

**Banking Safety and Regulation
in the US:
A Critical Realist Perspective**

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Abstract

This paper deals with the recent US banking safety and regulatory problem at a fundamental level, by reference to some original insights both in the field of economic methodology (Critical Realism) and in the interpretation of banking activity (a Heterodox Version).

The result is a basic support to those authors who stress the repeal of the Glass-Steagall Act and the introduction of the universal banking model as a means of structurally improving the safety of banking activity.

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0. Introduction

During the eighties both the Commercial Bank (henceforth CB) and the Savings and Loan Association (henceforth SLA) industries of the United States experienced a dramatic crisis.

In ten years the number of SLA was reduced to 25%, either through mergers or by failures. In 1980 there were 3993 SLA in activity. In 1990 this figure amounted only to 2400, 200 out of which were declared insolvent and 500 taken under the direct control of the federal authority¹.

The difficulties of the CB reached a peak during the second half of the decade. Between 1985 and 1991 the annual average number of failures was 165. This figure represented, yearly, 1.26% of the whole number of CB and 0.66% of the whole industry's assets. During the eighties 15% of the CB disappeared and at the end of 1991 the Federal Deposit Insurance Corporation had to manage 1069 banks².

These facts gave raise to a huge scientific and political discussion, they led to the elaboration of several proposals by economists and politicians, and they resulted in some regulatory steps taken by the authority in order to cope at a *structural* level with the decreased safety of banking activity³.

A browse through the recent literature shows an increasing criticism of the *regulatory* management of the crisis⁴. At the same time there is a growing number of analyses which aim at stressing both the inadequacy of the regulatory framework inherited from the thirties and the superiority of the so-called universal banking model⁵.

The *objective* of this paper is to attempt to support this trend by reference to some original insights both in the field of economic methodology (Critical Realism) and in the interpretation of banking activity (a Heterodox Version developed by myself within

¹ Dab, 1992: p. 47.

² White, 1992.

³ Depository Institutions Deregulation and Monetary Control Act, 1980; Garn - St. Germain Depository Institutions Act, 1982; Financial Institutions Reform, Recovery and Enforcement Act, 1989; Federal Deposit Insurance Corporation Improvements Act, 1991.

⁴ Kaufman-Litan, 1993/b: p. 12; Weintraub, 1993: p. 107; Gart, 1994: p. 363; Business Week (editorial), 9.12.91, in Gart, *ibidem*; Saunders-Walter, 1994: pp. v-vi.

⁵ Benston, 1990; Kroszner-Rajan, 1994; Jacobs, 1991; Saunders-Walters, 1994.

the so-called 'School of Dijon and Fribourg'⁶, with reference to some keynesian notions).

The *structure* is as follows. Firstly, I want to introduce the basic tenets of the Critical Realist methodology. The following discussion will be based on it. Secondly, I will point out the Traditional View of banking activity which underlies the regulatory framework settled in the thirties in order to enhance the safety of banking activity. Thirdly, I will recall the events of the seventies (monetary innovations) and of the eighties (banking crisis and deregulation) by emphasising the enabling role played by the regulatory framework inherited from the thirties. It will appear, fourthly, that banking safety and regulation in the nineties could benefit, in principle, from the reference to a Heterodox Version of banking activity. Lastly, I will take the liberty of concluding that the safety of banking activity would be likely to be structurally promoted if the universal banking model were introduced and the trend towards the setting of prudential (indirect) regulatory measures were pursued.

1. Critical Realism

Since 1980 the developments in economic methodology have mushroomed⁷. Critical Realism (hereafter CR) is one of those promising elaborations⁸.

CR can be quickly introduced by reference to the naturalist and the subjectivist methodological traditions. The former grounds science in positivist principles based on the notions of law and causality traditionally attributed to Hume. From this tradition CR maintains the case for a monist methodology of science but rejects its positivist, Humean-rooted, account. The subjectivist tradition defends the unlike character of natural and social science which stems from a difference in the nature of their subject matters. From it CR takes the idea of a pre-interpreted nature of social phenomena

⁶ The label 'school' has been introduced by Devillebichot, in 1969. Since then the interest in this 'school' has been growing (Cf., for instance, Baranzini, 1982: pp. 8, 9 et 1987: p. 34). Additional precise references will be given below.

⁷ Cf. for instance Backhouse, 1994.

⁸ It has been introduced into economics mainly by Lawson. In this field it has claimed its consistency with Post-Keynesianism and has settled itself against the general deductive approach underlying orthodox economic theory and econometrics (Cf. Lawson 1989a, 1989b, 1994a, 1994b, 1994c, 1994d, 1994e).

albeit parting with the claim that the social material is exhausted by this conceptual part⁹.

I will first enlarge on the former aspect by recalling Bhaskar's critics to the positivist - Humean-rooted - account of science. The transcendental realist position (henceforth TR) which emerges carries on over the social realm, thus defining CR.

1.1 The Layered Ontological Structure of the World and its Consequences

It is usually argued that Hume's '*Treatise of Human Nature*' suggests that knowledge stems from the sensory experience (impressions) of atomistic events. Bhaskar has emphasised that this position implicitly includes an empirical ontology (thus labelling this positivist - Humean-rooted - account of science 'empirical realism' - hereafter ER). *Atomistic events sensorily experienced exhaust the whole reality. Any additional element is merely a construction of the mind.* Our memory and imagination manage to associate those events on the basis of their likelihood and contiguity in time and space. Sense-experienced events regularities are the bases for, and the assessment of, scientific knowledge. This latter takes the form of universal laws of the type 'whenever event x then event y'. This conception implies that *reality is ontologically unstructured, as it is consumed by direct empirical perception.*

This vision underlies experimental activity, whose role in assessing scientific results in natural sciences (at least outside astronomy) and, increasingly, in orthodox economics is unquestionable¹⁰. It also clearly underpins econometrics and it is claimed to be a representative feature of the nature of neo-classical economics. In relation to the experimental activity Bhaskar has pointed out two facts¹¹.

First that strict empirical regularity between an event x and another event y (required to assess a scientific law) only takes place in a laboratory context, where human intervention manages to activate the 'ceteris paribus' condition. Second, Bhaskar noted that the laws thus obtained are successfully applied in the real world (outside the laboratory context).

⁹ Lawson, 1994f.

¹⁰ Cf. for instance Hey, 1991.

¹¹ Bhaskar, 1978.

These twin observations raise the following questions. First, what governs events outside of experimental situations? It would be absurd to rely on human intervention; it cannot be event x either, for outside the laboratory the strict regularity is not experienced, nor frequently is event x itself. Second, why are experimentally obtained results successfully applied outside experimental situations? Without human intervention the presumed empirical causal law isn't verified, thus leaving event y in search of an explanatory cause.

A transcendental question helps to render them intelligible. How must the real world look for the situation described by the twin observations to be possible? Bhaskar's answer is that *the ontological structure of the world is layered*, and this contrasts with the ontological *unstructured* reality presupposed by the ER account of science. It is thus necessary to suppose that *the empirical perception of events doesn't exhaust the whole reality*. Bhaskar distinguishes three ontological levels: the empirical, where events do actually occur; the actual, where events are empirically experienced, and *the 'deep', where structures and mechanisms operate and govern the events*. These domains are 'out of phase' with one another, i.e. the generative power of the deep structures acts *transfactually*: it acts independently of the actual occurrence of any strict event-regularity. Furthermore, not all events are experienced or experienced in the same way by each individual, as suggested by the distinction between the actual and the empirical level. Thus the world is composed in part of objects which are structured, i.e. irreducible to the events of experience, and intransitive (they exist and act whether or not they are identified).

In order to facilitate the message, it is useful to recall the pedagogical device of the falling leaf. According to TR, a falling autumn leaf is an actual event; our experience of it pertains to the empirical level; the gravitational pull governing the event is a deep structure. All domains are constituted by real objects. In the real world the generative power of the gravitational force doesn't manifest itself as a strict actual events regularity, because the action of other structures (aerodynamic, thermodynamic, inertial tendencies, etc.) comes to interfere with it. In this context the *transfactual* action of a deep structure such as the force of gravity is illustrated by the holding of the falling leaf on the hand.

