

The Case for Sovereign Money

Joseph Huber

In the process of coming to terms with the recent financial crisis, the easily visible causes were examined first (for example, perverse incentives, questionable risk management and accounting practices, insufficient capital buffers, missing firewalls). In the meantime, increasing attention is being paid to the money system which in fact is the foundation of it all. The present system of fractional reserve banking is the root cause of many financial problems. The final answer to unstable finances and unsafe deposits is likely to be sovereign money.

Sovereign money is legal tender issued by a state body such as the national central banks and the ECB in Europe and Japan, or the Treasury in the United States. Other terms include *public money* (Yamaguchi), *constitutional money* (Morrison), and *state money* (Werner). Sovereign money in *public circulation* (among nonbanks, including households, companies and government) takes the form of government coins and central-bank notes. Sovereign money in *interbank circulation* takes the form of reserves (money-on-central-bank- account). The opposite of sovereign money is bank money. Bank money takes the form of deposits created by banks' primary crediting of customer accounts. At 82–97% of the money supply (depending on country and monetary aggregate) bank money represents the lion's share today.

A plain sovereign money system would come into existence by completing the monopoly of creating coins and notes with money-on-account, while phasing out bank money. The monetary aggregates M0–M3 would no longer exist. There would be just one integrated money supply M flowing within a single circuit among banks and nonbanks alike. Today's savings accounts, certificates of deposit, or similar, would be regular customer loans to a bank, documented in banking statistics, not however as 'money', but as short-term capital.

Sovereign money is just as constitutive for a nation's sovereignty, or the sovereignty of a community of nations, as the prerogatives of legislation, state administration, jurisdiction, taxation and the use of force. Monetary sovereignty includes

1. determining the *currency* of the realm, i.e. the unit of account
2. creating and issuing the *money*, i.e. the means of payment denominated in that currency
3. taking the benefit from money creation, i.e. the *seigniorage*.

A term widely identified with sovereign money is chartal money. However, according to Knapp, who coined the term, and as restated by Keynes, chartalism refers to the existing two-circuit hybrid system of monies issued partly by the central bank and partly by the banking sector, assuming that the government or central bank exerts control over the banks' deposit creation, or even, as Modern Money Theory (MMT) has it, that issuing government debt is identical with issuing sovereign money. In this understanding, chartalism only

includes no.1 of the monetary prerogatives, and remains largely indifferent, or misleading, with regard to nos.2 and 3.

As to the economic paradigm involved, sovereign money is based on renewed currency-school theory, as opposed to banking-school theory. The core component of any currency teaching is control of the quantity of fiat money by separating money and credit, or to put it differently, by way of separation of *monetary* functions (central bank) and *financial* functions (banking and financial markets). In a sovereign-money system, banks can be free financial enterprises, acting as money intermediaries, but cannot create themselves the money on which they operate.

The present system is based on bank money

Some of the above may cause irritation. Is the present two-tier banking system not one of sovereign money, in that the banks' credit and deposit creation is carried out under the control of the central bank? No, not at all. The present system comes fairly close to ideas of free banking on the basis of bank money created at the banks' own discretion. Central banks and legal-tender laws are not what some economists assume them to be, among them MMT, and what supporters of free banking suspect them to be. Legal tender – i.e. means of payment by state fiat, in particular by central-bank fiat – does no longer lead in today's fractional reserve system. At source, deposits are not created by depositing sovereign cash, but by banks' primary credit creation. Cash comes into circulation as a technical sub-amount that is exchanged out of and back into those 'deposits'. By pro-actively extending bank credit when making loans and asset purchases, banks create the entire quantity of money, thereby also initiating the residual re-active creation of coins, notes and reserves. The central banks always re-finance the facts the banks have created in advance. If a central bank refused to do so, the flow of payments—and thus the economy—would come to a standstill.

