Matthew C. Klein writes: One of the oddest things about the aftermath of the financial crisis is the extent to which things haven't changed.

Yes, there are plenty of new rules, and stress tests, and of course there are more fines for wrongdoing, but the basic structure of the financial system doesn't look much different from before it blew up. There is still plenty of money to be made (and lost) issuing short-term "safe" debt to buy long-term, illiquid, risky assets. Lenders still exacerbate the cycle by increasing their leverage when asset prices rise only to cut back on lending when the economy sours. And everyone knows that taxpayers are still on the hook when things go bad, which acts as a massive subsidy for the financial industry.

As if all that weren't bad enough, the current system makes it far too hard for central bankers to accomplish their mission of stabilising the economy. Right now, changes in nominal spending power are largely due to decisions made at banks and other financial firms. The level of short-term interest rates affects their behaviour, as do asset purchases, but monetary policy is only one force among many that determines total nominal spending. Modestly raising the cost of short-term funds isn't enough to stop excessive credit growth, just as aggressive bond-buying has proven insufficient to restore the pre-crisis trend of nominal spending.

The continuity can't be explained by the lack of better ideas. In fact, the basic alternative to the status quo — moving the power to create money from private financial firms to the state — was suggested in detail in the 1930s by a group of economists led by Irving Fisher. Subsequent proponents have included Milton Friedman, James Tobin, researchers at the International Monetary Fund, John Cochrane, and Martin Wolf. (And me.)

Whether it was a fear of change or simply the power of vested interests, the reformers never made much headway. Despite the general willingness of the US government to experiment with all sorts of genuinely bad economic ideas in the 1930s, the 1933 "Chicago Plan" failed to gain traction. Then came World War II. Yawning budget deficits accommodated by the Federal Reserve's interest rate caps caused nominal spending to soar by about 122 per cent between 1940 and 1945. Private debts, as a share of national income, fell by about 100 percentage points during the war. That laid the groundwork for the subsequent boom and, understandably, dulled the appetite for significant reforms of the financial system.

The more recent crisis could have been another golden opportunity. In February, 2009, Alan Greenspan — Alan Greenspan! — was telling the Financial Times that "it may be necessary to temporarily nationalise some banks in order to facilitate a swift and orderly restructuring". However, the success of countercyclical policy (relative to the 1930s, anyway) seems to have had a comparable impact on the public debate as the WWII reflation.

But now it looks as if tiny Iceland, a country one one-thousandth the size of the US that nevertheless endured the third-biggest financial failure in history, is exploring more radical options. Frosti Sigurjonsson, the chairman of the Icelandic parliament's Economic

Affairs Committee, recently published a report, commissioned by Iceland's prime minister, that argues for the establishment of what he calls a "Sovereign Money System".

The essential proposal will sound familiar: separate money — the stuff we use for emergency savings and transactions — from credit, which is inherently risky but promises the possibility of higher returns. The Central Bank of Iceland would become the sole provider of "money" (analogous to today's bank reserves, except available to everyone) and safeguard it in "risk-free, electronic safe deposit boxes".

Commercial banks would manage these "Transaction Accounts" in exchange for fees, but they wouldn't themselves issue anything resembling demand deposits. Meanwhile, banks would only make loans to borrowers after first raising the money from savers, rather than by simply creating new money. (Read this Bank of England primer for more details on how the current system works.)

In theory, these changes should make the economy more stable by eliminating the risk of bank runs, while also removing the hidden subsidies the financial sector currently enjoys thanks to its ability to ransom the people's savings for government handouts. Oh, and it also ought to make it easier for monetary policymakers to prevent nominal spending from growing too quickly (or too slowly).

Economists at RBS seem to agree. From a recent note on Iceland's proposal:

> The key idea is a new Sovereign Monetary System, where only the central bank is responsible for money creation. The idea makes sense…Separating the creation of money and allocation of money powers could safeguard against excessive credit creation, and reduce incentives for commercial banks to create more credit to make private gains…Iceland's proposal is worth exploring.

A few of the details, however, give us some pause.

Start with the conduct of monetary policy.

According to Sigurjonsson, the CBI's new "Monetary Creation Committee" would decide each how many kronur the economy needed to grow, and then deposit that amount in the government's transaction account. Then it would be the responsibility of the politicians to determine what happens to this extra money. The fiscal authorities would then get to decide whether to spend this new money on higher salaries for public workers, make benefit schemes marginally more generous, cut taxes, repay the national debt, give everyone a "citizen's bonus", or lend to financial firms on the condition that they pass the new funds on to businesses.