On this account, it follows that events outside the laboratory context are governed by a blend of deep generative structures and that the role of human intervention in setting the *ceteris paribus* condition amounts to isolate a particular generative structure by holding off all other ones. Thus a strict actual events regularity is generated,

experienced and recorded. *According to TR, the work of science consists in rendering observable the deep determinations of the events we experience.* Outside the experimental situation the interplay of a series of generative structures inhibits the (conditions for the) existence of causal laws defined as the association between empirical events; the application of experimentally determined 'constant conjunction' laws outside the experimental situation is successful because the constant conjunction view doesn't express a law; rather it describes particular consequences generated by an isolated generative structure in a closed system. It follows that the ER approach incurs in an illegitimate generalisation concerning the ontological structure of the world: *the reality is not ontologically unstructured.*

In relation to scientific activity it appears that ER is concerned with the prediction of events through the seeking out of their constant conjunction (regularities). Its mode of inference is either deduction (all swans having been met were white, then the next one will be white) or induction (each swan having been met was white, then all swans are white): it always moves within the fused actual and empirical domains. A law statement always expresses an event regularity, because this is the only sort of generalisation conceivable.

On the opposite, TR implies that science is concerned with the identification of 'deep' generative structures that govern the outcome experienced. Thus, regarding knowledge TR distinguishes between its transitive dimension (specific theories, models or paradigms) and its object, which is real, intransitive and frequently unknown. *Through the use of the transitive dimension the scientist is able to improve (or to generate) the knowledge of an intransitive phenomena of interest.* What is vital for the realist is the empirical scrutiny of the reality of the transitive dimension of knowledge. This has to be done by invoking transcendental questions aiming at revealing "(...) what our conceptions of certain practices of interest presuppose about that world"¹². Progress is seen as the *discovery of successively deeper layers of reality and their subjection to explanatory power.* The TR's mode of inference has been labelled 'retroduction'. It depicts the movement from a statement about a phenomena of experience to a totally different entity responsible for the given event (from the observation that the swans are white to an account of their causal things). A law statement in this context expresses such structures and their modes of activity.

¹² Lawson, 1994b: p. 11.

1.2 Social Structure, the Individual and Scientific Work

TR carries on over the social realm, thus defining CR. This involves two analytical consequences. One related to ER, another concerning the subjectivist tradition.

The ER point of view has an important implication when carried on over the social realm: *it fosters an atomistic conception of the individual; one in which the individual passively reacts to external stimuli*. This is due to the necessity of producing 'laws' of the type 'whenever event x then event y'.

It is thus not surprising to find out that Hume supposed the uniformity of human nature, and that his approach implicitly underlies the general criteria of utilitarianism and positivism.

This vision of an individual which is merely a passive automata might be seen as quite depressing for the orthodox economic theory often labelled 'theory of choices'. In fact, the more the explanatory power of the model is enhanced through the endogenisation of further variables, the more human choice must be recognised as illusory (for it really concerns the few agents responsible for the setting of exogenous variables). The point is that the ER mode of theorising puts a constant pressure onto the closure of the system, i.e. onto the activation of the *ceteris paribus* condition, in order to allow the establishment of events regularities. In economics this amounts to trivialising human action.

The carrying on of TR over the social realm is facilitated by the fact that strict constant conjunctions of actual events are even more unlikely to happen in social activity. In addition, it is easily compatible with the accepted intuition that people have real choices (are really able to determine the course of social events). CR evacuates from the analysis the case for closure (activation of the *ceteris paribus* condition). It puts forward the *transformational model of social activity*¹³. An open system implies the reality of choices, and the latter supposes intentionality. This is itself bounded up with knowledgeability. For CR the objects of knowledge are the structures, i.e. the institutions. Here CR distinguishes itself clearly with the subjectivist tradition because it parts with the idea that the social material is exhausted by its conceptual part. *Deep social structures (institutions) really exist as intransitive dimensions of knowledge*. They represent the (social) conditions for individual actions. They act transfactually in both constraining and facilitating human action, i.e. they are operative whatever empirical behaviour ensues. They do not undermine the reality of human choices.

¹³ Bhaskar (1979), Giddens (1984).

Therefore a meaningful notion of agency is preserved. Institutions in their broader sense constitute the rather frequently unacknowledged conditions for intentional human action. Individuals and social structures are clearly distinguished in that the action of the former is purposeful, intentional and characterised by a degree of self-consciousness. It is only through human action that social structures come about and endure. They depend upon individual concepts and activities and can be treated as given only at the very moment of any individual action. The relationship between human action taken in total and the social structure is either of *reproduction (recreation) or of transformation (creation)*.

The pedagogical device frequently invoked here is the language code in relation to the activity of speaking. The language code is known by the individuals. It is an unacknowledged condition for their intentional action of speaking. It is necessary for speaking but it doesn't determine the content of the speech. The action of speaking of the individuals taken in total either reproduces or transforms the language code. It is thus to be treated as given only at the very moment of speaking.

1.3 Summing Up

CR is based on a layered ontological structure of the social world. The empirical perception of social events and entities does not exhaust social reality. Rather, it exists a deep level where institutions in their broader sense operate and govern the outcome of events. The interaction between individual actions and institutions is theorised on the transformational model of social activity. This model portrays the interaction as being, on the whole, either of reproduction or creation of the institutional set up. Social knowledge is seen as entailing two dimensions. The intransitive dimension corresponds to the object of knowledge. It is real and frequently unknown. The transitive dimension consists in the theories, paradigms and statements about the intransitive object. A CR scientific work, therefore, implies the discovery of deeper layers of social reality (intransitive phenomena of interest) through the development of the existing transitive dimension. The outcome should be characterised by an increased explanatory power of the object of knowledge. Once this is done, CR sets itself as a rationale for policy analysis and intentional change. The latter would entail replacing structures that are restrictive by those that are empowering¹⁴.

¹⁴ Lawson, 1994d; pp. 277 and 280-1.

In the following chapter I will point out the interpretation of banking activity which lies behind the regulatory framework settled in the thirties. This particular *transitive dimension* of the knowledge of banking activity is represented by what I will call the Traditional View of banking activity. This account presupposes an *ER ontology* and attributes to the purchasing power (intended as an economic quality of every monetary asset) the epistemological status of a *postulate*.

In chapter 3 I will suggest that the regulatory framework settled in the thirties performed the role of a *deep social institution* in enabling the events of the seventies and in not efficaciously opposing (at least at a structural level) those of the eighties.

In chapter 5 I will emphasise the belonging of what I will dub the Heterodox Version of banking activity to a *TR ontology* and the fact that this account provides an economic explanation of the constitution of purchasing power. Truly, this interpretation may be seen as a development of the *transitive dimension* of the knowledge of banking activity characterised by an increased explanatory power in relation to the *intransitive object* of knowledge (namely banking activity itself).

2. Banking Safety and Regulation in the Thirties

The wave of bankruptcy which had characterised the early thirties was interpreted as involving a management problem *and* a structural problem. The Roosevelt administration tackled the first with a three day 'Bank Holiday' followed by the coming into force of the Emergency Banking Act (9th March 1933). This intervention successfully restored public confidence in the banking industry and allowed for the reopening of the solvent institutions, for the reorganisation of the banks in difficulties, and for the winding-up of the insolvent ones.

However, the focus here is on the solution of the *structural* problem¹⁵. In this domain the administration decided to replace the universal banking model, defined nowadays as "(...) the conduct of a range of financial services comprising deposit-taking and lending, trading of financial instruments and foreign exchange (and their derivatives), underwriting of new debt and equity issues, brokerage, investment

¹⁵ This rationale was questioned in the thirties (Emerson, 1934; Fisher, quoted in Barth-Regalia, 1988: p. 128n) and is increasingly criticised nowadays (Benston, 1964; Ortino, 1989: pp. 69-70; Ely, 1988: pp. 64-6; Cargill, 1988; Shugart II, 1988: pp. 87 and 104; Benston, 1990; Kroszner-Rajan, 1994).

management, and insurance"¹⁶, by a 'safer' regulatory framework (set up by the Banking Act (June 1933), most commonly known as the Glass - Steagall Act), whose most popular feature consists in the "separation of the financial from the properly banking activity of banking activity".

