the government does in fact control broad monetary aggregates. This ability to generate and live with zero steady state inflation is an important result, because it answers the somewhat confused claim of opponents of an exclusive government monopoly on money issuance, namely that such a monetary system would be highly inflationary. There is nothing in our theoretical framework to support this claim. And as discussed in Section III, there is very little in the monetary history of ancient societies and Western nations to support it either.

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Figure 1. Changes in Financial Sector Balance Sheet in Transition Period (percent of GDP)

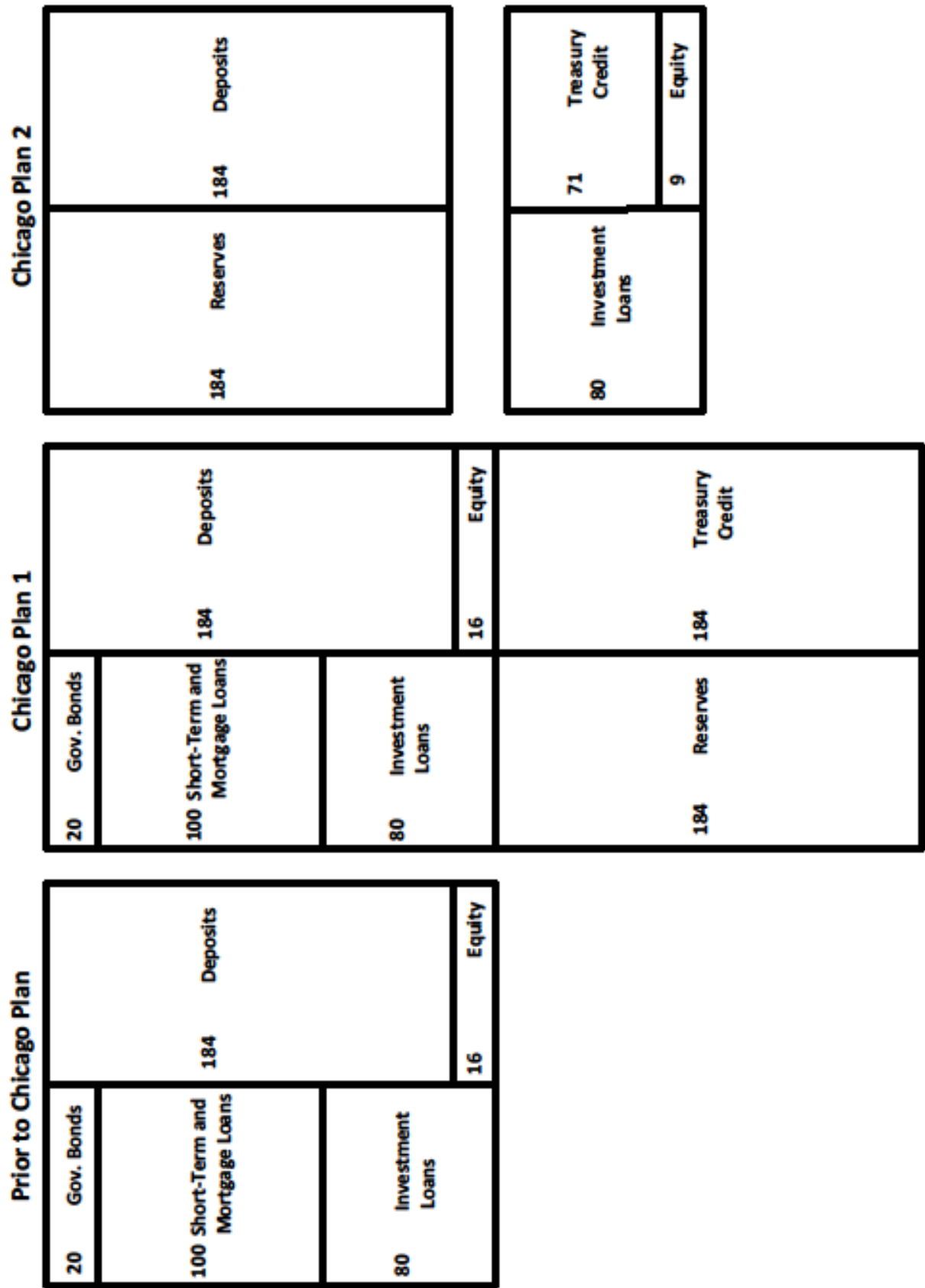


Figure 2. Changes in Government Balance Sheet in Transition Period (percent of GDP)

