

# An Economy Built on Debt? The Chicago Plan Alternative

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# 1 Introduction

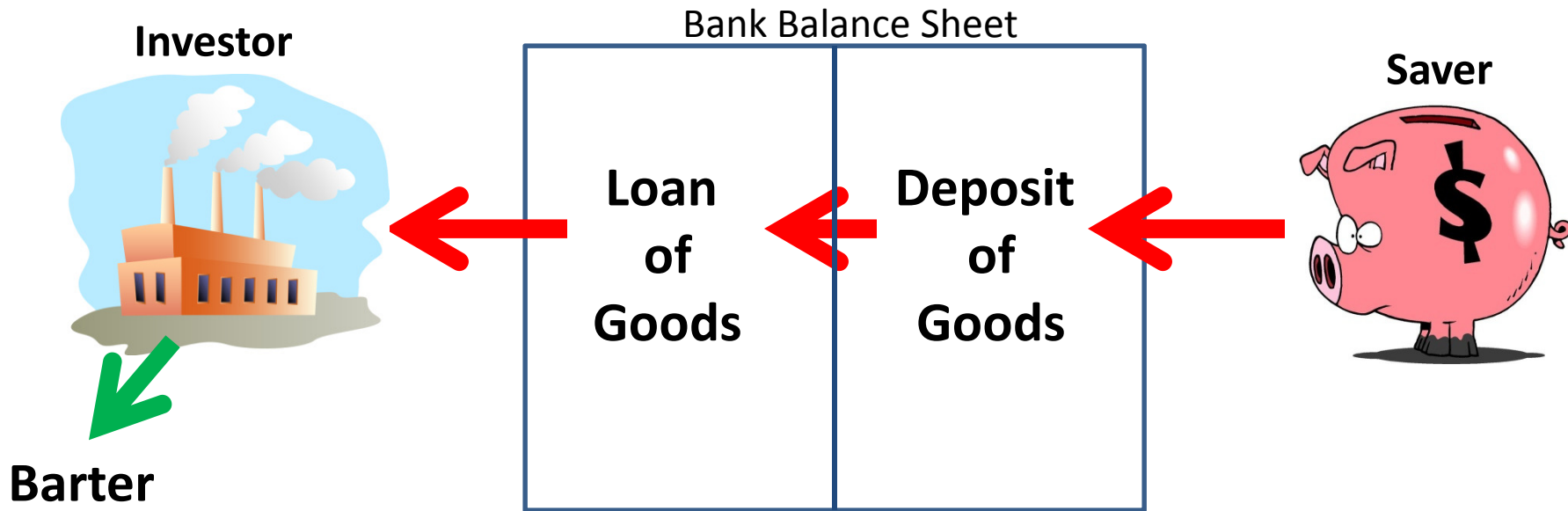
- The 1930s Chicago Plan was the result of a profound debate about how to make the financial system safer in the wake of the Great Depression.
- It was supported by:
  - Irving Fisher, Henry Simons, Frank Knight, Milton Friedman, ....
  - Basically, the founders of the “free market” Chicago School.
  - They saw control of money as a precondition for “free markets” in industry.
- In a nutshell, the Chicago Plan proposed:
  - Separation of the monetary and credit functions of banking.
  - **Money Banks:** Deposits must be backed 100% by public money.
  - **Credit Banks:** Financing of credit ...
    - \* not through ex nihilo creation of private money,
    - \* only through on-lending of public money.

This is very important. It makes no sense here to think about an individual bank. You need to think about the banking system as a whole.

