Institut für Weltwirtschaft
an der Universität Kiel

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Das Weltwährungssystem am Scheideweg

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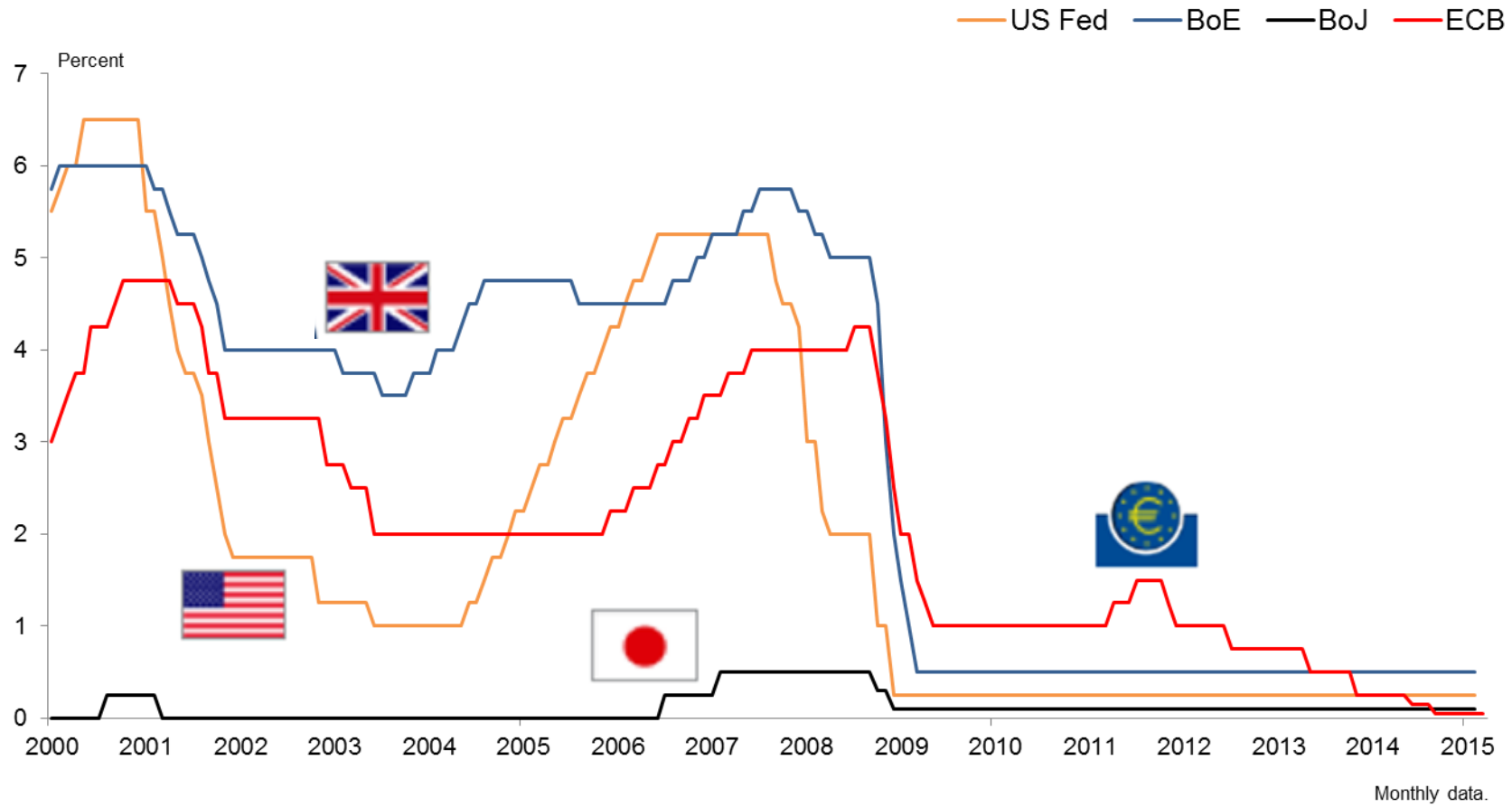
Global monetary environment