In order to maintain 100 currency units, banks in the euro area at present need about 3% central-bank money, of which 1% is the minimum reserve requirement, 1.4% notes for the ATM, and 0.1–0.6% are excess reserves for the settlement of payments. In the US, the need for fractional re-financing may be slightly above 10%, because of a minimum reserve requirement of 10% from which the cash in vault can be deducted.

The figures include different refinancing costs for cash and deposits. Because outgoing and incoming deposits are largely netting out, the final balance (real settlement) tends to be very low. This is why deposits need to be only fractionally re-financed. Cash and reserves by contrast need to be funded at 100%. When technical innovation, tax inspectors and the banking industry are eventually successful in doing away with traditional cash, the 100% funding costs of cash will also be gone.

As a result, what remains from the state's monetary prerogatives today is the currency unit – dollar, yen, yuan, etc (no.1). The money supply, however, is fully determined by the banks'

credit and deposit creation (no.2). Equally, the genuine seigniorage from coinage and the interest-borne central-bank seigniorage from residually re-financing banks and managing the national foreign reserves (no.3) are rather limited in comparison to the gainful advantages banks enjoy from being the primary creators as well as the first users of the money, which they provide at a 3% or 11% fraction of the full funding costs. The banking industry thus has far-reachingly captured the monetary prerogatives.

Dysfunctions of fractional reserve and the advantages of sovereign money

The creation of bank money is out of control. On balance, additions to the quantity of money have overshoot not only the growth of productivity and real income, but also the nominal growth of BIP several times. The consequences are consumer price inflation (more importantly before the 1980s) and asset inflation (being to the fore since then). Over-investment and debt bubbles drive business cycles and financial-market cycles to extremes, resulting in banking, debt and currency crises in migrating hot spots around the globe. Such crises have increased in terms of both numbers and severity since the 1970s, with knock-on effects on the entire economy of the nations involved. At such times, bank money proves to be unsafe and not coverable by deposit insurance, while government and the taxpayer have to bail out systemically relevant banks or other financial corporations in distress. Moreover, the BIP-disproportionate build-up of interest-bearing monetary and financial fortunes creates a distributional bias in favour of capital income to the detriment of earned income.

Adherents to banking-school thinking assert that markets cannot fail, and if they do it must be due to government or central bank interference. Banking doctrine thus refuses to acknowledge any monetary causation of financial problems. Historically this was set forth in various variants, from the real bills doctrine and the reflux theorem of the early 19th century to the efficient market hypothesis of late. In actual fact however, rather than limiting themselves to some point of 'equilibrium', money and capital markets *do* overshoot. The reason is that markets not only have crowd intelligence, but also crowd foolishness and – which makes for a dangerous combination – modern money has no natural anchor of scarcity. If one has the privilege of creating additional money, being the first to benefit from the immediate advantage, and expecting the disadvantages to fall upon all at a later point in time, the conclusion—often against one's better judgment—is straightforward.

Transition from bank money to sovereign money

In order to regain control of the money supply, a sovereign money system does today with bank money what was done with private banknotes in the 19th century. They were phased out and replaced with central-bank notes. Today, the same would apply to non-cash bank money (demand deposits), thereby including e-cash that can be closed out of and reconverted into money-on-account. In a sovereign money system, the central bank has full control of the quantity of money and is thus able to pursue monetary quantity policy rather

than interest-rate policy. The major principle would be to provide a money supply commensurate with the economy's growth potential at full capacity, with inflation and asset inflation as important additional target variables.

The growth potential at full capacity thus is the sought-after anchor of scarcity. Tying money to gold or a similar real-asset standard is not an answer because – in contrast to what Neo-Austrian supporters of free banking assume – this will induce undesired deflation and economic stagnation rather than achieving what they hope for, i.e. growing productivity and transmitting the wealth thereof by way of stable earned incomes and sinking prices. In real-world economies, voluntary smooth downward elasticity does not exist, just unemployment and stagnant productivity and purchasing power.