This *jeu de mots* is emblematic of the issue involved in structurally promoting the safety of the banking activity. The issue strictly consists in the *definition* of banking activity. It is for this reason that I'll proceed by pointing out the theoretical foundation of the structural reform which took place early in the thirties. This amounts to inquiring about what the theoretical knowledge of that time could have suggested doing in order to enhance the safety of banking activity (2.1). Once this is done, I will outline the main features of the structural reform (Banking Act of 16th June 1933) (2.2).

2.1 The Definition, the Identification and the Protection of Banking Activity

The designing of a structural reform in order to enhance the safety of banking activity involves an implicit or explicit reference to a conception of banking activity.

In what follows the expressions 'monetary asset', 'purchasing power' and 'monetary value' will be used as synonyms insofar as it is impossible to conceive a monetary asset which wouldn't enable purchases (i.e. that wouldn't have a value). This is the general meaning given to the expressions and on the basis of which I take them as synonyms.

Early in the thirties the Traditional View (henceforth TV) of banking activity had just replaced the Classical Theory (hereafter CT). The TV suggested that *banking activity consists in the creation ('manufacture') of purchasing power*. It reached this conclusion by considering the checking deposit as a monetary asset in itself, rather than a credit of central money. This idea would have been lately spread by authors like Hawtrey, Robertson, Hayek and, as traditionally reported, by Keynes¹⁷.

Taking Withers's book *The Meaning of Money*, published in 1909, as representative of the TV, the thesis has been shown by reference to an agent H who purchases a pre-existing real asset from another agent F. It was argued that the specific banking activity is performed when the bank B creates and lends to H a monetary asset which H uses to pay a purchase from F.

¹⁶ Saunders-Walter, 1994: p. 84.

¹⁷ Cf. Schumpeter, 1954.

It should be stressed that the specific activity of banking argued by the TV has to be taken in its most serious meaning. That is, in what follows the performance of the specific banking activity is taken to denote an action which positively adds, from $t(0)$ to $t(1)$, to the amount of purchasing power existing in $t(0)$.

The conception of the banking activity argued from Withers onward entails two steps which, as Withers himself rightly stressed, are strictly related to each other¹⁸.

2.1.1 The First Step

The first step is given by B creating a purchasing power and lending it to H. The granting of a loan to H implies that:

"(...) the bank's deposits are swollen by [£100], and on the other side of its balance sheet the entry 'advances to customers' is also increased by this amount, and the loan has clearly created a deposit"¹⁹.

That is (Cf. Figure 1; L, A, BS, MA, L, C, B and H, for, respectively, Liabilities, Assets, Balance Sheet, Monetary Asset, Loan, Creditor, Bank and Agent H):

Figure 1: The traditional first step

L	B's BS		A		L	H's BS		A
H's MA	100	H's L	100		B's C	100	MA	100

Two comments follow.

- (i) To preserve the idea of a positive creation of purchasing power this account has to suppose that on the assets side of the balance sheet B invests a value which it hasn't received from any source. Now, the necessary equality of debits and credits illustrates that the value invested (lent) by B to H has as its source the monetary asset of H, which, in turn, has as its source the purchasing power lent by B, and so on. To get rid of this complication the TV has to make two assumptions. Firstly, that the debt denoted by the monetary asset has no objects

¹⁸ Withers, 1909: p. 71-2.

¹⁹ Ibidem: p. 64.

but itself²⁰. That is, it has to assume that the monetary debt is self-solvent. It thus attributes to the industry of banking an accountancy privilege that no other industry possesses. Secondly, it has to give up any ambition of *economically* accounting for the *formation* of the new purchasing power. The monetary value thus created is such because it allows purchasing. This statement echoes Walker's or Hicks' dictum 'money is what money does'²¹. One has thus to refer to Knapp's motto 'money is the creation of the State', albeit remembering that this statement truly applies to the *legal* power of the monetary asset to settle payments rather than to the *economic* cause of it having a value.

- (ii) On closer inspection, the positively created purchasing power doesn't appear to have enriched any agents. As a matter of fact H owes to B the value that B owes to H. Therefore nobody owns the new value as a Proprietor's capital (i.e. as an enrichment not backed up by an indebtedness concerning the same value). Thus the advance granted to H might at best define a promise of a definite addition of monetary value into the economy. This observation explains both why the first step is intimately related to the second, and why the first step is frequently entered off-balance sheet (Cf. overdraft facilities).

2.1.2 The Second Step

The second step is given by the use of the advance in the payment to F for the purchase of the pre-existing real asset (Cf. Figure 2; R for Real asset and PC for Proprietor's capital). Line 1 illustrates the first step and introduces into the scene the pre-existing real asset. Lines 2 and 3 depict the second step, i.e. the payment from H to F. Line 4 illustrates the overall result stemming from the TV. It must be stressed that line 4 would be the same if line 1 was an overdraft, i.e. entered *off* balance-sheet.

²⁰ The analysis cannot refer to the material money of the central bank because it explicitly aims at differentiating from the classical theory by arguing that the checking deposit is a monetary asset in itself.

²¹ Cf. Schumpeter, 1954: p. 1086; Hicks, 1967: p. 1.

Figure 2: The traditional second step

	<u>L</u>	<u>H's BS</u>	<u>A</u>	<u>L</u>	<u>B's BS</u>	<u>A</u>	<u>L</u>	<u>F's BS</u>	<u>A</u>			
(1)	B(C)	+100	MA	+100	H(MA)	+100	H(L)	+100	PC	+100	R	+100
(2)			MA	-100	H(MA)	-100					R	-100
(3)			R	+100	F(MA)	+100					MA	+100
(4)	B(C)	<u>+100</u>	R	<u>+100</u>	F(MA)	<u>+100</u>	H(L)	<u>+100</u>	PC	<u>+100</u>	MA	<u>+100</u>

This payment changes the owner of the monetary asset from H to F, or constitutes a monetary asset for F (if step one is off-balance sheet). At any rate, the payee F owns the new purchasing power as a proprietor's capital, i.e. F is free of debt in respect either of B or H. The addition of monetary value is, in this case, indisputable. In relation to step 1 (Cf. above, 2.1.1.ii) this factual observation implies that to define a positive creation of monetary assets the TV *must* appeal to the performance of a payment.

Again this view stimulates some comments.

- (i) One may wonder if it is plausible to conceive that the performing of the banking activity (positive addition of purchasing power) always and only takes place when financing the purchase of pre-existing assets. This conception would presuppose two features of the world which appear to be hardly tenable. Firstly, the performing of the banking activity would always and only be conceived as adding to the monetary values while leaving constant the pre-existing real assets.

Secondly, it would presuppose that in order to perform its specific activity, the banking system would always expose itself to a situation of potential insolvency. The second step implies as a matter of fact (by its very assumption) that the banking system simply grants loans (financed by an addition of new purchasing power) without requiring any new real asset as a security. The real asset purchased by H pre-exists the emission of additional purchasing power. Thus, realistically, the real asset is, for the banking system, the real security offered by F to B in order to back up the loan of new purchasing power necessary to carry out the production of the real asset.