Monetary policy around the (Western) world:

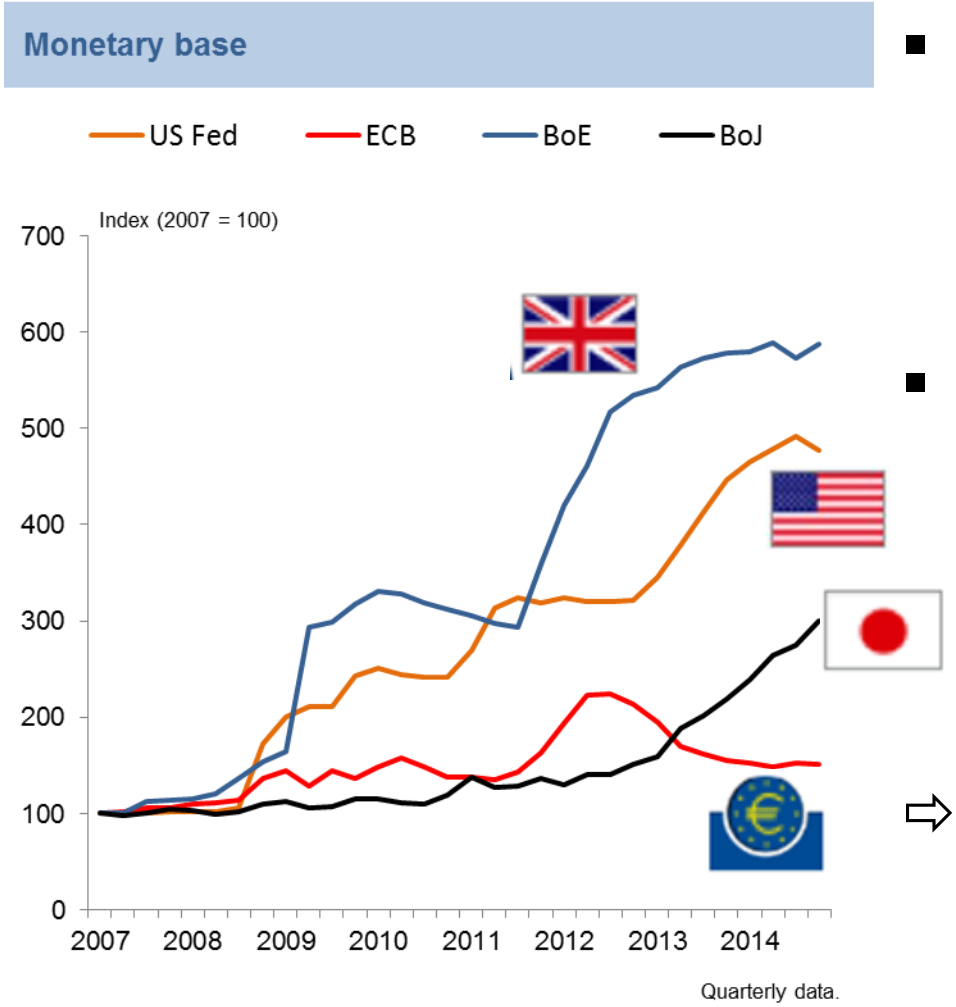
Mankind‘s largest monetary
experiment of all peace times

