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

US Fed | BoE | BoJ | ECB

Monthly data.
„Quantitative Easing“ at work

### Monetary base

- **Type 1:** Liquidity provision in times of financial turmoil
  - US Fed
  - ECB
  - BoE
  - BoJ

- **Type 2:** Boosting demand at the zero lower bound
  - Missing exit experience: The story is not over yet

Quarterly data.

Graph showing the increase in the monetary base for different central banks over time.
Interest rates: A centenary perspective
Nominal and real 10-year government bond yields 1900-2011

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

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

- 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

What about Tinbergen?
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**
Institut für Weltwirtschaft

Institute of the World Economy