Therefore, at any rate, Figure 4 miss line 0 and has to be corrected in its lines 1 and 4 (Cf. Figure 3, Z for agent Z):

Figure 3: The traditional corrected second step

	L	H's BS	A	L	B's BS	A	L	F's BS	A		
(0)				Z(MA)	+100	F(L)	+100	B(C)	+100	R	+100
(1)	B(C)	+100	MA	+100	H(MA)	+100	H(L)	+100			
(2)			MA	-100	H(MA)	-100				R	-100
(3)			R	+100	F(MA)	+100				MA	+100
(4)	B(C)	+ <u>100</u>	R	+ <u>100</u>	Z(MA)	+100	F(L)	+100			
				F(MA)	+ <u>200</u>	H(L)	+ <u>200</u>	B(C)	+ <u>100</u>	MA	+ <u>100</u>

This modification alters the overall results (line 4). It appears, firstly, that the only agent definitely enriched is Z and not F. Z possesses a monetary asset as a proprietor's capital, i.e. his purchasing power isn't backed up by any indebtedness concerning itself. Secondly the TV must rely on its second step (a payment) to show the positive addition of purchasing power. Therefore it is inflationary in a quantitative way. It constantly leaves the economy with more purchasing power than real final goods and services. Thirdly, and as a consequence of this argument, the TV would be specified in a more plausible way when relating to the remuneration of the factors of production. This latter case would avoid the above criticisms.

- (ii) The second comment concerns the compatibility of (I) the idea that the banking activity atomistically emits new purchasing power with (II) the payment to the factors of production. This is a common structure in those business cycle theories which developed early this century on the basis of the TV of banking activity²².

First of all let me emphasise the fact that if the payment to the factors of production is coupled with the idea of the purchase of a pre-existing real asset, the productive service is assimilated to a final good or service. This establishes an identity between the market for productive services and the market for final goods and services which is of course questionable.

Secondly, and quite heuristically, the possibility of simultaneously maintaining (I) that the payment of the factors of production gives rise to two additional values (monetary and real) *and* (II) that, nevertheless, those assets are atomistically the product of the banking activity on the one hand and the

²² As, for instance, Wicksell (1898), Fisher (1911), Hawtrey (1913), Robertson (1926) and Hayek (1931).

factories on the other hand, may be seen as a difficult endeavour. As a matter of fact, the new purchasing power can hardly precede the real asset. Firstly because of (i) above; secondly because of the financing of the working capital being most of the time carried out by overdraft (which "(...) does not (at present) appear anywhere at all in a bank's statement of its assets and liabilities"²³). This eventuality opens, in other words, the possibility of linking the emission of purchasing power with the creation of new real value in an original way. This path has been followed by the heterodox version of banking activity which will be sketched below.

2.1.3 Conclusion

Several points should be made.

- (i) It is worth recalling that insofar as the TV is concerned, the economic existence of *the purchasing power (as a quality of any monetary asset) has the status of a postulate.*
- (ii) *The TV of banking activity appears to pertain to an empirical realist ontology.* The banking and monetary reality is ontologically unstructured. It is consumed by direct empirical experience. As a matter of fact, the checking deposit is a monetary asset because it allows payment, and for

"(...) every loan makes a deposit, and since [the consolidated] balance-sheet [of the six major Joint Stock Banks] shows 180,5 millions of loans, 180,5 out of the 249 millions of deposits have been created by loans"²⁴.

- (iii) According to TV the banking activity distinguishes itself, in nature, from the financial activity of an intermediary. The former makes monetary assets from loans, the latter keeps on making loans from monetary assets previously deposited. The liabilities side of the balance sheet acquired a special significance in the identification of banking activity. Accordingly, each depository institution involved in the management of checking deposits (i.e. payments) were seen as exercising a banking activity. *The identification of banking activity has thus been bound up with that of checking deposits.* In the

²³ Keynes, 1930: p. 37.

²⁴ Withers, 1909: p. 62-3.

thirties, in the US, the identification of the banking activity was an easy task; only one kind of checking deposit existed, namely the demand deposit.

- (iv) This definition of banking activity has put an emphasis on the activity of lending connected with the management of payments. In this respect, *a structural improvement in the safety of the banking activity was seen as possible by preventing the depository institutions who exercise it to have access into financial activity*. Such an intervention would have granted that the monetary assets, as well as their creation, will respectively not be involved in, or take place against, the financing of financial operation (purchase of securities, bonds, shares) but only in, or against, the financing of safer loans (industrial and commercial working capital, consumption goods and residential mortgages) - thus improving the overall solvency of the banking industry. The coming into force of the Banking Act of 1933 set up such a system.

2.2 Some Features of the Banking Act of 1933

The Banking Act of 1933 has introduced a high level of specialisation into the banking industry. This has been split into two broad categories: Depository Institutions and Non-Depository Institutions. The latter category includes the Investment Banks, the Pension Funds and the Insurance Companies. The Depository Institutions are four: The CB, the SLA, the Savings Banks and the Credit Unions. The last three institutions are usually referred to as Thrift Industry. They are specialised, respectively, in the mortgage market and in the consumption loans.

For the purpose pursued in this paper it is important to highlight three aspects of this regulation. Firstly, the monopolies which the Act has defined and attributed to different institutions. On the one hand *commercial and industrial loans (working capital) and of the management of the demand deposits* (respectively on the assets and liabilities sides of the balance sheet) *have been attributed to the CB*. On the other hand, *the private financial activity* (shares, bonds, securities traded by the private sector) *has been attributed to the Investment Banks*. This has been done in order to prevent any relation between the creation and the use of monetary assets (purchasing power on the one side) and financial activities on the other side. Secondly, to improve further the safety of banking activity, the reward attached to the demand deposits has been stated to be nil (Regulation Q), while the remuneration of time and savings deposits of the

depository institution industry has been fixed by the authority in 1966 (Interest Rate Control Act). Thirdly, the Banking Act has managed to settle a federal insurance for each deposit. This amounted to \$2'500 each. Accordingly, some specific organisms have been created (Federal Deposit Insurance Corporation; Federal Savings and Loan Insurance Corporation; National Credit Union Share Insurance Fund)²⁵.

3. The Seventies and the Eighties: Innovation, Deregulation and Banking Safety

After four decades of relative empirical coherence between the regulatory framework and the safety of banking activity, the process of monetary and financial innovation - fostered, as I want to argue, by the regulation itself - broke down this situation. The partial deregulation which followed, early in the eighties, may be seen as both recognising the inadequacy of the Banking Act (concerning at least the identification of banking activity) and questioning its effectiveness in strengthening the safety of banking activity.

3.1 Innovations, Deregulation and the Identification of Banking Activity

On a macroeconomic basis the seventies were characterised, among other things, by high and volatile levels of inflation and short term interest rates, and by a growing public deficit²⁶. The decade will also be remembered for the spread of the computer revolution.

This context is important. 1971 witnessed the appearance of the first Money Market Mutual Fund. A MMMF collects relatively small amounts of money (\$500 - \$5'000) and invests them on the money market. The fund is linked with a CB. It thus allows each investor to draw cheques on a third party (i.e. to make payments). The success of

²⁵ On the structural reforms of the early thirties, Cf. Mitchell, 1975; Burns, 1974; Kennedy, 1973; Carosso, 1970; Preda, 1987; Jones, 1979; Schwartz, 1979. For an overview of the evolution of the US banking regulation, Cf. Pierce, 1984; Goldfeld-Chandler, 1986; Ritter-Silber, 1989; Kaufman, 1986; Cooper-Fraser, 1986; Streit, 1986; Camera dei deputati, 1988.

²⁶ The evolution of the short-term interest rates paralleled the one of the rate of inflation: 3,2% in 1972, 6,3% in 1973, 10,8% in 1974, 7,6% in 1978 and 11,4% in 1979. The size of the public deficit increased from 14,8 billions of dollars in 1973 to 100 billions in 1981.

those funds has been impressive: they collected 2 billions of dollars in 1974; 45 in 1978 and 200 four years later²⁷. The fund allowed the depositors to combine a certain degree of liquidity with a substantial remuneration, i.e. to partially avoid, at least, the restriction imposed by the Regulation Q and the Act of 1966. This evolution was labelled 'disintermediation' mainly because the capitals which nourished the MMMFs came from the depository institutions, particularly from the SLA. In reaction, the SLA industry developed various forms of checking deposits, all of them carrying a positive rate of interest. At stake are the Negotiable Order of Withdrawal (NOW, 1972) and the Credit Union share draft (CUsd, 1974). In addition, the depository institutions applied some technological devices in order to further enhance the liquidity of the savings deposits and increase the amount of checking deposits carrying a positive rate of interest. Those are the telephone transfer and the pre-authorized transfer systems (1975). As a result, in 1980 the traditional demand deposit amounted to only 70% of the M1.