Monetary policy at the zero lower bound

Monetary policy rates



„Quantitative Easing“ at work



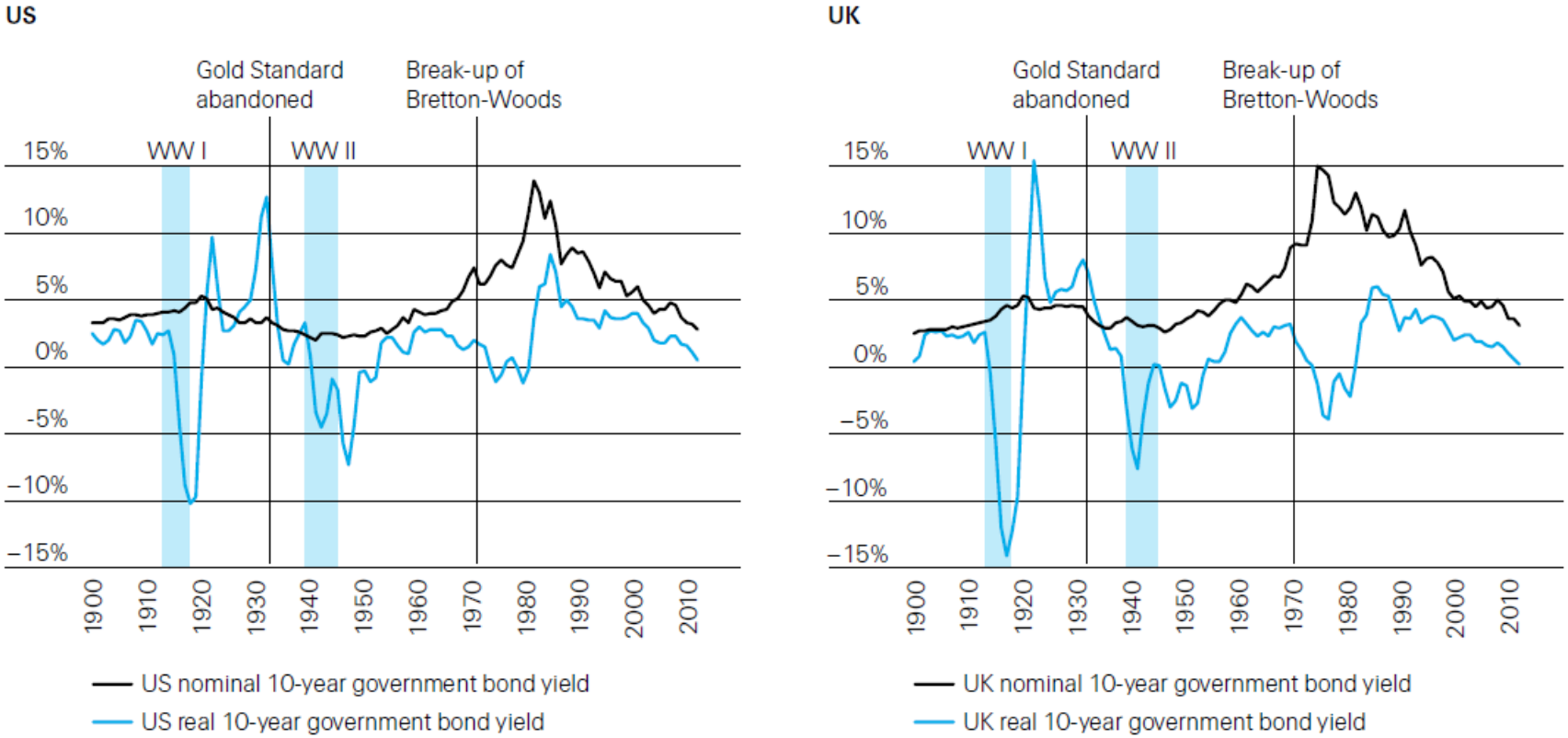
- Type 1:
  Liquidity provision in times of financial turmoil

- Type 2:
  Boosting demand at the zero lower bound

⇨ **Missing exit experience: The story is not over yet**

Interest rates: A centenary perspective

Nominal and real 10-year government bond yields 1900-2011



Sources: Datastream; Homer Sidney and Richard Sylla, A History of Interest Rates (New Jersey: Wiley Finance, 2005); Swiss Re Economic Research & Consulting

- Interest rate regime transitions vs. ultra-low interest rate levels

The role of interest in society

Interest rates …

- … just another policy instrument for short-run aggregate demand management?

- … or the price of time preference?
  - » Coordination of saving/investment decisions
  - » Shaping capital stock/production structure (= future production portfolio possibilities)
  - » Reflected in all other prices

⇨ **„Capital gives money time to cause trouble.“ (Garrison)**

Fighting the financial crisis: “Whatever it takes”?