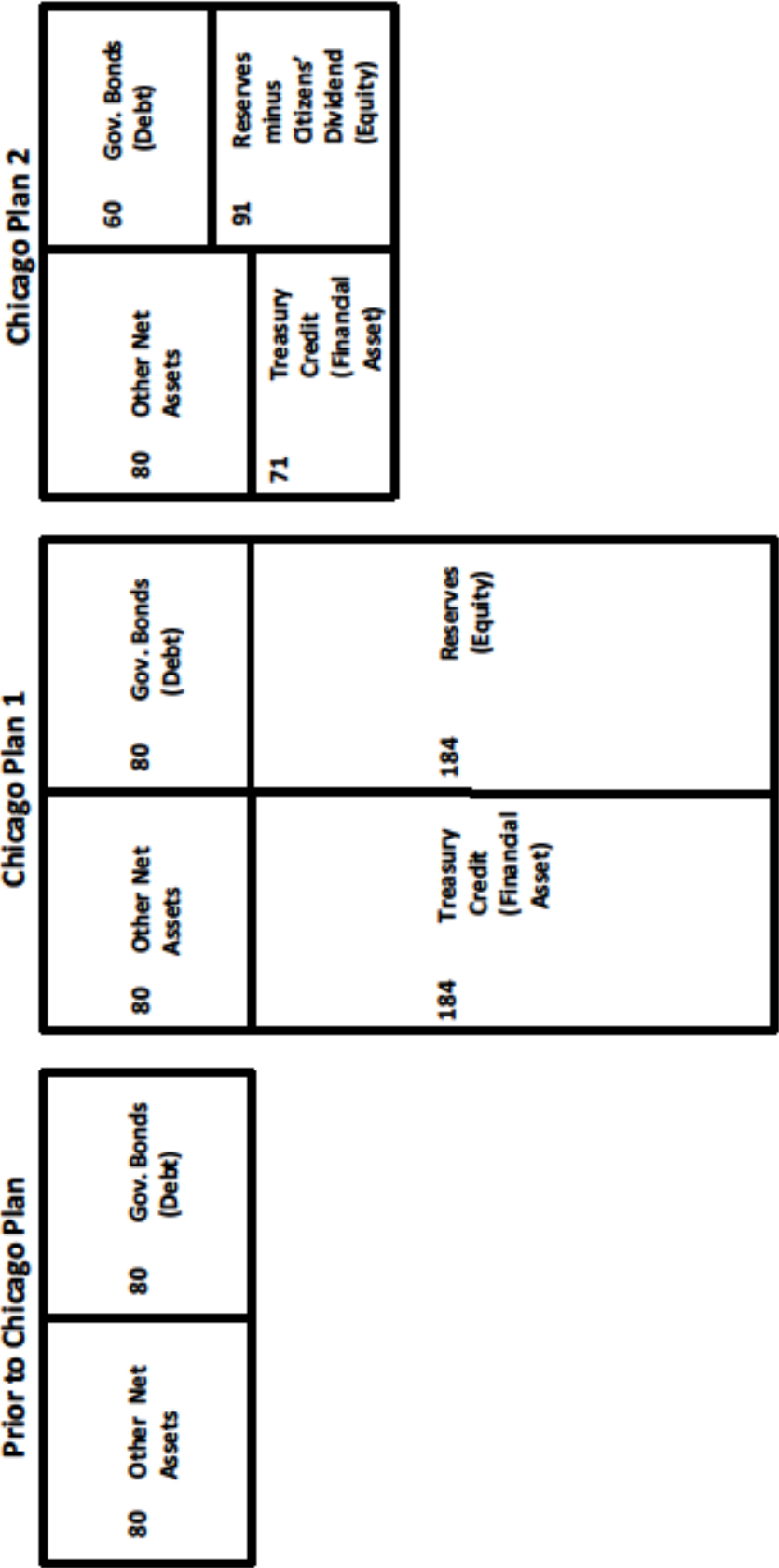