For our purpose, the effect of this evolution to be retained concerns the *identification* of the banking activity protected into the CB early in the thirties. The identification of banking activity is linked with the presence of checking deposits on the liabilities side of the balance sheet. It is so because the underlying definition of banking activity stresses the ability to create those monetary assets as its distinctive feature. After the process of monetary innovation of the seventies it is clear that such an identification appears to be frustrated by the evolution of the facts and thus transient in nature. Furthermore the law is infringed, as the monopoly attributed to the CB has been lost. The process of innovation has spread banking activity off limits.

3.2 Innovations, Deregulation and the Safety of Banking Activity

The above mentioned reaction of the SLA, undertaken in order to cope with the success of MMMF, caused an increase in the cost of their liabilities. This consequence became a real difficulty when the level of the interest rate paid on the deposits, which is of a short term kind, overcame the one charged to the borrowers, generally fixed on a long term basis. The actions undertaken by the SLA were obviously constrained by the regulation. Finding themselves confined into the mortgage market, the SLA tried to

²⁷ Cf. Cook-Duffield, 1979; and Gramley, 1982: p. 304; Hadjimichalakis, 1982: p. 22; Gilbert, 1986: p. 32.

increase the yield on their assets by undertaking more risks. The SLA developed the variable interest rate mortgages, the collateralised mortgage obligations and the mortgage strip, giving rise to a blend of secondary markets. Gaining awareness of this evolution entails of course becoming suspicious about the real ability of the regulation in place to enhance the safety of the depository industry. Those conjectures were notably reinforced during the eighties.

The deregulation of the early eighties was mainly a reaction to the effects of the process of innovation²⁸. It consisted of two Acts: the Depository Institutions Deregulation and Monetary Control Act of 1980²⁹ (henceforth DIDMCA) and the 'Garn - St. Germain Depository Institutions Act of 1982³⁰ (hereafter GGDIA). The first Act aimed at reducing the problems faced mainly by the SLA industry and at restoring the monetary control of the Federal Reserve. I am not concerned here with this latter issue. The DIDMCA is in fact the consequence of two previous studies realised by the Hunt Commission in 1971³¹ (President's Commission on Financial Structure and Regulation) and by the House Banking Committee in 1975³² (Financial Institutions and the Nation's Economy Study). It provided for the progressive repeal of the Regulation Q (including the 1966 extension) over six years; it stated the increase in the amount of the federally insured deposits from \$2'500 to \$100'000; it formally authorised the depository institutions to offer the remunerated checking deposits mentioned above (NOW and Cusd). The Act didn't deregulate in a substantial way the assets side of the balance sheet of the depository industry. The DIDMCA amounted to the 'de jure' recognition of the banking activity exercised by the SLA and to the official acknowledgement of both the infraction and the transient character of the identification of banking activity effectuated early in the thirties.

According to Pierce, the GGDIA transformed the SLA into a bank³³. This Act authorised the SLA to offer two new forms of remunerated checking deposits: the Super Negotiable Order of Withdrawal (SNOW) and the Money Market Deposit

²⁸ Camera de deputati, 1988: pp. 33-4; Yaeger, 1985: p.103; Greenbaum, in Gart, 1985: p. 11.

²⁹ Cf. Pierce, 1984: pp. 301-4; Goldfeld-Chandler, 1986: pp. 187-9; Cooper-Fraser, 1986: chapter 4; Ritter-Silber, 1989; Kaufman, 1986; Fraser-Kolari, 1985: pp. 46-57; Hadjimichalakis, 1982: pp. 29-39; Cargill-Garcia, 1982: chapters 4 to 7; Bottiglia, 1984: pp. 1081-90; Streit, 1986: pp. 33-9; Gart, 1985: pp. 12-6.

³⁰ Cf. Cooper-Fraser, 1986: chapter 5; Goldfeld-Chandler, 1986: p. 193; Pierce, 1984: pp. 310-12; Kaufman, 1986: pp. 336-41; Fraser-Kolari, 1985: pp. 53-65; Pons-deMargerie, 1983; Gart, 1985: pp. 17-8; Garcia et al., 1983.

³¹ Cf. Klein, 1978: pp. 150-2; Fraser-Kolari, 1985: pp. 48-9; Gart, 1985: pp. 12-6.

³² Cf. Chandler-Jaffee (1977) and Degen, 1987: pp. 167-8.

³³ Pierce, 1984: p. 311.

Account (DDMA). Furthermore, the GGDI provided for the repeal of any differences in the remuneration of similar deposits among the institutions. This Act followed the DIDMCA in preserving in a relevant way the regulatory restrictions on the assets side of the balance sheet of the depository institutions.

The monetarist experiment of the early eighties sharpened the management difficulties of the SLA through the exceptional increase in the short term interest rate which it engendered. Furthermore, following this macroeconomic evolution, even the CB showed management difficulties. The cost of their liabilities increased while the movement of disintermediation magnified following the competition of MMMF, SLA and the Non-Bank banks.

A non-bank bank is an institution whose business entails either the presence of checking deposits on the liabilities side *or* the industrial and commercial lending (the financing of the working capital). It thus differed from a CB (defined by the Bank Holding Company Act of 1970 by the presence of checking deposits *and* the activity of industrial and commercial lending). It was not concerned by the commercial bank's regulation, and allowed the depositors to have direct access into the financial market.

The reaction of the SLA and CB was to try to enhance their financial situation. Unfortunately a sword of Damocles hung over this attempt, namely the existing restrictive regulation (summarised by the expression 'asymmetric playing field') and overall the moral hazard settled by the huge increase in the federal deposits' insurance (as noted by Kareken in 1983 or argued by Corrigan in 1989³⁴). The reaction of the CB has been framed by this regulatory set up and has either produced or further developed a series of financial innovations (Securitisation, Off-Balance sheet operations, Derivatives). As I have pointed out at the beginning of this paper, during the eighties, the US depository institution industry experienced one of the worst crisis of its history.

³⁴ "But having managed significant deregulation, the Congress has yet to make a start at changing the U.S. deposit insurance scheme. (...) It can invite a wave of bank failures. (...) it can do nothing more than decrease the insurance limit from the present \$ 100'000 to, say, \$ 2'000 or thereabouts" (Kareken, 1983: pp. 1 and 9). 'Vi è uno stretto nesso fra gli squilibri di carattere strutturale dell'economia statunitense e gli elementi di fragilità finanziaria', Corrigan, quoted by Ortino (1989).

4. Banking Safety and Regulation in the Nineties: An Awkward Issue

At the end of the seventies the regulators had the choice between reforming or not reforming the New Deal regulatory framework. They chose to deregulate it partially in order to help the management of the depository institutions. Two points should be noted. Firstly, the deregulation and its rationale implicitly recognised, at least in some degree, the present ineffectiveness of the whole Banking Act in granting the safety of the banking activity. Secondly, the deregulation was based on the explicit recognition that the transformational action of the economic agents had changed the environment (through a series of innovations). What should be recognised however is that most of this innovative action had been fostered by the regulatory framework itself, which thus acted as a powerful generative structure. It can hardly be denied, in fact, that the processes of disintermediation and of production of remunerated checking deposits hasn't at least in some proportion been caused by the regulatory limits imposed on the remuneration of checking deposits. Similarly, it can be argued that the competitive struggle of the depository institutions during the eighties was negatively influenced by the asymmetrical playing field, and that the mismanagement was certainly not counteracted by the huge increase in the federal deposit insurance (Moral hazard)³⁵.

Once it is recognised that the regulatory framework bore a certain responsibility both in the process of innovation and in the crisis of the eighties (something that authors like Saunders and Walter explicitly suggested³⁶) one feels authorised in embracing the CR suggestion and in consequently considering the case for the replacement of the present restrictive structure by one which is empowering. In this respect it is worth noting that an increasing number of authors claim the repeal of what remains of the New Deal's Banking Act and the introduction of the universal banking model. Benston for instance concluded his study by arguing that "(...) universal banking can provide considerable benefits and pose few problems for the economy", while Saunders and Walter argued that "(...) the time for universal banking in the United States has arrived"³⁷.