- Financial crisis = capital stock crisis
  - » Crisis as response to excessive credit creation (monetary boom-bust)
  - » Massive distortion of the physical capital stock/production structures
- Financial crisis = systemic over-indebtedness
  - » Central banks can print money … (liquidity crisis)
  - » … but they cannot print capital (solvency crisis)
  - ⇨ „Lender of last resort“ not the solution
- Central bankers as heroes in the economic policy arena?
  - » Inflation-targeting and deflation-phobia
  - » Massive increase of high powered money (“quantitative easing”)
  - » Negative interest rates? Helicopter money? Debt monetization?
  - ⇨ **Key price within capitalist system manipulated by bureaucrats**

Money production: The big picture

- **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 (43 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 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
  - ⇨ Interplay of central bank and commercial banks:
    Money production as a Public-Private-Partnership (Seignorage sharing)

- **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

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
  - » Non-neutrality of money (Cantillon effect)
  - » Key mechanism in monetary business cycle theory (Hayek 1932)
- **Macroeconomic benefits?**
  - » 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
  - » 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: Self-reference

- Money (means of payment) backed by …
- … securities (promises of future payments)

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

Central banking

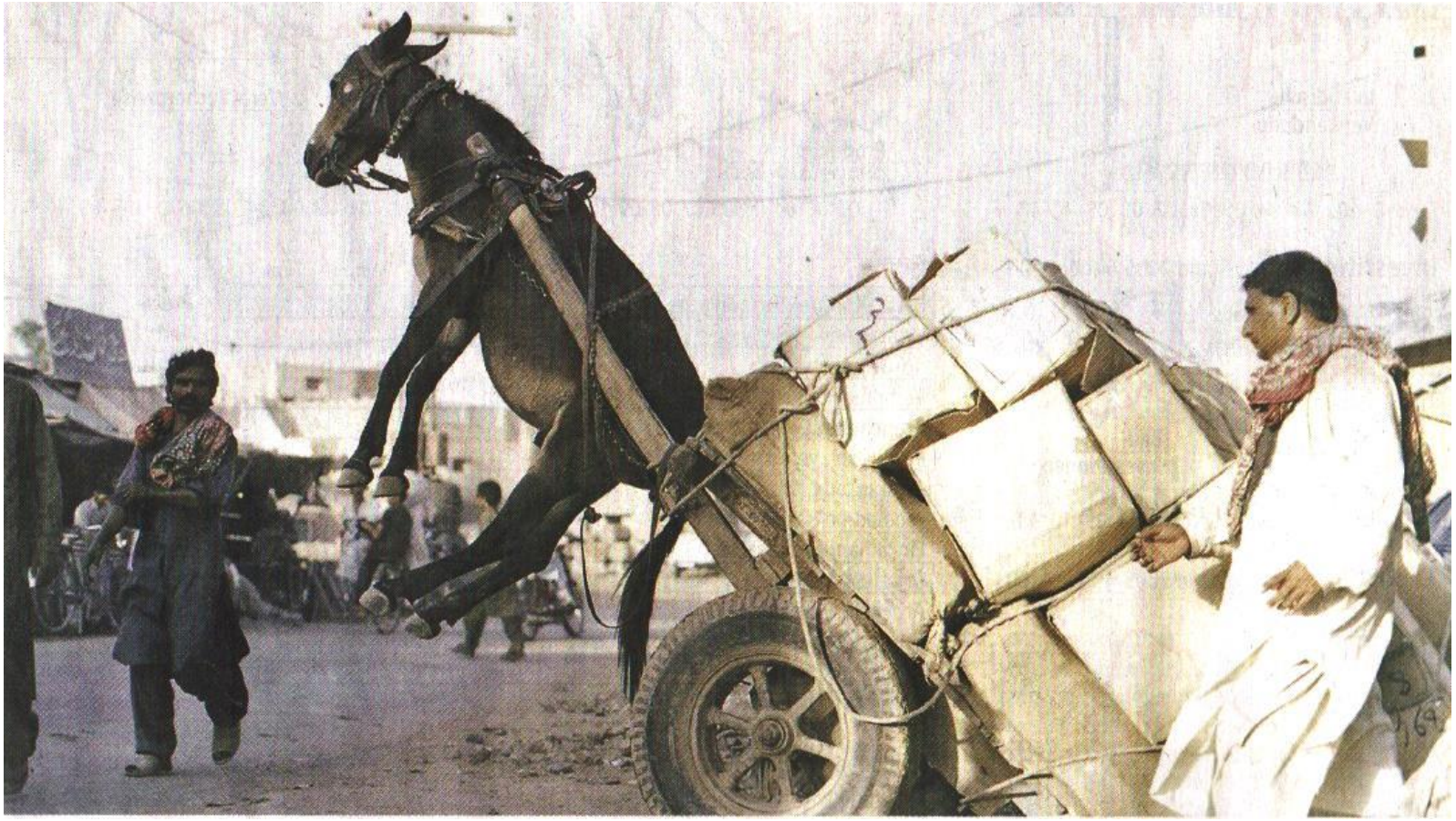
- Possibility of banks-runs due to fractional-reserve banking
  - » Central bank as “Lender of Last Resort” for liquidity support only
  - » Solvent, but illiquid banks (Bagehot 1873)
  - ⇨ Creeping process of expanding role as LoLR (concept dilution)
- Collateral risks infect stability of payment systems
  - » Central bank as bail-out agency? ⇨ only seemingly
  - » Ring-fencing financial stability by central supervision?
  - ⇨ Promoting monocultures of risk assessment/regulatory overkill
- Technically unlimited money creation capacity
  - » But: Too much money is no money (hyperinflations)
  - » And: Financing illusion of the money press (monetization = taxation)
  - ⇨ Technical feasibility ≠ economic effectiveness