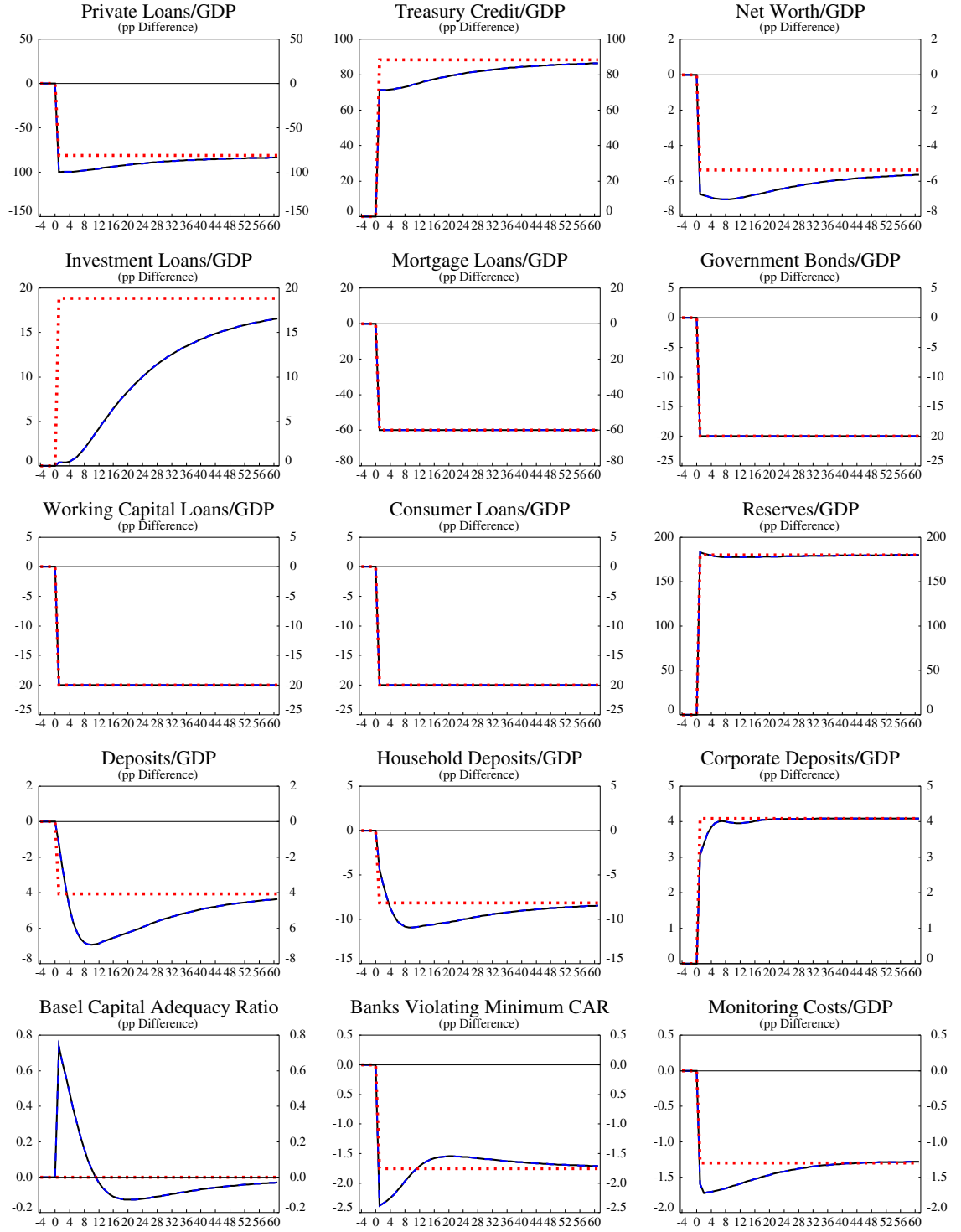