³⁵ As found out by Pantalone-Platt in 1987, the deregulation has increased the failures of depository institutions.

³⁶ "(...) the Congress has consistently failed to act in the national interest. (...) the existing U.S. bank regulatory structure seems to embody a triple threat to the national interest in being comparatively inefficient, uncompetitive, and unsafe, all at the same time" (Saunders-Walter, 1994: pp. v-vi).

³⁷ Benston, 1990: p. 213; Saunders-Walter, 1994: p. 236.

Nevertheless, I want to argue, for a complete repeal of the present regulatory restrictions to be sustainable, one needs to overcome what I refer to as an awkward issue.

The regulation settled in the thirties is logically deducted from the definition of banking activity in terms of the creation of monetary assets within the financing of payments. Now, the preservation of the terms of the deduction would entail denying any structural involvement in the events of the eighties. This would be a bold position because it would result in maintaining the effectiveness of the regulation in enhancing the safety of the banking activity - a hardly defensible conclusion in the light of the recent facts. The preservation would also amount to resigning ourselves to a transient identification of the banking activity, thus to its 'ad hoc' protection. Furthermore one would have to elaborate another rationale in order to account for the partial deregulation early in the eighties: which one if not the ineffectiveness of the regulation in protecting the banking activity?

The repeal would indeed break down the deduction. It would amount to recognising an inaccuracy either on the definition of banking activity or on the deducted regulation. Either the deduction was sound and the interpretation of banking activity unsound, or the latter correct and the deduction unfit. The repeal is thus a step full of scientific implications. This might explain why it has been a heavily debated and yet unsettled issue.

In what follows I will sustain the movement toward the repeal of the Act by maintaining that the deduction was sound and arguing that the definition of banking activity is unfit. I will thus attempt to develop the suggestions put forward by some economists according to which "(...) to make progress on the issue, it is necessary to determine what a 'bank' is (...)"³⁸.

³⁸ Pierce, 1991. p. 67.

5. A Heterodox Version of Banking Activity³⁹

In chapter 2 I have pointed out that the regulation settled in the thirties to enhance structurally the safety of banking activity has been based on the TV of banking activity. The TV identifies the particular and distinctive feature of banking activity with the creation of purchasing power. It therefore straightforwardly suggested the limitation of the lending activity of the banks. I have emphasised that the TV presupposes an ER ontology and attributes to the purchasing power (as a quality possessed by every monetary asset) the epistemological status of a postulate. In chapter 4 I have emphasised the fact that the growing accepted intuition - according to which the safety of banking activity would be improved if the regulatory structure was that of the universal banking model - would be enhanced if the conception of banking activity which underlies the regulatory framework inherited from the thirties was improved.

The Heterodox Version of banking activity aims at *rejecting* the propositions according to which, firstly, the specificity of banking activity lies in its power to create purchasing power, and, secondly, that the purchasing power, as an economic quality possessed by every monetary asset, should be maintained as fully postulated. It *argues* that the monetary asset is part of a complex entity (the income) and that banking activity maintains its specific character though acting as an intermediary of purchasing power. In sum the HV settles itself as a development in the knowledge of banking activity.

For the sake of simplicity I chose to introduce the two basic features of the HV by relying on some concepts borrowed from Keynes's *A Treatise on Money*. Those are the definitions of income, industry and finance:

- (i) In *A Treatise on Money*, by *income* Keynes proposes "(...) to mean *identically the same thing* by the three expressions: (1) *the community's money income*; (2) *the earnings of the factors of production*; and (3) *the cost of production* (...)"⁴⁰. He excluded the profits. The heterodox version would *stick* to the suggested *identity*.
- (ii) Under the heading of *industry* he included the payments related to "(...) the business of maintaining the normal process of current output, distribution and exchange and paying the factors of production their incomes (...)"⁴¹.

³⁹ Schmitt (1960, 1966, 1984), Cencini (1988, 1995), Friboulet (1988), Rattaggi (1994, 1995), Greppi (1994).

⁴⁰ Keynes, 1930: p. 111 (italic partially added).

⁴¹ *Ibidem*: p. 217.

- (iii) By *finance* he referred to "(...) the business of holding and exchanging existing titles to wealth (...) including stock exchange and money market transactions, speculation and the process of conveying current savings and profits into the hands of entrepreneurs"⁴². Keynes included the formation of profits.

In addition, the HV fully adheres to Keynes's suggestions that (I) "(...) everything is *produced* by labour [and that] it is preferable to regard labour (...) as the sole factor of production (...)", and that (II) the labour-unit has to be measured by the money-wage, thus giving rise to the wage-unit⁴³.

On this basis it is possible to illustrate how the HV accounts for the *constitution* of purchasing power and its *use* (which entails a *particular* banking activity and pertains to the industry) as well as for the nature of finance (which doesn't entail any particular banking activity other than that of an intermediary of purchasing power).

5.1 The Constitution of Purchasing Power and Banking Activity

The definition of *income* put forward by Keynes suggests the division of the national economy into three *functional* aggregates (i), namely Factories (F), Households (H) (factors of production), and Banks (B). (ii) It emphasises the particular economic nature of the *cost*, and (iii) illustrates itself as a *complex* entity.

- (i) For the income meaning *identically* a *cost* and an *earning*, and, in addition, still a *positive* quantity, it is necessary to suppose the existence of F and H as distinct entities. As a matter of fact, the cost and the earning could not coexist within a single entity because they will counterbalance themselves, thus cancelling the income. Furthermore it would be absurd to conceive F as the factor of production of itself. The cost concerns the Profit and Loss account of the functional aggregate F and the earning concerns the Balance sheet of the functional aggregate H.

The third functional aggregate of the economy is B. In fact the management of the payment to the factors of production neither defines a cost nor an earning for B which would be equal, or bear any relation, to the sum managed. Of course, B becomes an F when remunerating its own factors of production.

⁴² Ibidem.

⁴³ Keynes, 1989: p. 454; Keynes, 1936: p. 41-3.

- (ii) The observation that the income identically denotes a cost and an earning, and yet still a positive quantity, leads to emphasising the economic nature and role of the *cost* of production of the current output.

Since its very introduction into the practice of accountancy (around the year 1300) its meaning and role have been clearly defined. A cost absorbs all the differences between capital values (assets and liabilities) which cannot be attributed to capital accounts themselves. That is, a cost indicates the capital used in the process of production but *not yet lost* by the factory.

Thus the cost allows for the income to be a created value. It is so because as a result of the payment to the factors of production, H hasn't lost any value and F has earned a positive value (purchasing power).

- (iii) It is possible, and useful at this stage, to provide an illustration of the notion of income with the help of some 'T' accounts (Cf. Figure 4, line 3; PL, PC, C and D, respectively standing for Profit and Loss account, Proprietor's Capital, Credit and Debit).

I suppose that the remuneration paid by a Factory 'a' to a Household 'a' amounts to £50, and that Fa disposes of a £50 monetary asset (line 1).

It is worth stressing that the reference to a micro element 'a' of F and to a micro-element 'a' of H doesn't disturb the analysis of the income because the cost and the earning refer to two distinct aggregates. Therefore the cost of Fa and the earnings of Ha are of an identical nature as those of F and H.

Figure 4: An illustration of Keynes's definition of income

	Fa	B	Ha	Fa	B	PL	Ha
	D	C	D	D	C	D	C
1.		50 ⁴⁴		50	50	50	
3.	50		50				PC 50 B 50

The income depicted by the three debits and the three credits is a *complex whole*. It is so because of Keynes's emphasis 'to mean identically the same thing by the earnings of the factors of production and the cost of production'. That is, the earnings of Ha and the cost of Fa stand in a relation of *identity* to each other albeit being distinct entities. Therefore income seen in this way is a complex whole internally constituted by two entities linked by a relation of identity. This

⁴⁴ I am supposing here that the Bank's debit counterpart is a loan to an agent Hb.

observation bears some consequences both to the ontological nature of the monetary asset of Ha and of the income itself (iv), as well as to the value (purchasing power) of the monetary asset earned by Ha (v).

