The Case for the Separation of Money and Credit

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Abstract This paper argues that central banks could control consumer price inflation better by injecting money through lump-sum transfers to citizens, rather than by manipulating the credit market and interest rates. Lump-sum monetary transfers lead to less intersectoral distortion and less intertemporal discoordination than measures aimed at stimulating the credit market. They allow central banks to target inflation without building up financial imbalances.

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> While credit expansion by a bank seems far more sober and respectable than outright spending of new money, it actually has far graver consequences for the economic system, consequences which most people would find especially undesirable.
>
> Murray Rothbard (1962, p. 991)

1 Introduction

The outbreak of the recent financial crisis has shown that price stability does not guard against financial instability. This paper argues that the pursuit of price stability by a central bank in the current monetary system brings about unintended consequences, because the increase in money necessary to stabilise the price level in a growing economy is injected into the credit market, which creates financial imbalances. It thus calls for the separation of money and credit, that is for changing the process by which money is brought into circulation such that an increase in money does not require an increase in credit. This is achieved by means of lump-sum

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monetary transfers to citizens. The central bank could indeed control (CPI) inflation better by injecting money through lump-sum transfers to citizens, rather than trying to control inflation by manipulating the credit market and interest rates. Lump-sum transfers lead to less intersectoral distortion and less intertemporal discoordination than measures aimed at stimulating the credit market.

In the current monetary system, the creation of money is closely linked to the granting of credit.[1] The stock of money increases when commercial banks grant credit, stimulating aggregate demand and inflation, and it decreases when credit is paid back, exerting a downward pressure on prices. As the phrase goes, money is *lent* into existence. This makes the pursuit of price stability fundamentally at odds with financial and economic stability because the central bank needs to induce an increase in credit and leverage for the quantity of money to increase. Furthermore, the central bank needs to fight against a contraction of credit and a reduction in leverage to prevent a contraction of money and deflation. Although the deleveraging of the economy may be welcome from a financial stability perspective, the central bank must prevent it from occurring to meet its objective of price stability.

Several central banks around the world have found it difficult to meet their inflation targets since the beginning of the recent financial crisis. Central banks and academics have shown imagination in designing new measures for stimulating inflation despite the zero lower bound on nominal interest rates. Whereas measures such as quantitative easing aim at lowering positive long-term interest rates, other proposals such as negative interest rates on reserves, floating exchange rate between reserves and cash, or simply abolishing cash, aim at lowering short-term interest rates in negative territory. As a result of the various measures taken to increase liquidity and lower interest rates, inflation has remained low, while prices for financial assets have soared. Creative though these measures may seem, they all fall within the credit-money economy framework, according to which conducting monetary policy is tantamount to manipulating interest rates. The attempt to stimulate inflation with such measures is prone to exacerbate leverage, credit and asset price bubbles; all this for presumably little effect on consumption spending.

Lump-sum monetary transfers to citizens, however, represent a break with the traditional credit-money economy, because money is not issued through the granting of credit but is simply *spent* into existence. The quantity of money in circulation is thus independent of the course of the credit market because it does not increase and decrease with the granting and repayment of credit. Lump-sum transfers are more effective and less distortionary than credit expansion for two reasons.

First, the transmission from an increase in the quantity of money to CPI inflation is more direct and stronger when money is injected through lump-sum transfers than when it is injected into the credit market. When money is injected into the credit market, the new money primarily boosts the price of goods whose demand is stimulated by the granting of credit, such as real estate. Rises in real estate prices,

[1] See McLeay et al. (2014) for a description of money creation in the fractional reserve banking system.

however, do not directly affect CPI inflation. However, when money is injected through lump-sum transfers, each citizen will spend his new money according to his own preference, stimulating economic sectors more evenly and raising the price of a broader range of goods than credit expansion. Moreover, the benefit of monetary injections is more evenly distributed across economic agents with lump-sum transfers to citizens rather than with credit expansion.

Second, lump-sum transfers do not distort interest rates and the intertemporal structure of the economy because the money injected through transfers does not necessarily and immediately reach the credit market. The unhampered interest rate is thus free to play its coordinating role between investment and savings. By contrast, when money is injected into the credit market, an increase in the quantity of money lowers interest rates in the short term, which makes investment exceed savings and which builds up financial imbalances through credit and asset price bubbles.