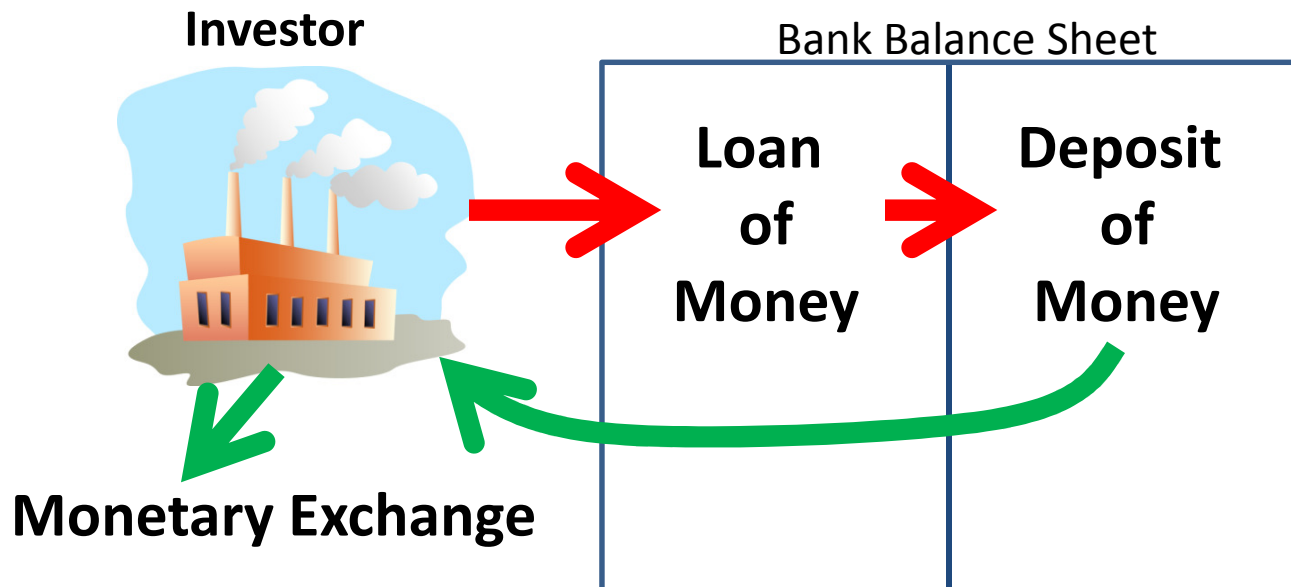
## 2 Understanding Today's Banks

- Banks as a whole do not intermediate pre-existing loanable funds.  
There are no pre-existing loanable funds.
- Banks as a whole do not accept deposits from non-banks.  
They create deposits in the act of lending.
- **Two Implications:**
  1. Efficiency: Adequate money creation must load the economy with debt.
  2. Volatility: Banks can quickly start a lending boom by “printing” money.
- **The Chicago Plan would change this:**
  - Most public and private debt would be replaced by public money.
  - Credit banks could only intermediate sovereign money.
  - Banks could no longer create private debt-based money.

## Intermediation of Loanable Funds Model



## Financing Through Money Creation Model



I have omitted almost all mathematics underlying the model.

The exception is balance sheets and budget constraints.

You cannot discuss the Chicago Plan without being very precise about balance sheets and budgets.

Otherwise you end up making outlandish claims that have no support.

## 3 The Model Pre-Chicago-Plan

### 3.1 Households

- Preferences over consumption and hours worked.
- Production functions in capital and hours worked.
- Deposits are indispensable for (four) real economic activities.
- Banks extend loans based on (four) different types of collateral.
- Budget constraint (simplified):

**Saving  
= Physical Concept**

**Deposits (money)  
= Financial Concept**

$$Deposits_t - Loans_t = \text{Gross Income}_t - \text{Gross Spending}_t$$

If the household/firm wants more deposits:

- Loans need to change
- Saving cannot increase deposits, it can only move them around.
- Example: Talk through a check deposit

Again: Loans Create Deposits

## 3.2 Wholesale Banks

- Balance sheet:

$$Loans_t + GovBonds_t = Deposits_t + NetWorth_t$$

- Minimum capital adequacy rules impose penalties  $\implies$  capital buffers.
- Set spreads between wholesale lending rates and the policy rate.

## 3.3 Retail Deposit Banks

- Monopolistic competitors (market power) towards retail holders.
- Set spreads between the policy rate and retail deposit rates.

## 3.4 Retail Lending Banks

- Need to be compensated for the risk of borrower default.
- Set spreads between retail and wholesale lending rates.

## **3.5 Bond Investors**

- Hold and arbitrage government bonds and wholesale bank deposits.

## **3.6 Monetary and Fiscal Policy**

- Monetary policy - interest rate on reserves rises with expected inflation.
- Fiscal policy - deficits increase when the economy is slack.