In the 1960–80s, central banks in the western world wanted to implement monetary quantity policy of some kind. It came out as a complete failure due the overriding realities of fractional reserve banking. Central banks thus had to resort to short-term interest-rate policy, which is a weak substitute for quantity policy. Up to the present day, central bankers are still reluctant to admit to their far-reaching loss of control and to identify fractional reserve banking as the major cause.

The quantity theory of money, one of the oldest and most proven elements of economics, is as fundamental as ever. Therefore, the key to safe money and stable finances is regaining control of the money supply. Rather than being a neutral 'veil' on the economy, as neoclassical teaching maintains, 'money matters'. As a core component of economic thinking this is also called monetarism—which basically is an appropriate term, were it not for Friedman's unfortunate wedding of this general and politically open notion of monetarism with the one-eyed supply-side ideology called Reaganomics or Thatcherism half a century ago. This, together with the actual impossibility of quantity policy under fractional reserve banking, has done lasting damage to the notion of monetarism.

Beyond that misalliance, however, quite many economic teachings concerned about inflation, asset inflation, crises and their consequences—politically adversarial as they are to an extent—include monetarist thinking in the general open meaning, among them Smith, Ricardo and Marx, the Currency School of the early 19th century, the state theory of money or chartalism of the late 19th century, the Austrian School of old and the Neo-Austrians today, the earlier Chicago School that developed the Chicago Plan (100%-reserve) in the 1930s (including young Friedman), the German Ordoliberalismus at the same time, new currency approaches of today, institutional and historical economics, much of present-day post-Keynesianism, but also Keynes himself. His position on the quantity theory of money was definite: 'This theory is fundamental. Its correspondence with facts is not open to question' (Tract on monetary reform, 1923, 74). Many among his later followers have seemingly not paid attention.

Moving from bank money with a fractional reserve to a single-circuit sovereign money system is *not* about nationalization of banking. It is about nationalising *money creation* while retaining banks as free financial enterprises, albeit stripped of the monetary privileges they have captured today. The seigniorage from additions to the money supply would entirely benefit the public purse, to the relief of the taxpayer, and allowing for cutting down sovereign debt to more sustainable levels.

Seigniorage in the traditional sense refers to the difference between the cost of providing a means of payment and its actual purchasing power. Genuine seigniorage in this sense accrues if newly created money is spent into circulation debt-free, rather than loaned into circulation as interest-bearing credit money (typically bank money) which results in interest-borne seigniorage. (Banks today, incidentally, not only enjoy interest-borne seigniorage, but also an equivalent of genuine seigniorage when purchasing securities and other assets that are paid for in the same way of fractional settlement as any other payment going out of or coming into a bank).

In a sovereign-money system, the bigger and long-term additions to the money supply would be spent into circulation debt-free by way of public expenditure. This includes, as a special variant, the issuance of new money as a per-capita-dividend. The smaller and short-term additions to the money supply would be issued by way of short-term central-bank loans to banks. This, together with the array of open-market instruments, will ensure flexible options in monetary policy.

As regards the technical side of the transition to sovereign money – i.e. accounts, balance sheets and the payment system – there are basically two types of approaches. One is the concept of 100%-reserve of the 1930s, also known as 100%-money (Fisher), or 100%-banking or Chicago Plan. It involves raising the present 1% or 10% fractional reserve up to 100% reserve coverage of deposits. The other approach is the newly developed concept of a one-circuit plain money system as pursued by most contemporary monetary reform initiatives (cf. internationalmonetaryreform.org). The first remains an arrangement within the present two-circuit system where the money still is the property of the banks rather than the customers. The one-circuit money system represents a post-reserve system where customers are actually in safe possession of their money. The 100%-reserve approach involves a number of snags that are not easily discerned at first glance. In a one-circuit money system the split between reserves (in M0) and deposits (in M1) no longer exists. The money is the full property of its respective owners, a liquid asset that does not simultaneously exist as a liability in the balance sheet of a counterparty. (For more about 100%-reserve in comparison to a single-circuit plain money system, see > sovereignmoney.eu/100-per-cent-reserve).

