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*Währungskonferenz 2019: Wie weit sind wir auf dem Weg zur Entnationalisierung der Währungsordnung?*

# Weltgeld und Free Banking 2.0

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LI-Paper

# Das ungeahnte Potenzial des digitalen Geldes

STEFAN KOOTHS\* • November 2013



<http://www.libinst.ch/?i=das-ungeahnte-potenzial>

# Point of departure

## ▪ Monetary regimes in retrospect

- » Series of upheavals escaping the high-frequency radar of “routine economics”
- » 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 (48 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

# Fragility of fractional reserve banking



# 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) blurs

- **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?
- » 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

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





- **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 as implicit taxation)
  - ⇒ Technical feasibility ≠ economic effectiveness

# Risk of overloading monetary policy

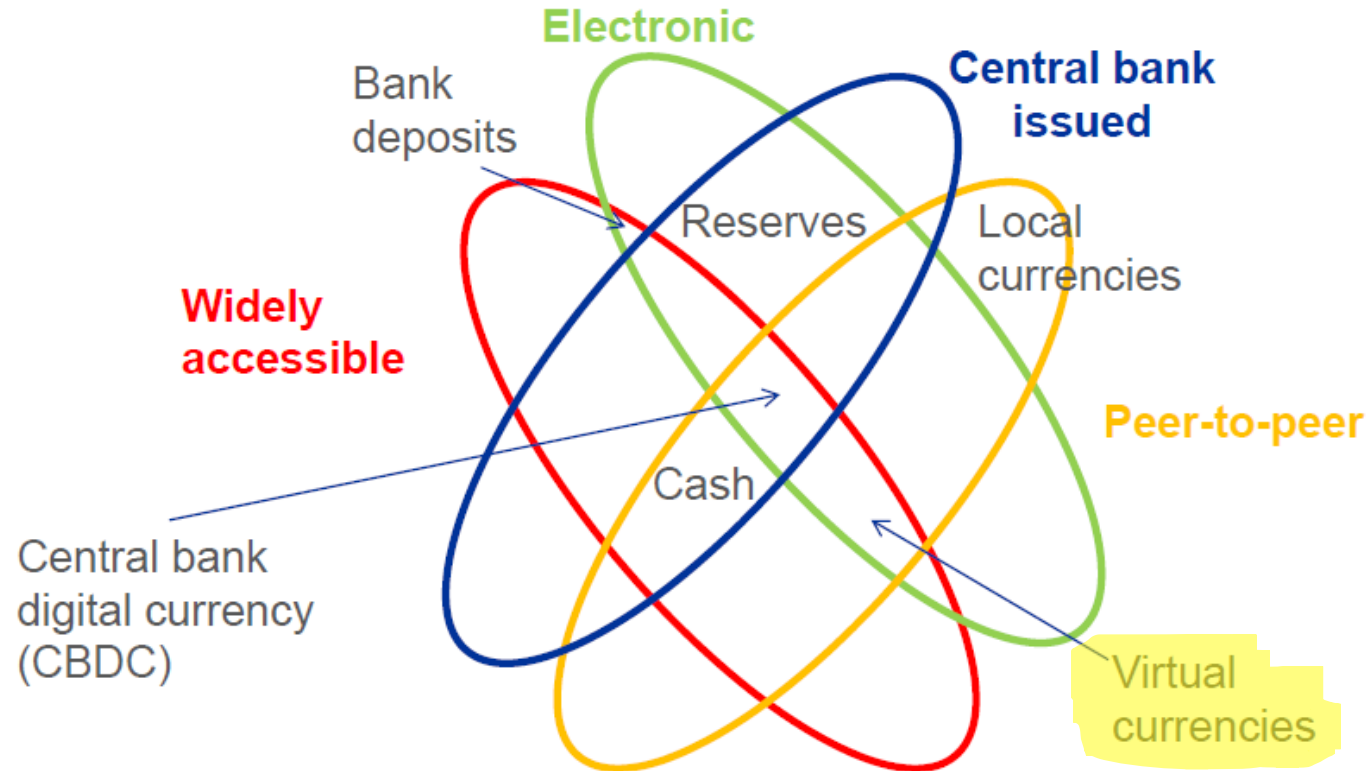
- One instrument, multiple targets? (Tinbergen 1952)
  - Generic target: Provision of a means of exchange
  - Other targets: Government financing, debt-monetization, boosting employment, business-cycle stabilization, financial stability
- 
- ⇒ **Potential conflicts**
  - ⇒ **Room for excessive rent-seeking**
  - ⇒ **High risk of sacrificing the (most abstract, general) generic target for (more simplistic, partisan) non-generic targets**

# Monetary policy: Overloaded!



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

# Monetary taxonomy



Source: BIS (2018)

# Foreseeable trends

## ▪ **Unknown monetary territory**

- » World-wide (JP, USA, GB, EMU): inflated 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 (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**



# End of monetary policy

Not a bug, but a feature.

# Get in touch



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