## 4 The Model Post-Chicago-Plan

- Preferences, production function, etc. almost completely identical.

### 4.1 Banks

- **Money banks** ( $M_t = \text{reserves}$ ):

$$D_t = M_t$$

Deposits are fully backed by central bank reserves

- **Credit banks** ( $F_t = \text{treasury credit}$ ):

$$L_t^k = F_t + N_t^b$$

Loans can only be made after attracting public money deposits

- All bank-held government bonds are repaid.
- All loans except investment loans  $L_t^k$  repaid via a citizens' dividend.
- The remaining balance sheet is financed through treasury credit.
- Even  $F_t$  could be partly or wholly paid out as a citizens' dividend.

## 4.2 Monetary Policy

- Interest rate on **reserves** (policy rate) rises with inflation (like now).

Optimal response to inflation is very aggressive.

- Interest rate on **public money** is at a fixed spread under the policy rate.

- Interest rate on **public credit** rises with bank credit.

Optimal response to credit is aggressive.

## **5 The Six Advantages of the Chicago Plan**

**Advantage 1: Dramatic Reduction of Private Debts**

**Advantage 2: Dramatic Reduction of the (Net) Public Debt**

Part of treasury credit is used to repay bank-held government debt

Part of treasury credit is used to pay out a large citizens' dividend that citizens use to repay loans

# Banking Sector Transition

Pre-Transition

Assets		Liabilities	
15	Government Bonds	148	Deposits
100	Short-Term and Mortgage Loans		
50	Investment Loans		
		17	Bank Equity
148	Reserves	148	Treasury Credit

100% Reserve Cover

Post-Transition

Assets		Credit Banks		Liabilities	
15	Government Bonds	15	Earmarked Treasury Credit	100	Citizens' Accounts
100	Short-Term and Mortgage Loans	100		50	Investment Loans
50	Investment Loans	33	Remaining Treasury Credit	17	Bank Equity
		148		148	Deposits

(numbers in % of steady state GDP)

Private debt goes from 150% to 50% of GDP

Important! This assumes that the primary use of the balance sheet gains is balance sheet repair, not spending. This is a choice.

# Government Transition

Pre-Transition

Assets		Liabilities	
75	Other Assets	75	Government Debt
148	Treasury Credit	148	Reserves

Post-Transition

Assets		Liabilities	
75	Other Assets	60	Government Debt
33	Treasury Credit	48	Reserves minus Citizens' Dividend

Reserves are not a debt of the consolidated government - they are "social equity" (Kumhof et al. (2021))

**Net public debt goes from 75% to 27% of GDP**  
**Public "equity" goes from 0% to 48% of GDP**

### Advantage 3: Complete Elimination of Bank Runs

- Money is completely safe because its value no longer depends on:
  - The *quantity* of private debts.
  - The *performance* of private debts.
- Run on the credit system?
  - *Payments system*: Remains 100% safe.
  - *Credit system*:
    - \* Marginal source of funding is now treasury credit.
    - \* Regulation can ensure private funding is only long-term or equity.