Section 2 traces the origin of the close relationship between money and credit back to the gold standard, and argues that this relationship has become superfluous in our world of unredeemable fiat currency. Section 3 briefly presents the arguments raised during the Banking School and Currency School controversy on the economic consequences of the relationship between money and credit. The intersectoral and intertemporal effects of lump-sum transfers and credit expansion are discussed in Sects. 4 and 5. The role of the monetary system is discussed in Sect. 6. Section 7 addresses further issues related to the implementation of lump-sum transfers, such as monetary targeting, reducing the quantity of money, central bank independence, capitalism, and fiscal policy. Section 8 concludes.

2 Is the Credit-Money Economy a Barbarous Relic?

Nowadays, modern economists assess the monetary policy stance primarily in terms of the interest rate. The textbook example is Woodford (2003), *Interest and Prices: Foundations of a Theory of Monetary Policy*, which revives the pure credit economy approach of Wicksell (1898), where monetary policies are described in terms of rules for setting a nominal interest rate.[2] The pure credit economy refers to a monetary system where money is issued through the granting of credit.

The interest rate is the price paid for credit (i.e. intertemporal) transactions, that is the price for borrowing money over a certain period of time. Why should the creation of money be related to the granting of credit? Why should money be issued through lending? Why are money and credit so strongly intertwined in our minds? The short answer is because of the gold standard.

When currency is redeemable into precious metal, the flexibility of the quantity of currency is severely limited. Nevertheless, the overall quantity of money in circulation can be made flexible by issuing currency substitutes in the form of bank

[2]See Laidler (2004) for a monetarist view on Wicksell and Woodford.

deposits (i.e. monetary aggregates).[3] Currency substitutes are part of the overall quantity of money as long as agents accept them as a final means of payment in place of currency.

Commercial banks bring currency substitutes into circulation as they lend currency for a given period of time: money is *lent* into existence. Because currency substitutes are redeemable in currency, the promise by the issuer of currency substitutes to pay currency on demand is exchanged against the promise by the recipient to pay back currency at a later date. Currency substitutes must be issued against the promise of repayment (i.e. against credit), because if they were not, the issuer of currency substitutes would rapidly become bankrupt, as it cannot issue the currency in which currency substitutes are redeemable. The redeemability of currency substitutes in currency is thus the underlying reason why currency substitutes (money) are issued through the granting of credit. In turn, the severe limitation that the gold standard imposes on the expansion of currency explains why currency substitutes play an important role in such a monetary system and, thus, why money, credit and interest rates have become so closely intertwined.[4]

When currency is not redeemable into precious metal but consists of an unredeemable fiat currency, as it is the case worldwide since the closure of the 'golden window' by US president Nixon in 1971, the quantity of currency is not bound by any natural limit. The central bank in charge of managing the currency can issue as much currency as it desires and can never go bankrupt because fiat currency provides the bearer with no claim for redemption whatsoever. Thus, flexible management of the overall quantity of money does not necessarily require currency substitutes to be issued by granting credit since the quantity of fiat currency can be flexibly managed at will. Moreover, fiat currency itself does not necessarily need to come about along with the granting of credit because it is not redeemable and can, therefore, simply be *spent* into existence. For instance, the central bank can distribute the new money necessary to fulfill its inflation target through lump-sum transfers to citizens. So, the increase in the quantity of money would not require the granting of credit. As discussed in Sect. 5, the credit market would be a market of pure financial intermediation, unhampered by monetary policy, where the granting and repayment of credit would not yield an expansion and contraction of money.

Friedman (1960) expresses the superfluous relationship between money and credit in these terms (p. 43):

> In modern financial systems, the creation of money is linked with lending and investing activity and changes in the stock of money generally take place through the credit markets. There is, however, no necessary connection.

[3] *Money* is defined as the common medium of exchange and consists of currency and currency substitutes in circulation. *Currency* is defined as outside money, monetary base or central bank money. Currency can be redeemable in precious metal or unredeemable if it is a fiat currency. *Currency substitutes* are redeemable in currency (claims issued by commercial banks to pay currency on demand) and are a synonym of inside money, monetary aggregates or bank deposits.

[4] Note, however, that changes in the stock of currency itself (gold) would not take place through the granting of credit but through the purchase and sale of gold.