Monetary policy: The all-purpose weapon?

- Generic target: Provision of a means of exchange
- Other targets
  - » Government financing
  - » Debt-monetization
  - » Boosting employment
  - » Business-cycle stabilization
  - » Systemic financial stability

  What about Tinbergen?
- Conflicts
  - » Room for excessive rent-seeking
  - » "Guaranteeing" its own collateral?
  - ⇨ **High risk of sacrificing the (most abstract, general) generic target for (more simplistic, partisan) non-generic targets**

Monetary policy: Overloaded!



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

Massive risks of crisis resolution via the money printing press

- Non-performing financial claims (over-indebtedness)
  - » Core problem unsolved
  - » Creating even higher debt positions
- Ultra-low interest rates
  - » Bubbles, search for yield
  - » New capital stock distortions
- Delaying structural reforms
- Risk management
  - » Risk transfer to central banks (= tax payers)
  - » „Safe“ government bonds: Dysfunctional hammock for the wealthy

⇨ **“Wasting time” rather than “Buying time”**

Inflation targeting or back to the (Bbk) roots?

- Hampered credit and money creation in post-crisis era
  - » Distressed banks (limited credit-creation capacity)
  - » Over-indebted non-banks (limited debt-carrying capacity)
  - » Inflation not surprisingly low
- Time frame: medium-term
  - » Rather 5 than 2 years
  - » Overstressing monthly inflation figures
  - » Prices: No role for adjusting disequilibria?
- Inflation/deflation debate
  - » Price structure more important than price level
  - » Money injection is never neutral (process
  - » Asset price inflation beyond the radar of monetary policy

⇨ **Recalling for monetary stability (former 1st ECB pillar)**

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
    - – 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**

Two monetary perspectives

- The optimistic (utopian?) view
  - » Emergence of (parallel) hard currencies
  - » Transition to 100-percent money
  - » Restoration of market principles (accountability)
  - » Separation of money and credit
  - ⇨ **Stable global means of exchange**

- The pessimistic (realistic?) view
  - » Devaluation spirals, currency wars
  - » Wealth taxes, financial repression, hyperinflation
  - » Interventionist regulatory overkill
  - » Disruption of financial stability
  - ⇨ **Economic chaos**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