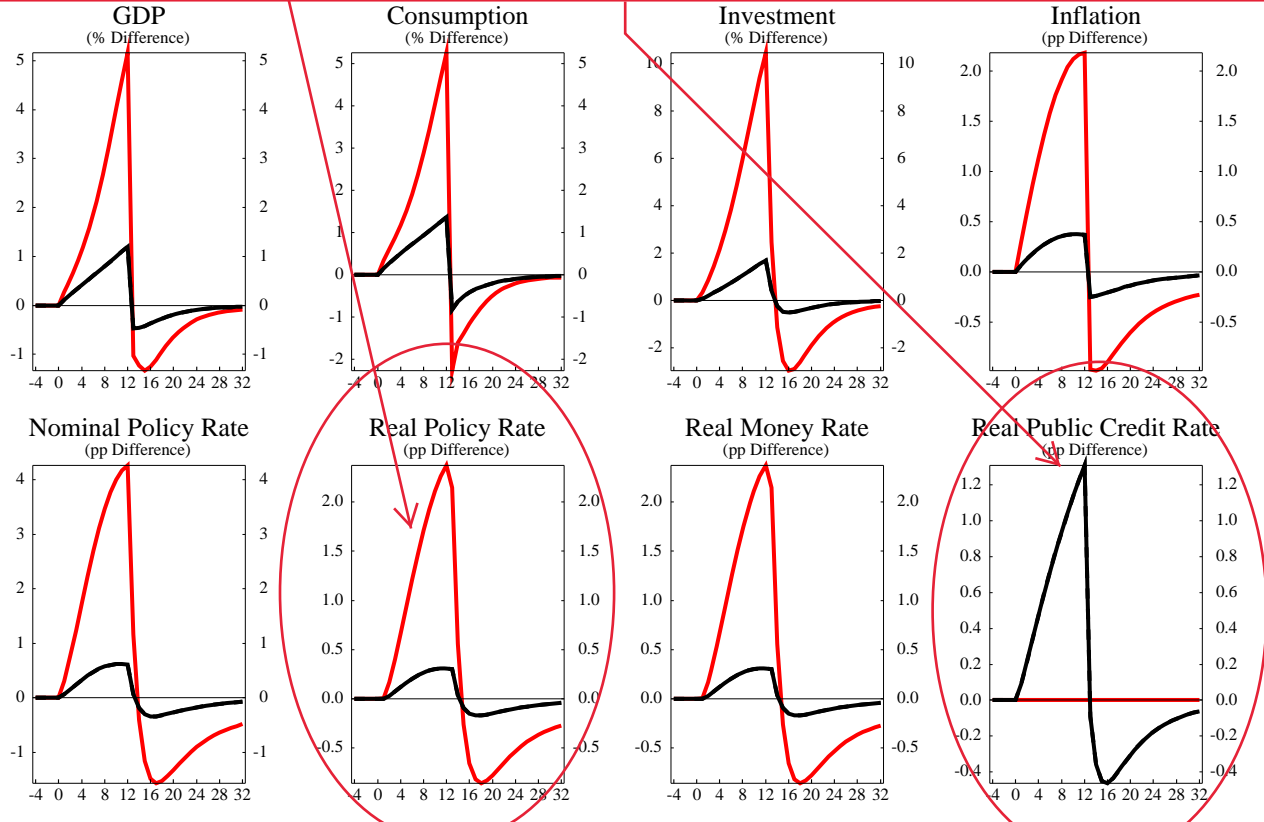
When it's equity, the worst that can happen is something akin to a stock market crash

## Advantage 4: Much Better Control of Credit Cycles

- The money creation privilege of banks can be a major source of credit cycles:
  - Banks never face loan financing risks, only deposit refinancing risks.
  - Credit decision can be funded 100% in house, through money creation.
  - Government guarantees: Banks and depositors pay less attention to risk.
- Under the Chicago Plan this money creation privilege is removed:
  - Intermediary banks must first persuade investors to make cash deposits.
  - These risky deposits have (need) no government guarantee of any kind.
  - Investors will therefore be more cautious.
  - This makes credit-driven business cycles less likely.
  - But of course it does not rule them out completely.
- Under the Chicago Plan, policy controls 3 tools rather than 1:
  - Interest rate on **reserves**: Same as today.
  - Interest rate on **treasury credit**: Charged to credit banks.
  - Interest rate on **public money**: Paid to money banks.

# Credit Supply Shock Boom-Bust Cycle

The key is the much stronger effect of the public credit rate, compared to the conventional policy rate, on credit and thereby activity



