MINDS

A MINDS INITIATIVE WITH THE SUPPORT OF BNDES AND CAIXA ECONOMICA FEDERAL

The PRESENT and the FUTURE of Development Financial Institutions: A LEARNING DIALOGUE

BNDES The Brazilian development bank

Panel: Looking Ahead: Public financial institutions after the crisis: a new financial deal in the making?

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Organising Principle:
Schumpeter/Hahn/Minsky on Financing Development

"It would be quite mistaken to regard … the granting of bank credit without already existing commodities, as a deviation from sound banking principles… . Rather it is one of the most important functions of the banking business to do just this."
Schumpeter (1917)

"Credit is essentially the creation of purchasing power for the purpose of transferring it to the entrepreneur, but not simply the transfer of existing purchasing power," *Schumpeter (1934)*

In this View:
Investment is Limited by Bank Financing Not by Saving

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Quick Summary

- ✓ To "manufacture money" requires control of the payment system
  - ✓ We have a private deposit bank fetishism

- ✓ First Banks were PUBLIC
  - ✓ provided public means of payment
    - ✓ Monte
    - ✓ Giro Banks

- ✓ Note Issuing Private Banks came later
  - ✓ Bank of England (public charter)
- ✓ Private Deposit (Commercial) Banks even later

  - ✓ Notes and Deposits were Creative Destruction innovations of the payment system

- ✓ PRIVATE BANKS provide PRIVATE (risky) means of payment

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Prudential Regulation of Banks

- ✓ Prudential Regulation required because means of payment provided by private banks are subject to risk

- ✓ Regulation seeks to reduce that risk
  - ✓ Limiting loan portfolio to “Commercial Loans”
  - ✓ Collateral, work in process, circulating capital

- ✓ Financing Investment in Innovation is inherently risky

- ✓ The “Safer” the private financial system the less long-term, patient, financing it provides for Innovation
  - ✓ Narrow Banking: Banks only invest in Government Paper
  - ✓ Investment banks fund investment

- ✓ **Prudential Regulations Seeks to Restore the Savings Constraint on Investment**

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A private banking system cannot finance innovation without cycles

- ✓ Prudential regulation to eliminate instability eliminates financing for investment in Innovation
  - ✓ The problem comes from innovation in the private provision of Means of Payment
- ✓ Currently mobile payments systems and financing systems are proliferating
  - ✓ Pay Pal, Google Wallet, Square
  - ✓ P2P private lending networks:
  - ✓ Funding Circle, Lending Club
- ✓ The mobile payments systems and private and risky
- ✓ The P2P are saving constrained

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Payments System

- ✓ US supports multi-bank payments system
  - ✓ Fed imposed par clearance of checks in 1917
  - ✓ Managed by the Fed

- ✓ Who will do this for the mobile payments system?

- ✓ If it is to work, everyone has to on the same system
  - ✓ A single (monopoly) private system?
    - ✓ Potential for Fraud
  - ✓ Government would likely regulate or impose its own system

  - ✓ Which again would be limited to short term retail transactions
  - ✓ Not to Development Financing

- ✓ Thus the new electronic finance does not resolve the dilemma of how to have stability and innovation

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Possible Alternative

- ✓ The problem is in the private liabilities that serve as means of payment
- ✓ In the past public banks have provided public liabilities
- ✓ Henry Kaufman has predicted that "*in the future the entire deposit function will be handled by some giant cloud computer facility*" "*controlled and guaranteed by the government*."
- ✓ How would investment in innovation be financed from the Schumpeter/Hahn/Minsky Perspective?

PUBLIC DEVELOPMENT BANKS

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How would Public Banks break the Savings Constraint?

- ✓ In such as system only the government has a balance sheet that is not constrained
- ✓ Government deficits will be the source of the "manufacture of money" with the Central Bank funding the Development Bank on the basis of government liabilities.
- ✓ This future system shows clearly the inherently integrated operation of Treasury Functions and Central Bank functions which CB independence has arbitrarily tried to separate

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