- (iv) The monetary asset earned as a remuneration is *not* an atomistic event. Against any empirical experience, the monetary reality appears to be, according to the heterodox view, ontologically layered. The monetary asset of Ha though experienced as an atomistic entity, is the term of a relation. It is intrinsically tied up with the cost of Fa, via its counterparts in B(Ha), B(Fa) and Fa(B). The monetary asset is part of the complex income. In this view Keynes's income is a macro-entity, irreducible to any micro-quantity. Every attempt at reducing it, for instance by considering the monetary asset in Ha as an atomistic event, would entail a logical fallacy (i.e. would entail the loss of the definition of income).
- (v) If the income is a complex entity defined identically by a cost (in Fa) and a monetary asset (in Ha), the HV would argue, then the value of the monetary asset is given (by virtue of a relation of identity) by the real result of the remunerated productive activity. The real result of the remunerated production is 'lodged' in Fa as a monetary cost. It is expressed in wage-units. This makes clear why a cost denotes, for Fa, an investment of value not yet lost. The capital of Fa is preserved because the resources invested in the production of the current output come out as the new output; the new output, which is an economically created entity appearing in Fa, therefore replaces and balances (cost) the physically invested resources. As a result the purchasing power (value) of the monetary asset earned by Ha is (by reference to the complex income to which the monetary asset belongs) internally determined by the real result of the productive activity. That is, the remuneration of the factors of production gives rise to a new purchasing power (a monetary earnings linked within the income via a relation of identity with its real value).

This interpretation revives the intention of the classical theory to explain the formation of monetary value. It avoids the problem of the mismatch of values although following an analogous track (cost of production). The difference lies in the fact that the HV is not committed to an atomist and materialist conception of monetary assets, and can therefore refer to the cost of production of the current output.

Let's now turn to the banking activity performed in relation to the payment to the factors of production (vi to viii).

- (vi) The complex income, with its constituent parts (cost (real product) and monetary asset) linked by a relation of identity, is the *result* of a payment. The fact that (I) Fa has not lost any capital while Ha has positively earned a capital, and that (II) the cost and the monetary asset identically denote a *newly produced economic value* (the result of the activity of production) suggests the existence of a value-*hiatus* between the economic situation prevailing before the remuneration of the factors of production and the result of this payment. Therefore, against any empirical realist ontology, the monetary value which pre-exists to the payment is *not transferred as a value* to Fa. This is easily illustrated if we suppose the payment being financed by overdraft because the unused overdraft facility does not appear anywhere at all in a balance sheet account. But the above statement should hold even when Fa uses a (material or checking deposit) monetary asset, if a meaningful notion of the activity of production (creation of new economic value) is to be preserved. That is, used in the payment to the factors of production, the prior monetary asset is deprived of its purchasing power (as it is intuitively understandable, it being used by Ha to *pay* Fa for the productive service) and is associated with a new value (the new current output).
- (vii) The hiatus is filled up by a particular banking activity (Cf. Figure 5, lines 2 and 4). Fa cannot rely on (the transfer of) the value denoted by its monetary asset, (Cf. line 1, when existing), for remunerating the factors of production (i.e. for starting the series of debits and credits which will constitute the income; Cf. line 3. Therefore, a specific banking activity is called for. This activity cannot consist of the creation of a purchasing power because this would not allow for the income to stem in its internal related identity form. As a matter of fact Fa cannot rely on any pre-existing purchasing power (created or not by B) for remunerating Ha, if the income as interpreted here is to be preserved. Rather, the HV argues that the banking activity consists in enabling the payment through the creation of its pure means.

This may be highlighted by adding lines 2 and 4 within Figure 4, respectively after line 1 (when existing) and after line 3. For the sake of simplicity those lines can be taken as representing an unused overdraft facility (off-Balance sheet). That is, those lines don't denote a value, rather they illustrate a pure means of payment. They illustrate the necessary predisposition of B toward Fa (the authority given by B to Fa) for the payment to be made through a *unique*

accountancy action. Of course, the commitment to a realist position entails the real existence of such an entity.

Figure 5: The constitution of purchasing power and banking activity

	Fa		B		Ha		Fa		PL		Ha				
	D	C	D	C	D	C	D	C	D	C	L			A	
1.		50			50										
2.		(50)													
3.	50						50		50		PC	50	B	50	
4.	(50)														

(viii) Line 2 enables Fa to pay Ha through a unique accountancy action and yet (and therefore) without relying on any pre-existing purchasing power (monetary asset). The necessary line 4 denotes B's recovery of its payment predisposition (or authority to pay, or opportunity to pay, or pure means of payment) spontaneously offered to Fa. The payment (its very action) originates in B rather than in Fa and ends up in B rather than in Ha (due to the logical equality of debits and credits).

For our purpose it is vital to stress that, in the heterodox view, banking activity does not create a purchasing power when managing the payment of Fa to the factors of production. Rather, and against any commitment to an empirical ontology, banking activity appears to be (or to have been) that of an intermediary of purchasing power, providing but *not* creating a *new* purchasing power for both the depositor Ha and the borrower Fa. Banking activity allows for income to exist in its complex, internally related identity, form.

5.2 The Use of Purchasing Power, Banking Activity and Industry

The prior chapter has illustrated the *constitution* of purchasing power. In this chapter I intend to sketch the way the HV accounts for the *use* of the earned purchasing power (income). Logically the purchasing power should be consumed in a payment which is wholly opposed to the remuneration of the factors of production. Such a payment requires that F or Fa *compensates* the excess of credits in the assets and liabilities 'T' accounts accumulated when remunerating the factors of production. For this to happen it suffices that Fa debits in an equal excessive amount the same kind of accounts (Cf. Figure 6; RA stands for real asset).

Figure 6: The use of the purchasing power

	Fa	B	Ha	Fa	B	PL	Ha
6.	D	C	D	D	C	D	C
	50	50	50	50	50	50	50
							L
							B
							RA
							A
							50

In the preceding Figure, in order to isolate the use of the purchasing power, I supposed that Ha spends the whole income, that the output consists totally of consumption goods and services, and that the selling price is equal to the cost of its production. Before arguing about the relaxation of those assumptions, let us put forward some comments.

- (i) This payment causes the collapse of the income. The complex structure doesn't survive this payment. As a result, the income is used.
- The collapse of the income leaves Ha positively enriched, as it was, in terms of value, before using its purchasing power. Fa finds itself in the same situation which prevailed before the remuneration of the factors of production (Cf. Figure 7).

Figure 7: The settlement of lines 1, 3 and 6

	Fa	B	Ha	Fa	B	PL	Ha
8.	D	C	D	D	C	D	C
	50	50	50	50	50	50	50
							L
							PC
							RA
							A
							50

- (ii) This result suggests that the increase in value of Ha actually followed its remuneration from Fa rather than the purchase of real goods and services. Therefore the change of a monetary value into a real value is merely a change in the form of the value rather than in the value itself. This observation is consistent with the characteristic of income (as suggested here) being *identically* a monetary and a real value. The two internally related terms of the income being identically the same thing (value), they cannot be *exchanged* one for the other. They can only be *changed* from one into another.
- (iv) It follows that, against any empirical realist ontology, the monetary value of Ha is not the mean of the payment depicted in Figure 6 by line 6. The monetary value would be the means of this payment if as a result Fa received it. However the payment does not increase the capital of Fa and furthermore does not decrease the capital of Ha. That is, Ha does not transfer any value. It cannot do that because it

is logically impossible to exchange a monetary value against its *identical* real counterpart.

Therefore a banking activity of the kind called for when analysing the constitution of the purchasing power is also needed for studying the use of it. The means of payment (which is not a value) is created and spontaneously offered to Ha by B (Cf. Figure 8, lines 5), used by Ha (Cf. line 6) and recovered by B (Cf. line 7).