red = pre-transition, black = post-transition

The same results (qualitatively) can be shown for all other shocks in the model

## Advantage 5: Large Output Gains

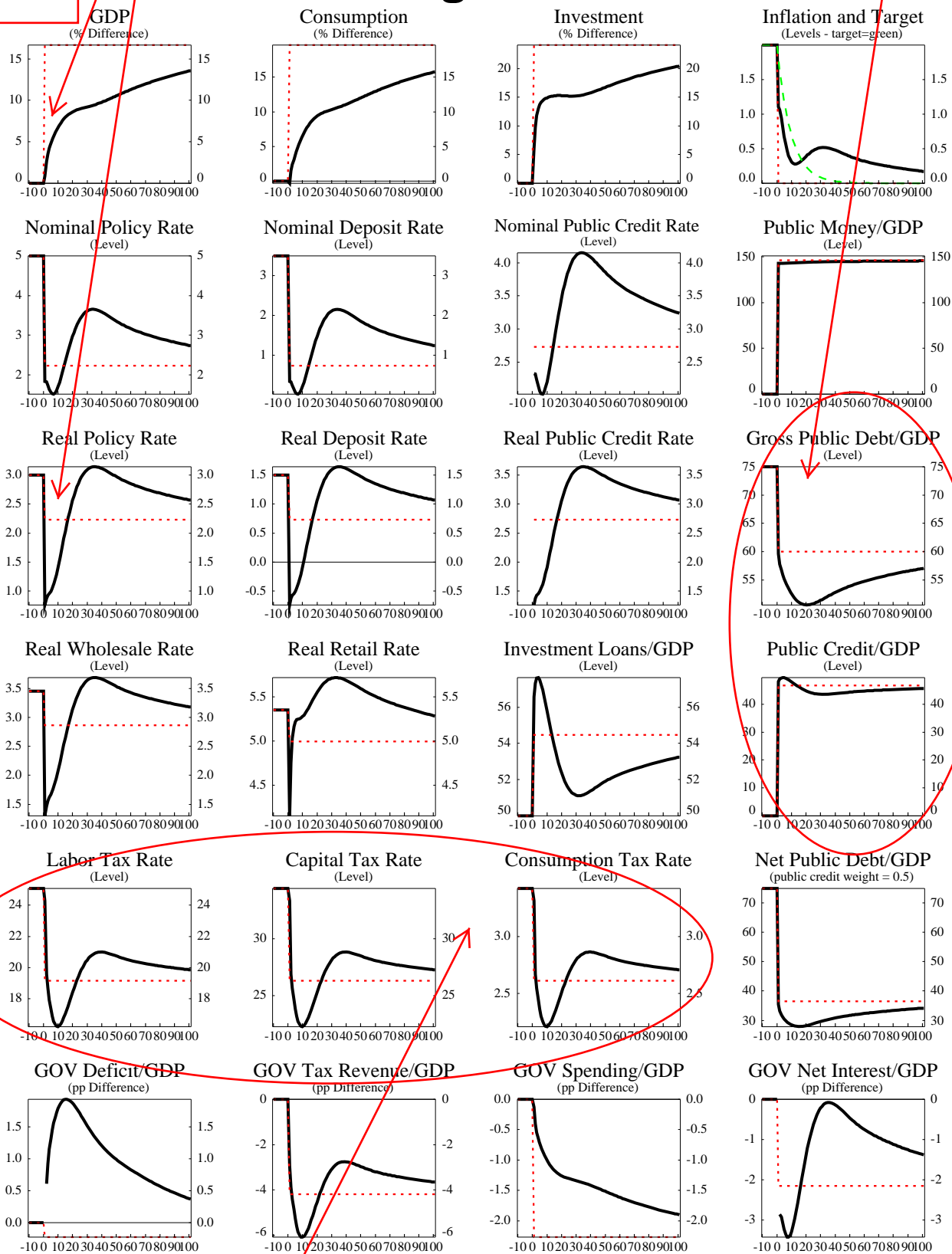
1. Lower interest rates: Due to *lower debt levels*.
2. Lower tax rates: Due to non-inflationary *fiscal revenue from money creation*.
3. More abundant liquidity

2. Lower real interest rates

1. Big drop in net public debt

# Transition to Chicago Plan

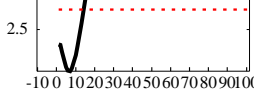
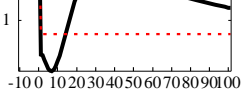
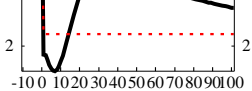
4. Higher output



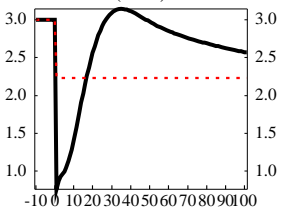
(\_\_\_ = transition path, - - - = final steady state)

