Kiel Institute
for the World Economy

Macro Reading Group | Kiel, 21 January 2014

Global Money and Free Banking 2.0 – A Follow-up

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Key aspects

- **Money = medium of exchange** (nothing else)
  - Persistence of current monetary system?
  - Policy assignment for central banks (Tinbergen problem)
  - Global network good (role of national borders?)
- **Credit-backed fractional reserve banking**
  - Minimum reserve requirements vs. genuine banking
    - Legal privilege
    - Why not 100 percent or: What is **elastic credit supply** good for?
  - Implications of credit-backed reserve medium (**pseudo-financing**)
  - Gateway to **macroeconomic destabilization** (Cantillon effects)
  - Source of **regulatory overkill** (permanent fight against inherent incentives)
- **Deflation** – a case for monetary expansion?
  - Deflation as the flip-side of increasing productivity
  - Deflation as a side-effect of crises (provoked by what?)
- Scope for **private, supra-national money production**
  - Search for better medium of exchange, overcoming fiat money systems
  - Commodity money and digital technological opportunities

Preliminary remarks

- **Genesis:**
  - Hayek Seminar 2012
- **Current version:**
  - Economic Essay for the general public (Schweizer Monat, Liberales Institut)
- **Future version:**
  - Discussion paper

- **Subject:**
  - Very broad and fundamental (visionary?)
  - Qualitative scenario, NOT a forecast, indefinite horizon (pattern prediction)
  - Positive, not normative analysis:
    Description of an alternative monetary system derived from consideration of self-interested human action

Point of departure

- **Monetary regimes in retrospect**
  - Series of upheavals escaping the high-frequency radar of "routine economics" (generations rather than decades)
  - No obvious tendency towards a steady-state

- **Global monetary system**
  - Key features
    - Debt-backed
    - Fractional-reserve system
    - State-owned central bank
  - Short episode in the history of finance (42 years only)
  - By no means "normal" or "natural"
  - Should not be taken for granted/permanent
  - Costly (money half-life: 35 years), fragile (financial crises)

Money as a market phenomenon

- **Money emerged by evolutionary learning**
  - Enabling indirect exchange
  - Dramatically widening the division of labor
- **Money = medium of exchange**
  - Pre-monetary value (regression theorem, Mises 1912)
  - Homogenous
  - Permanent
  - Reversibly divisible
  - ⇨ Precious metals emerged as best-suited candidates
- **Money is a product of the market**
  - Private money production prior to state monopoly (Menger 1892)
  - Contrary to the "State theory of money" (Knapp 1921, Peacock 2013)
  - Standardization (defined units of weight and fineness) reduce transaction cost even further
  - Governments can act as standard setters for monetary units …
  - … but historically acted primarily as counterfeiters

Fractional-reserve banking (1/2)

- **Legal privilege**
  - Granted to the banking industry only
  - Deposit vs. loan contracts (Huerta de Soto 2012) (safekeeping vs. temporary transfer of availability)
  - Borderline between liquidity provision (deposits) and capital provision (loans) becomes legally and economically indistinct
  - Car-park/car-rental analogy
- **Genuine banking**
  - Deposit services (100 percent reserve requirement) subject to charges
  - Credit intermediation (bringing savers and investors together) including risk assessment, volume (and maturity?) transformation

- BTW: “Dr. Econ” (Federal Reserve Bank of San Francisco)
  - Q: What is the economic function of a bank?
  - A: Intermediation of funds (money creation not even mentioned)

Fractional-reserve banking (2/2)

- **Macroeconomic consequences**
  - Credit and money creation out of thin air
  - Drives a wedge between ex ante saving and credit/investment ("elastic credit supply")
  - Shift of purchasing power to early creditors, non-neutrality of money (Cantillon effect)
  - Key mechanism in monetary business cycle theory (Hayek 1932)
- **Macroeconomic benefits?**
  - Compare two economies distinguished only by their quantities of money: Which one is better of? (Mints 1950)
  - Deflation – a case for monetary expansion? (Hülsmann 2008)
    - Deflation as a side-effect of crises (provoked by what?)
    - Deflation as the flip-side of increasing productivity
    - Consumer restraint not convincing
  - Commodity money: Cost reduction, freeing resources for final use (Wicksell 1935, Selgin 1988)
  - Fiat money: Risk transfer to private banks (but: moral hazard)