Figure 3. Changes in Financial Sector Balance Sheet - Details (percent of GDP)

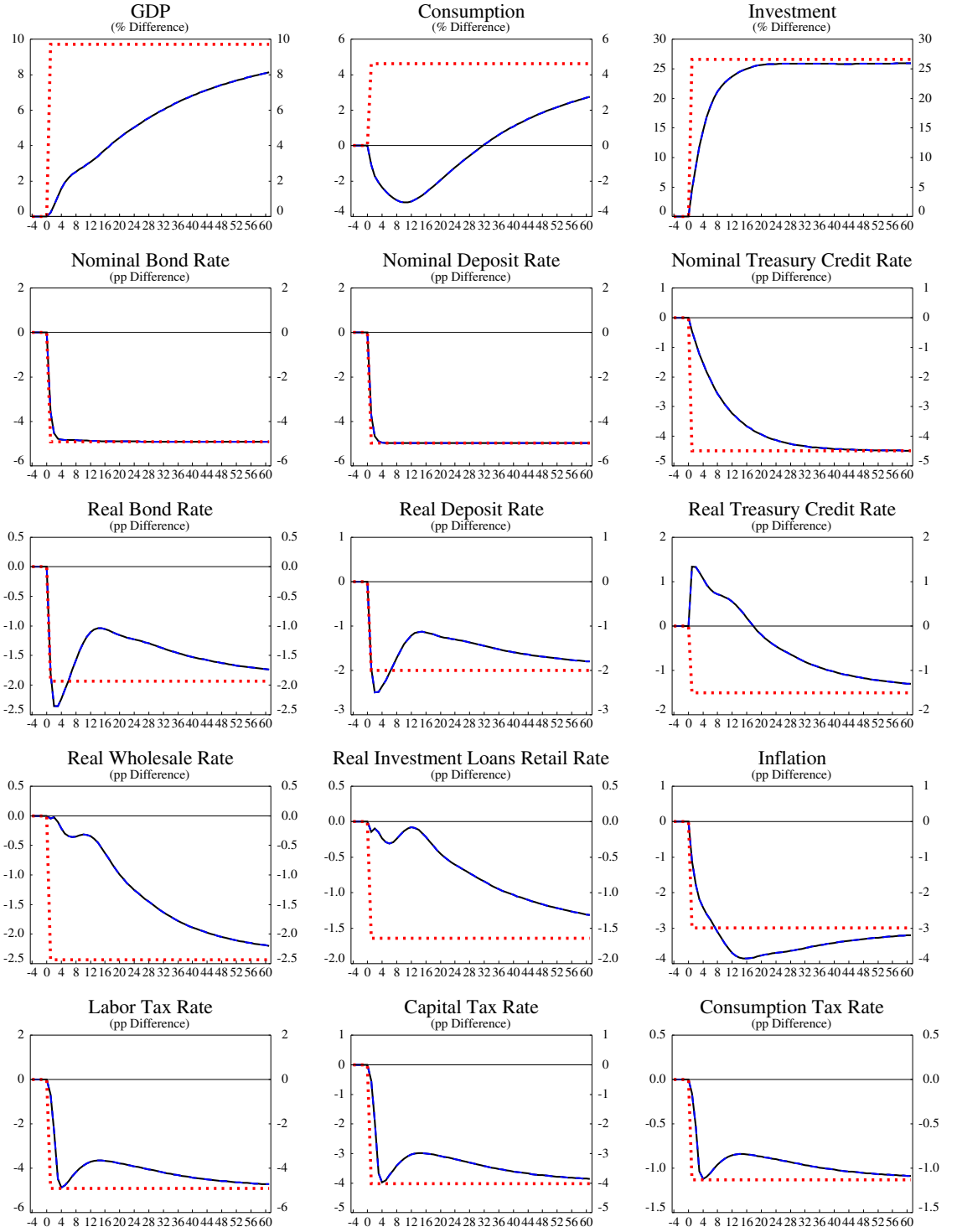
Pre-Transition				Post-Transition 1				Post-Transition 2			
20	W. Capital Loans	40	Manufacturer Deposits	20	W. Capital Loans	40	Manufacturer Deposits	183		43.1	Manufacturer Deposits
20	Consumer Loans			20	Consumer Loans						
20	Gov. Bonds	40	Constrained Household Deposits	20	Gov. Bonds	40	Constrained Household Deposits		Reserves		
60	Mortgage Loans			60	Mortgage Loans					139.9	Household Deposits
80	Investment Loans	104.25	Unconstr. Household Deposits	80	Investment Loans	104.25	Unconstr. Household Deposits				
		15.75	Equity			15.75	Equity	80.4	Investment Loans	71.3	Treasury Credit
				184.25	Reserves	184.25	Treasury Credit			9.1	Equity