While acknowledging that the flexibility of fiat currency makes the relationship between money and credit superfluous, the question at stake is whether it is desirable to maintain a system in place in which money is injected into the credit market. It must be addressed in the light of the economic consequences of such a practice. This is what the next sections propose to do by reviewing the arguments raised by the Banking School and Currency School, and then by analysing the intersectoral and intertemporal effects of monetary injections.

3 The Real Bills Doctrine and the Credit Cycle Theory

The views on the desirability of the intertwined relationship between money and credit vary according to the doctrine. This was the subject of the intensive debate between the Banking School and the Currency School in Great Britain in the nineteenth century.[5] Whereas the former saw in the relationship between money and credit a means of providing the economy with the optimal quantity of money, the latter identified this relationship as the source of business fluctuations.

In the real bills doctrine, the representatives of the Banking School (Tooke, Fullarton) maintain that the expansion of the banking system naturally adjusts to business needs. This is because money, in the form of currency substitutes or bank deposits, is created when commercial banks grant credit. The quantity of money increases when money is needed to finance credit transactions. The creation of money, so the argument goes, can never exceed its demand because money automatically adjusts to the volume of transactions. When business needs increase, money adjusts to satisfy the rise in demand for credit. Money remains in circulation as long as businesses need it. When businesses need less credit, money automatically contracts as bank loans are repaid. Expansion and contraction of money are seen by advocates of the real bills doctrine as the consequence, never the cause, of fluctuations in business activity. The proponents of this doctrine assert that the automatic adjustment of money to business needs is not inflationary and does not create distortions in the productive structure because the money created by credit expansion flows back to banks when credit contracts.

The representatives of the Currency School (Ricardo, Thornton, Lord Overstone) oppose the real bills doctrine and claim that commercial banks can easily overissue currency substitutes, even though the issuance of currency substitutes arises along with the granting of credit. According to the credit cycle theory, the fallacy of the real bills doctrine lies in its assumption that business needs are exogenous, that is independent of the credit policy pursued by commercial banks. Since the

[5]The controversy between the Banking School and the Currency School also dealt with other issues, such as the equivalence between bank notes and bank deposits or the role of precious metal in the determination of prices. We focus in this paper on the economic consequences of the relationship between money and credit, which remain of the utmost importance in today's debate.

profitability of investment depends on the level of interest rates, the credit policy of commercial banks influences the demand for credit. The demand for credit expands as interest rates fall, and contracts as interest rates rise. When commercial banks pursue an expansionary credit policy, they induce an increase in the demand for credit by reducing interest rates. The banking system cannot adjust to business needs because business needs themselves are dependent on the interest rate that commercial banks demand for granting credit. Fluctuations in the demand for credit may therefore reflect the credit policy of commercial banks (or of the central bank, if any) rather than exogenous changes in business needs. Thus, the intertwined relation between the creation of money and credit does not naturally help to stabilise the economy but can, rather, be the cause of business fluctuations. The credit cycle theory was continued and further developed in the twentieth century, highlighting the role of the credit market for the intertemporal coordination of the economy, as discussed in Sect. 5.

In the current environment of strong mortgage development, the Banking School would claim that banks passively provide the money necessary to finance new housing offered on the market (business needs), whereas the Currency School would emphasise that the supply of cheap credit by banks (under the auspices of the central bank) actively stimulates new housing and builds up financial imbalances.

The idea of lump-sum monetary transfers to citizens provides for the separation of money and credit, and lies, therefore, within the Currency School tradition. The superiority of this practice over credit expansion is now discussed in respect to the intersectoral and intertemporal effects of monetary injections.

4 Intersectoral Distribution and Inflation

The first advantage of lump-sum monetary transfers to citizens is that they affect economic sectors more evenly and stimulate the demand for and the price of a broader range of goods than money injected into the credit market. Lump-sum monetary transfers are thus more effective than credit expansion at stimulating the price of the CPI components. As a result, lump-sum transfers create less intersectoral distortion and less inequality.

An increase in the quantity of money does not affect all economic sectors evenly, depending on the process by which money is injected. Cantillon (1755) was the first economist to highlight that an increase in the quantity of money primarily affects relative prices rather than affecting all prices to the same extent.[6] When money enters the economy at a certain point, an increase in money has the greatest effect on the demand for and the price of the goods on which it is first spent. As money spreads into the economy, step by step, other markets are also affected by the monetary expansion. The process by which money is injected determines

[6] See Ledoit (2011) for a formal model of the Cantillon effect.

the economic sectors which are the most stimulated by monetary expansions and, thereby, the development of inflation.