Debt-backed money creation (inside money)

- Self-reference
  - Money (means of payment) backed by securities (promises of future payments)
  - Recent debate whether central bank money must be backed at all (De Grauwe/Ji 2013)

I PROMISE TO PAY THE BEARER ON DEMAND THE SUM OF TWENTY POUNDS

Central banking

- Possibility of banks-runs due to fractional-reserve banking
  - Central bank as "Lender of Last Resort" for liquidity support only
  - Solvent, but illiquid banks (Bagehot 1873)
  - ⇨ Creeping process of expanding role as LoLR (concept dilution)

- Collateral risks infect stability of payment systems
  - Central bank as bail-out agency? ⇨ only seemingly
  - Ring-fencing financial stability by central supervision?
  - ⇨ Promoting monocultures of risk assessment

- Technically unlimited money creation capacity
  - But: Too much money is no money (hyperinflations)
  - And: Financing illusion of the money press (monetization as implicit taxation)
  - ⇨ Technical feasibility ≠ economic effectiveness

Risk of overloading monetary policy

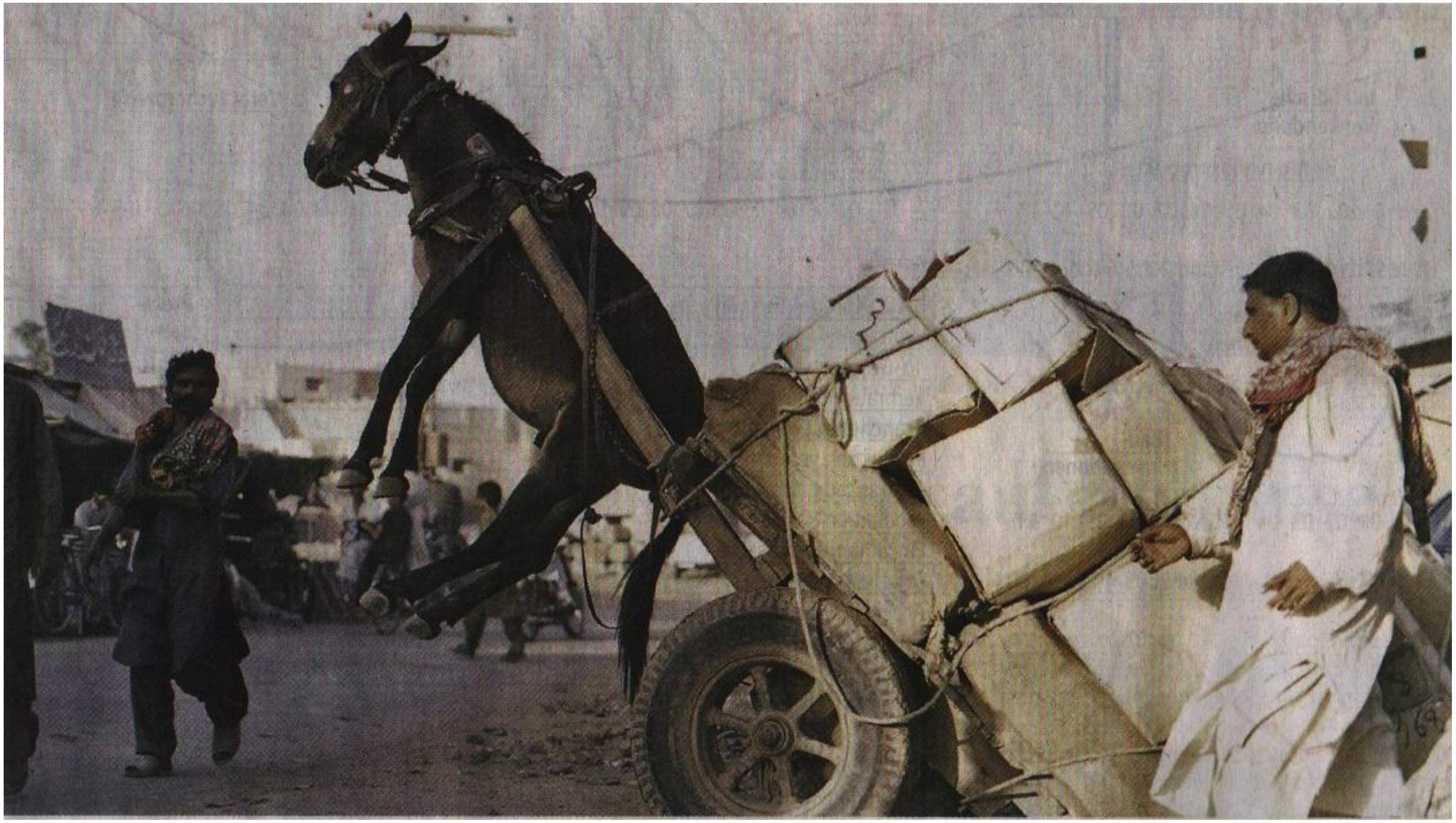
- One instrument, multiple targets? (Tinbergen 1952)
- Generic target: Provision of a means of exchange
- Other targets: Government financing, debt-monetization, boosting employment, business-cycle stabilization, financial stability