Figure 4. Transition to Chicago Plan - Financial Sector Balance Sheets



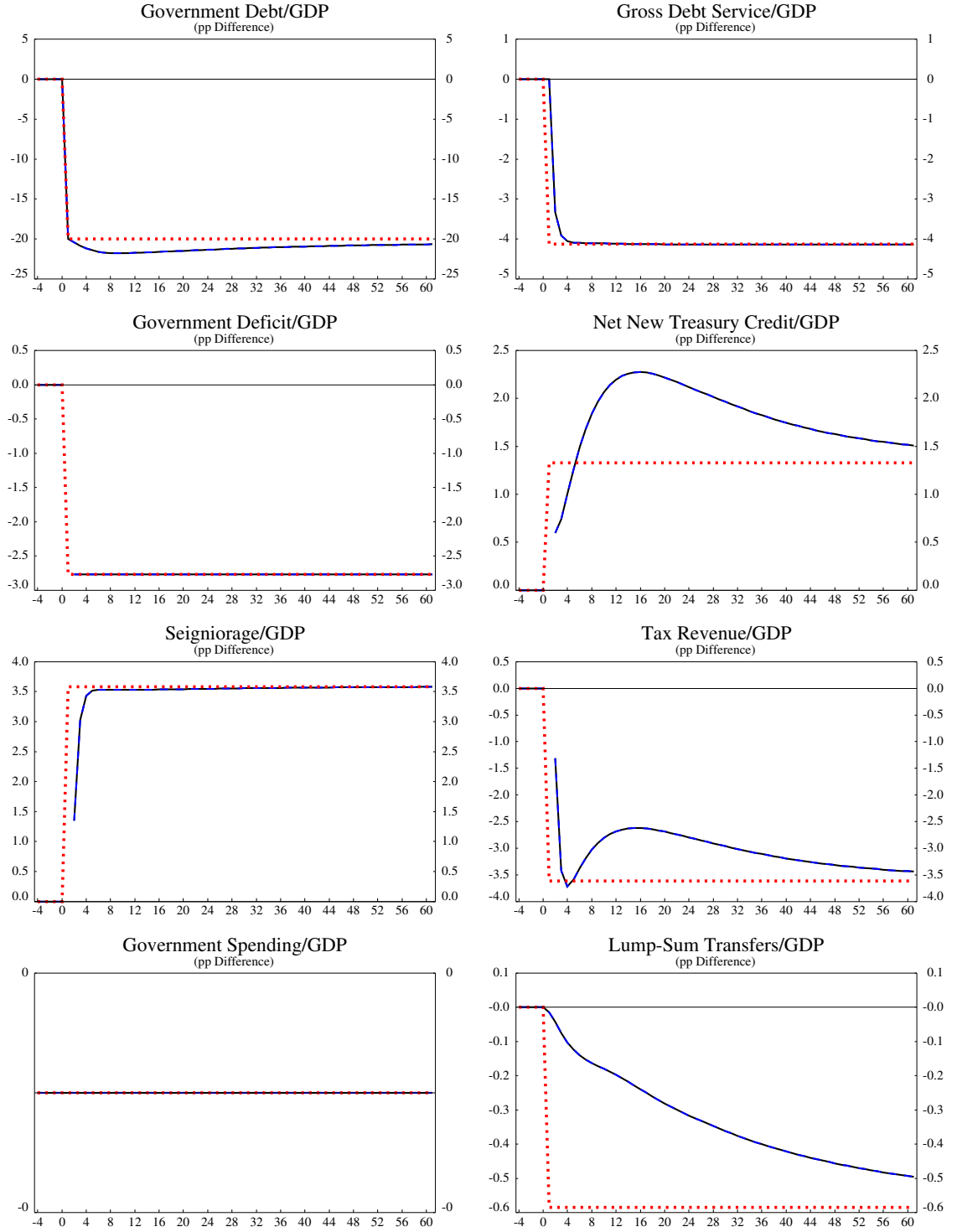
(\_\_\_ = transition path, - - - = final steady state)