3. Lower tax rates

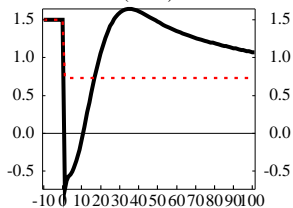
Big drop in net public debt



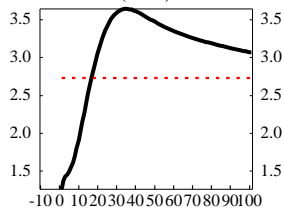
Real Policy Rate  
(Level)



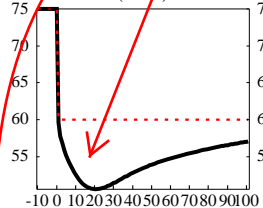
Real Deposit Rate  
(Level)



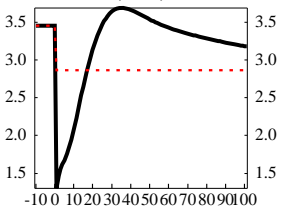
Real Public Credit Rate  
(Level)



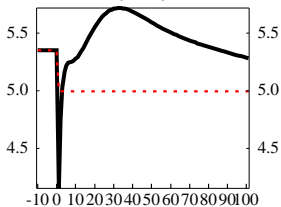
Gross Public Debt/GDP  
(Level)



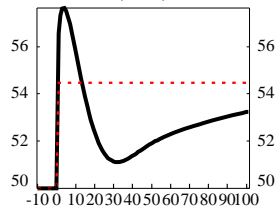
Real Wholesale Rate  
(Level)



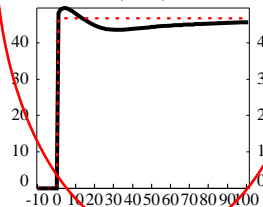
Real Retail Rate  
(Level)



Investment Loans/GDP  
(Level)

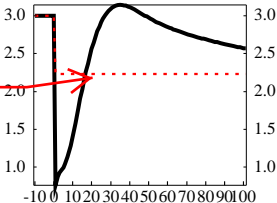


Public Credit/GDP  
(Level)

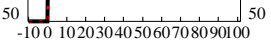
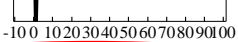
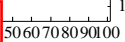


Lower  
real  
interest  
rates

## Real Policy Rate (Level)

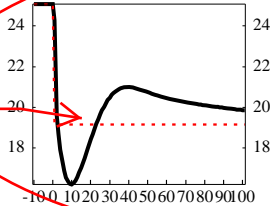


Important! Taxes cannot go to zero. This is not Christmas. This emphasizes the importance of studying the budget constraint.

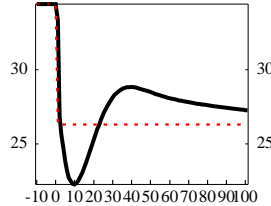


**Lower  
tax  
rates**

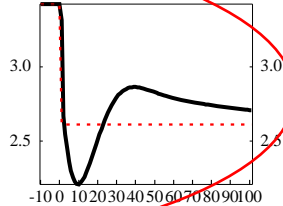
Labor Tax Rate  
(Level)



Capital Tax Rate  
(Level)

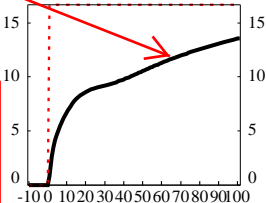


Consumption Tax Rate  
(Level)



# Higher output

GDP  
(% Difference)



- I often get the comment: I don't like these big results so there must be something wrong with the methodology.
- Of course that is anti-scientific.
- The only scientific objection would be: I don't like the methodology so there must be something wrong with the results.
- The problem with that is: We are using completely standard methodology!

## 6 Criticisms - and Rebuttals - of the Chicago Plan

### Criticism 1: What Is the Market Failure?

- **Idea:** If it ain't broke, don't fix it.
- **Counterarguments:**
  1. **Rent Seeking:**
    - Seigniorage rents.
    - Due to market power and government support.
    - Extensive literature.
  2. **Increasing Returns to Scale:** In the trust needed for money creation.
    - Government/society: Maximum scale.
    - Silicon Valley Bank: Very small scale.