⇨ **Potential conflicts**

⇨ **Room for excessive rent-seeking**

⇨ **High risk of sacrificing the (most abstract, general) generic target for (more simplistic, partisan) non-generic targets**

Overloaded ...



Source: FAZ, 26. Oktober 2011, p. 11

Foreseeable trends

- **Unknown monetary territory**
  - World-wide (JP, USA, GB, EMU): drastically increased monetary base unseen in peacetime before
  - Threat of solving fiscal burdens at the expense of money users
  - ⇨ Search for alternatives (demand side)

- **Technological trends**
  - Cash will disappear very soon (10 years?, 15 years?)
  - Enhanced electronic payments infrastructures
    - Integrated into internet-based services as a layer above traditional banking systems
    - Cash-like ubiquitous and permanently available virtual wallets (necessary for money as a network good)
    - Vast opportunities for data mining
  - ⇨ Ability and incentives: new players (supply side)

⇨ **Potential demand and lower barriers-to-entry**

The search for alternatives (1/2)

- **Forthcoming situation**
  - Increasing potential demand for less costly medium of exchange
  - Full-fledged infrastructure for switching the reserve medium
  - ⇨ Lower barriers-to-entry for private money production (back to the roots: denationalization/re-privatization of money)

- **What private money?**
  - Reserve medium: fiat money or commodity money
  - Pure cyber money (BitCoin etc.): contrary to regression theorem, no backstop, highly exposed to fraud due to incentives and intransparency
  - Virtual wallets make precious metals fully fungible
  - Come-back of gold (strong suck-in effects)
  - Free banking and reputation building: 100-percent-money? (maximum degree of transparency, ETF-like situation)
  - ⇨ **Private money services as management of gold reserves**

The search for alternatives (2/2)

- **Transition process**
  - Gradual, not a 1-0-decision (experimental phase)
  - Remonetization of gold and the gold price: positive feedback loop
  - From the start a globally accepted means of payment
  - Reverse of Gresham's law (Thier's law) applies

- **Regulatory preconditions**
  - None, only full protection by existing civil laws (deposit laws)

- **Governmental response?**
  - Repeated prohibition of monetary gold (New Deal 2.0)?
  - Compulsory state-issued currency for public-private-payments?
  - Safe sites for the gold base of global money providers?

- **Consequence: End of monetary policy**