Figure 5. Transition to Chicago Plan - Main Macroeconomic Variables



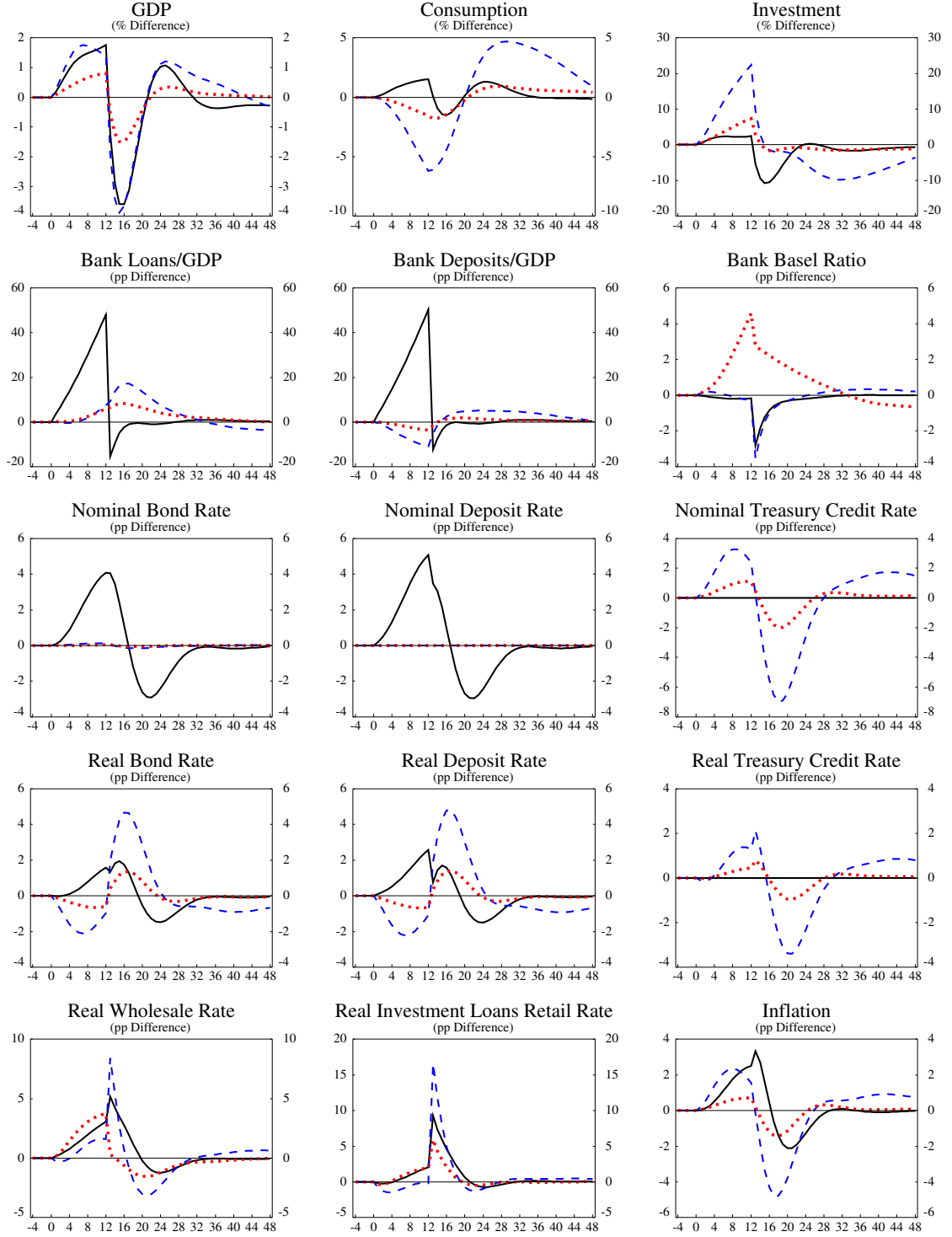
(\_\_\_ = transition path, - - - = final steady state)

Figure 6. Transition to Chicago Plan - Fiscal Variables



(\_\_\_ = transition path, --- = final steady state)

Figure 7. Business Cycle Properties Pre-Transition versus Post-Transition



\_\_\_ = Pre-Transition, --- = Post-Transition,  $p_\ell = 0$ , .... = Post-Transition,  $p_\ell = 8$