## Criticism 2: Money Substitutes Prevent Monetary Control

- **Idea:** Public money control impossible due to private money substitutes.
- **Counterarguments:** There are many reasonable **countermeasures:**
  1. Only public money accepted by *government*: Private money less viable.
  2. *No deposit insurance* for private liabilities: The essence of money is trust!
  3. No *tax advantages* for borrowing + tax advantages for equity financing.
  4. *Maturity mismatch regulations*.
  5. *Legal incentives* to pay in public money.
  6. *Legal prohibition* on paying in private money.

### Criticism 3: Maturity Transformation Benefits Will Be Lost

- **Idea:** CP cannot offer desired maturity profiles without transformation.
- **Counterarguments:** Maturity transformation is not an end in itself  
**The point is maturity, not transformation!**
- Maturity transformation accomplishes two objectives:
  1. Provides desired maturity profiles:
    - Short-term liquid assets for savers.
    - Longer-term illiquid liabilities for borrowers.
  2. May reduce borrowing costs (not necessarily if banks have market power).
- The Chicago Plan not only accomplishes both objectives, it does better:
  1. Desired maturity profiles are available without maturity transformation.
  2. Borrowing costs are lower due to the large debt-to-equity swap.

## Criticism 4: Competitiveness/Crowding-out of Banks

- **Competitiveness - Idea:** I am not really sure.
- **Counterarguments:**
  1. *Money banks:* Can operate payment system without worrying about asset quality.
  2. *Credit banks:* Can operate credit system with far fewer worries about liability risks.

## **Criticism 5: Too Much Money**

- **Idea:** Public money creation becomes excessive and leads to inflation.
- **Counterarguments:** No reason to expect inflation, for three sets of reasons:
  1. Monetary Theory
  2. Institutional Arrangements for Money Issuance
  3. Monetary History

## Monetary Theory

- Inflation is determined by the relative quantities of
  - goods and
  - money in private hands.
- CP: Quantity of money in private hands remains unchanged.
- The nature of money changes, not its quantity.

## Criticism 6: Too Little Money

- **Idea:** Small businesses will be starved of credit and money.
- **Counterarguments:** This is a question of price. What does the model say?

Implications of much lower debt levels:

- Public debt ↓ ⇒ leverage ↓ ⇒ **risk-free rate** ↓ ⇒ cheaper borrowing.
- Private debt ↓ ⇒ leverage ↓ ⇒ **spreads** ↓ ⇒ cheaper borrowing.
- Private cheap deposits ↓ ⇒ **lending rates** ↑ ⇒ more expensive borrowing.
- Our paper: Net effect is **cheaper borrowing**.
- Average firm is **less likely to have to be in debt to obtain cash**.

## Criticism 7: Government Control over Credit

- **Idea:** Government would interfere with credit and credit allocation.
  - **Counterarguments:** Government ...
    1. would not control the *quantity* of credit,
    2. would not control the *allocation* of credit,
    3. could only affect the *price* of credit,  
and it could do that more effectively than today.
- That is one of the objectives of monetary policy today

## Criticism 8: Risk of Speculative Attacks

- **Idea:** Speculators could attack the currency if a country does the CP alone.
- **Counterarguments:**
  1. The country's economic fundamentals would get stronger, not weaker.
  2. The policy tools for fighting attacks would be stronger, not weaker.

## 7 Conclusions

1. What can we learn from the 1930s debate?
  - About the nature of the financial system:
    - Banks have the privilege of being able to create money to fund loans.
    - This implies that bank balance sheets can **grow and shrink rapidly**.
    - It also imparts a **debt bias** to the entire financial system.
    - This makes discontinuing that privilege a legitimate part of the debate.
  - About monetary and financial reform:
    - The Chicago Plan calls for the end of the money creation privilege.
    - It has maximal benefits, but also requires the most radical transition.
2. Do we have new reform options today that did not exist in the 1930s?
  - New technologies make sovereign money much more practically feasible.
  - Sovereign money proposals include both CP and CBDC.
  - CBDC is on the agenda of several central banks now.

THANK YOU