Figure 8: The use of purchasing power and banking activity

	Fa	B	Ha	Fa	PL	Ha
	D C	D C	D C	D C	D C	L RA A
5.						
6.	50	50	50	50	50	(50) 50
7.		(50)				(50)

Let us now look at the assumptions made to isolate the use of the purchasing power (Cf. above). Those assumptions are in fact related because, in order to allow the new income to be spent on inter-industrial purchases rather than on the market for consumption goods and services, one should permit Fa to borrow from Ha (i) or to make a profit (ii).

- (i) The borrowing from Ha (through B) in order to purchase an investment good from Fb would entail, firstly, a financial transaction of the nature of that illustrated below (Cf. below, 5.3), and, secondly, an industrial payment of the type depicted above. The financial transaction, I anticipate, doesn't entail a banking activity. Rather, it consists in the substitution of Ha from Fb, or, identically, in the transmission of the purchasing power from Ha to Fb. Therefore the relaxation of the assumptions introduced above seems to be neutral in relation to the conception of banking activity.
- (ii) In this case a step which gives rise to a similar result as that of a financial transaction is firstly realised between Fa and Ha. Keynes's suggestion is helpful. The constitution of profits pertains to finance in the sense that it results in a purchasing power being transferred from Fa to Ha. Secondly, Fa simply uses the purchasing power in the place of Ha, thus reproducing a kind of payment depicted above. Again the relaxation of the assumptions does not change the specified banking activity.

In conclusion, the HV conceives the nature of banking activity and of monetary assets as pertaining to a deep ontological level. The reality of banking and money is layered. It is not exhausted by its simple empirical experience. The banking activity takes place on a deep ontological level; the means of payment which it creates is a deep structure. Banking activity is the deep causal monetary condition for the formation and the consumption of purchasing power (income).

In terms of purchasing power the activity of banking is always of an intermediary character. The specific macro-activity of banking creates the means for the two payments sketched above. This activity is thus encapsulated, though necessary, in the formation or in the collapse of a financial relation in terms of monetary values.

5.3 An Example of a Financial Transaction

For the HV, the transactions which Keynes grouped under the heading of 'Finance' do not require any banking activity. The reason for this is that they do not deal with the production or consumption of wealth, but, rather, with the creation, exchange and destruction of *titles to wealth*. The wealth in itself is always transferred between agents by the financial transactions.

Let me refer, as an illustration, to Ha investing his monetary earnings in the constitution of a savings deposit within a Savings Bank (SB) (Cf. Figure 9; MA for monetary assets and FA for financial assets). The SB provides a certificate of deposit to Ha and the former line 5 (Cf. Figure 8) must be rewritten.

Figure 9: An example of a financial transaction

	B				SB				Ha	
	SB		Ha		MA		Ha			
	D	C	D	C	D	C	D	C	L	A
5.	50		50	50	50			50	MA	50
									FA	50

Here there is no need of a formation or of a use of purchasing power. There is no need of a (pure) means of payment as defined above; there is no payment at all and therefore there is no banking activity. The Profit and Loss account of the aggregate functional entity Fa is untouched (Cf. Figure 10).

Figure 10: The situation of Fa



The pure financial activity does not entail the banking activity and thus maintains the level of income and the associated value. There only is the creation of a relation of indebtedness between SB and Ha, i.e. the creation of a *financial asset*. The operation only concerns two agents rather than three. Only by performing a separate and additional accountancy operation, SB can lend the monetary assets deposited by Ha to a third-party.

As a conclusion it is worth endeavouring an evaluation of the HV. It seems clear that, in relation to the ontological elements given above, the heterodox approach pertains to transcendental realism. It emphasises the existence of deep banking and monetary structures which govern the empirical experienced monetary assets, income, the production and consumption of wealth. In this respect the discovery of a deeper layer of the monetary and banking reality may be seen as constituting a scientific progress. As a matter of fact the explanatory power seems to have improved in relation to the explanation of the formation and the use of purchasing power (something which seems to be, as far as I know, a 'première'). Nevertheless, the increased explanatory power is accompanied by the setting of the economic analysis into a new analytical framework, dominated by the identity of real and monetary values. Therefore this approach has to elaborate the consequences of this foundation for macro-economics and political economy⁴⁵.

⁴⁵ The interpretation of banking activity presented above draws from Rattaggi (1994). The analysis of inflation has been proposed by Friboulet (1988) and Schmitt (1984); in relation to monetary theory and to the history of monetary thought Cf. Cencini (1988); for German forerunners of this approach Cf. Greppi (1994); for the extension of this approach into international monetary matters Cf. Schmitt-Cencini (1991); the fundamental reference is however Schmitt (1984).

6. Final Comments and Conclusion

Throughout this paper I have attempted to support the analyses which, in relation to the recent US depository institutions turmoil, increasingly stress both the inadequacy of the regulatory framework inherited from the thirties and the superiority of the so-called universal banking model. The discussion has been based on two recent original insights, respectively in the field of economic methodology (Critical Realism) and in the interpretation of banking activity (a Heterodox Version).

Critical Realism emphasises the layered ontological nature of social reality, in which deep institutions represent the social condition for the individual behaviour. The relation between individual action and the institutional set up is conceived as being either of reproduction or of creation. Furthermore Critical Realism conceives scientific progress as the discovery of deeper layers of social reality (through the elaboration on existing knowledge of a phenomena of interest), provided that they enhance the understanding of the phenomena of interest.

On this methodological basis I have endeavoured to show, firstly, that the existing regulatory framework inherited from the thirties and settled in order to enhance the safety of banking activity relies on an interpretation of banking activity (the Traditional View) which presupposes an empirical realist ontology and postulates the purchasing power of monetary assets (intended as a quality which characterises every monetary asset). Secondly, I have taken the liberty of suggesting that the regulatory framework settled in the thirties might be seen as a deep structure in both having promoted the events of the seventies (monetary and financial innovations) and in not having successfully enhanced the safety of banking activity in the eighties.

Once the relation between the interpretation of banking activity and the regulatory framework settled in the thirties is taken into account, the problem of how to promote structurally further the safety of banking activity (especially in the light of the events of the eighties) may be perceived as an awkward issue. Its treatment might therefore benefit from an alternative interpretation of banking activity. The Heterodox Version provides an alternative insofar as it might be seen to allow us to go behind the usual postulate of monetary assets having the economic power to purchase, and therefore to enhance the knowledge of banking activity.

To conclude, I want to point out the kind of regulatory structure which would best promote the safety of banking activity according to the Heterodox Version. This interpretation defines banking activity as the creation of a pure means of payment. This

means is not an asset; rather it is a kind of flux (payment predisposition, authority to pay, opportunity to pay) which sets itself as the deep structure of each payment and of any alteration of income. The Heterodox Version stresses that the banking activity takes place within the activity of financial intermediary. The payments entail the creation of the means, which is not a monetary asset, and the creation or the collapse of a financial relation in terms of monetary assets, which is not a banking activity. Furthermore, according to this interpretation, the means of the payments is a public good because it is impossible to define any private appropriation of a structure which is never present as an asset (as a fixed situation) in any account. It follows that for the Heterodox Version the best regulatory protection of banking activity should be indirect, through the setting up of the regulatory framework which helps at best the entrepreneurial banking management. The least suitable framework should grant a *levelled* playing field amongst every banking or financial institution, while the safety of the banking activity ultimately lies in the *managerial skills* of the executive bankers. Thus, referring to the US situation, the conception put forward above would sustain the introduction of the so-called *universal banking model* and the trend towards a *prudential indirect public supervision* of the activity of the banking and financial industry.

As a final clue, it could be argued that the overall banking experience in the countries where the universal model has never been given up, appears to have proved less dramatic than in the US. Similarly the ongoing structural adjustment within the Swiss banking industry appears to be substantially sustained, from an internal management point of view, by the contribution of the purely financial activity and, on an externally regulatory perspective, by those measures fostered by the international regulatory institutions which aim at framing *indirectly* the management of the institutions (and which are therefore compatible with a universal banking model).

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