The role of central banks

As regards the central banks today, it is obvious how they act as *last-resort bank of the banks*. In contrast, it has become difficult to recognize how they would act as *money-issuers of first instance* and *bank of the state*. Overt monetary finance by central banks is interdicted by law, while banks are allowed to do it any time at any amount – certainly not without practical short-term restrictions, but basically unrestrained over time.

Central banks today no longer pretend to control the money supply. Instead, they have switched to directly targeting a desired inflation rate by means of short-term base rate policy. Many economists, including those in central banks, tend to believe this would influence banks' credit and deposit creation indirectly. There are at least four reasons why this is questionable. Firstly, central-bank interest rates have no short-term effect on banks' demand for money because that demand is price-*inelastic*. The facts that have been created pro-actively have thereafter to be fractionally fulfilled, no matter how expensive. In the longer term there may be some feedback, but it is unclear to what extent, because, secondly, how should a refinancing rate of 3% or 11% have a decisive transmission effect on the entire 100%? Thirdly, even if higher/lower base rates and interbank rates contribute to lower/higher profit margins of the banks, this will not deter them from creating additional money, because the lending interest and expected capital gains are normally higher than central-bank base rates, interbank rates and deposit rates. Fourthly, the base rate may influence other interest rates to a minor extent, but it does not determine the spectrum of interest rates and the general level of interest. The latter is much more determined by the asset markets. This is why in the context of present crisis interventions secondary buying and selling of sovereign bonds on a large scale on the open market has been the most effective instrument of central-bank interest-rate policy.

In a future sovereign-money system as much as today, *monetary* functions of the central bank and *fiscal* functions of the government will have to be kept apart. This does not exclude the transfer of seigniorage to the treasury, even if the seigniorage may at times represent a big amount of money. Likewise, monetary and financing functions have to be kept apart. Banks would no longer fulfill monetary functions as they do today, and the central bank ought to abstain from interfering in banking and financial markets, except as far as monetary open market operations are concerned.

Most supporters of monetary reform agree that central banks ought to be able to pursue discretionary rather than mechanically rule-bound policies. The reason is that additions to the money supply and economic growth will have to be kept largely in step with each other. Economic growth evolves in cycles that are caused not only by monetary factors. Economic growth thus is a moving target. Continually anticipating the need for money and readapting the actual money supply to that moving target, also including the rates of inflation and asset inflation, in fact requires the ability to act and react flexibly.

Sovereign money would largely contain or partly even do away with the dysfunctions of the two-circuit fractional reserve system. Sovereign money is safe. In a bank crisis it cannot be lost like deposits. Since the money supply is under control and has its anchor of scarcity in the real growth potential of the economy, the central-bank toolset of monetary policy instruments will be effective in controlling inflation and asset inflation. This will curb the formation of hyper-inflated bubbles and resulting severe crises. Moreover, BIP-proportionate additions to the money supply will result in a similarly proportionate increase in monetary and financial assets, curbing the bias towards disproportionate growth of capital income. Not least, the seigniorage from money creation will help to balance budgets and avoid public over-indebtedness. At the same time, sovereign money retains beneficial elements of the present system such as convenience, transactive efficiency, maturities transformation, currency convertibility, and flexible monetary policies that— in contrast to the present system – exclude overextension, as well as shortages in the money supply.

For sure, replacing bank money with sovereign money is not a cure-all. It does not make redundant certain other measures aimed at stabilizing banking and financial markets, for example, complete reporting on risk exposure, increased capital adequacy, or ring-fencing of various activities. Without monetary reform, however, such measures will ultimately again prove to be no sustainable answer by themselves. Modern economies are money-based and financialised. Money governs finance, as finance governs the economy. If the money system does not work properly, the financial and the real economy won't work properly either. For stabilizing the financial economy and re-orienting it towards the needs of the real economy, the most fundamental prerequisite is having a reliable, well-run money system.