This strikes us as overly complex and liable to create needless confusion. Sigurjonsson's report makes a convincing case that private lenders aren't the best judges of how much money the economy needs to sustainably grow. Why should central bankers and politicians be any better? Monetary policy rules have failed in the past because they have been unable to adapt to structural changes in the financial system. If Iceland were successful in centralizing the control of nominal purchasing power, the appeal of policymaker discretion should vanish and a simple money-growth target would suffice.

Those are minor criticisms. We're more concerned by Sigurjonson's treatment of what he calls "Investment Accounts." These "will earn interest for customers in proportion to the account's risk and duration" and take the form of bank debt. After an Icelandic saver moves money from her transaction account into a bank's investment account, the bank then decides how to invest that money to generate the promised yield. Unlike the money in transaction accounts, nothing in an investment account is guaranteed by the state. And these investment accounts can't be redeemed for risk-free money on demand.

While we wholeheartedly agree that savers ought to be able to take risks in exchange for the possibility of higher returns, this proposal leaves too much of the existing system's dangerous features in place. Most obviously, there is still a fundamental mismatch between bank assets and bank liabilities. From the report (emphasis ours):

> The funding of long-term loans with short-term investments is called maturity transformation. A bank can perform a maturity transformation in the Sovereign Money System, as it can in the present system. In both cases the bank matches the demand of long-term borrowers with supply of several successive short-term investors. Maturity transformation carries risk in the present system and will continue to do so in the Sovereign Money System. A bank that is unable to find new investors to replace the investors that choose to end their investment, may run into liquidity problems.
>
> It is not the purpose of the Sovereign Money System to eliminate this risk, but rather to reduce the danger of losses being passed on to the state, by protecting the payments system and the funds of those who did not wish to take any risk. Furthermore this risk will decrease significantly under the Sovereign Money System, as short term funding in the form of deposits will not be part of commercial bank's balance sheets.

On the bright side, the payments system would be protected in the event of large losses. Plus, banks would be constrained in their ability to create credit beyond what the economy can support. Since basically all of the growth in private debt as a share of GDP since the late 1970s came from mortgages, rather than investment in productive capacity, both developments would be big improvements.

On the downside, banks would be almost exactly as vulnerable to runs as they are in today's system.

It's worth recalling that, for the most part, the bank runs that were so damaging during the 2007-2009 crisis weren't the fault of household depositors queuing outside their local branches. Rather, they were caused by nonfinancial corporations, insurers, pension plans, hedge funds, and other banks that were pulling their savings out of money-market mutual funds (the big buyers of commercial paper issued by banks) and the repo markets. These are, presumably, the same sorts of institutions that would be keen on buying relatively short-term investment accounts under the new system — which would be almost as vulnerable to runs.

Suppose that a bunch of investment account holders decided that, at maturity, they wanted to redeem their accounts for risk-free money, rather than roll over their risky assets into a new investment account. (Maybe they saw other investment account holders take losses and got nervous.) The bank could have a tough time getting the cash needed to repay these quasi-depositors without dumping a ton of assets, which could cause problems elsewhere, or the bank might simply go bust.

Either way, you could expect a sudden spike in the cost of borrowing, assuming credit were even available, as other holders of maturing investment accounts rushed to redeem for cash. It's the familiar story of something previously believed to be relatively safe suddenly looking far too risky. A whole cascade of failures could ripple through the system.

The central bank could prevent the extreme bad outcome if it printed new money that would be used to fill the hole in bank investment accounts created by fleeing savers, but that wouldn't be much different from the existing system in terms of its impact and perceived unfairness. (While the obvious parallel would be to QE, it's worth remembering that the Fed experimented with fixed targets for reserve creation in the 1980s, but was forced to abandon them because they didn't want to blow up any banks that needed a little extra liquidity.)

The government could accomplish something similar by paying people to roll over their existing investment accounts, but again, this would be fiscal transfer by other means. It would also look a lot like the deposit insurance schemes that Iceland wants to dismantle.

Even if the maturities of the investment accounts perfectly matched the maturities of the banks' assets, there is still a danger that lenders might be unwilling to roll over their maturing loans when borrowers want to roll over their maturing debts. Hyun Song Shin has argued that this is already something to worry about within the context of bond funds that invest in emerging market fixed income, and that monetary policymakers should be aware that sudden changes in the portfolio preferences of unlevered investors can create conditions somewhat similar to traditional bank runs.

Sigurjonsson's plan for Iceland is an intriguing beginning that hopefully will lead to more debate about the future of the financial system. If implemented, it would dramatically improve the ability of central bankers to stabilise nominal spending without distorting the composition of economic activity.

However, the current proposal leaves open a large loophole in the way that banks can fund themselves, to say nothing of bank-like financial firms. Closing this loophole would require more radical measures, such as a requirement that all investments are funded by equity, or by venture capital-style lockups.