If money is injected into the credit market, it primarily stimulates sectors where demand is stimulated by credit, such as housing. In the first round, the increase in money stimulates real estate prices but has only a subdued effect on CPI inflation. By contrast, if money is injected through lump-sum transfers to citizens, the monetary injection is likely to be less concentrated in the housing market in the initial stages; rather it will be more broadly distributed across economic sectors, according to how citizens spend their income. An increase in the quantity of money will thus be more effective at stimulating the components of the CPI when money is injected through lump-sum transfers than when it is injected into the credit market. Equivalently, the central bank needs to implement a smaller increase in money to reach its CPI inflation target with lump-sum transfers than with credit expansion.

Moreover, lump-sum transfers entail less intersectoral distortion and less inequality than credit expansion.[7] Aside from various effects on inflation, the process by which money is injected into the economy determines the sectors which will benefit most from monetary expansion. If money is injected into the credit market for the purchase of real estate, the increase in money benefits construction companies and real estate brokers. A construction company will benefit from the monetary expansion as the demand for housing rises, and it can spend its additional revenue before prices have risen on other markets. In the second round, the spending of the construction company will determine which sectors benefit next from the expansion. Not all sectors, however, derive advantages from the increase in money. Economic sectors whose demand is barely stimulated by credit expansion suffer from the rise in the prices of other goods, while their own prices remain unaffected. Assuming, for instance, that the increase in credit leaves the demand for and the price of bread unaffected, then the credit expansion will make bakers poorer because their nominal revenue remains stable while other prices, such as those for property, rise.

However, if money is injected through lump-sum transfers, the redistributive effect of monetary policy will be smaller because every citizen will benefit from the monetary expansion to the same extent in the first round. Each citizen will then spend his or her overall revenue according to their own preference. Of course, some citizens will do better than others, but these inequalities will be the result of market bargaining (and of the free exercise of private property rights) and not that of monetary expansion.

5 Intertemporal Coordination and Economic Cycles

The second advantage of lump-sum monetary transfers to citizens over credit expansion is that they do not create a discrepancy between investment and voluntary savings and, thereby, do not contribute to building up financial imbalances.

[7] See Huelsmann (2014) for an essay on the distributive effect of monetary policy.

In aggregate, the identity between investment and savings must hold. Nevertheless, credit expansion differs from lump-sum transfers in respect to the economic process making this identity hold.

When money is injected through lump-sum transfers, the credit market remains unhampered by monetary expansion and the natural (Wicksellian) interest rate is allowed to play its coordination role between investment and savings. The credit market is thus the process which coordinates the demand for funds from investors with the supply of funds offered by savers. By contrast, when money is injected through a supply of credit, an increase in money lowers interest rates and makes investment exceed voluntary savings. The discrepancy between investment and savings gives rise to (and is resolved by) business cycles and financial crises. To better understand this mechanism, let us highlight the economic effects of an injection of money into the credit market.

5.1 Credit Expansion

Credit transactions are intertemporal transactions whereby the borrower and the lender exchange goods over time. The interest rate is determined by the demand for and supply of funds, and reflects the superior productivity of more capital-intensive production processes and the subjective time preference of agents.[8] The interest rate freely formed in the market indicates to investors and savers the relative scarcity of resources available for investment. If the supply of funds voluntarily offered by savers in the market increases, the resulting decline in interest rates increases the discount factor and thus allows investors to engage in more capital-intensive projects, which were not profitable at the previous higher level of interest rates.

When money is injected into the credit market, it has the same downward effect on interest rates as an increase in the funds voluntarily offered by savers. Economically, however, Mises (1912) highlights that an increase in money is not equivalent to an increase in savings because the creation of money does not require any economic agent to save (i.e. to reduce present spending). On the contrary, credit expansion allows both the borrower and the successive recipients of the newly created money to increase their spending in concert. In response to lower interest rates, investors are disposed to engage in more capital-intensive projects, although voluntary savings have not increased. This yields a discrepancy between investment and voluntary savings on the credit market.

If the identity between investment and savings is not satisfied on the credit market because money is injected into this market, other macroeconomic processes, such as business cycles and financial crises, are set in motion to make the identity

[8] See Bernholz (1993) for a discussion on the reasons for the existence of interest rates in the tradition of Böhm-Bawerk (1889), and Kirzner (1993) for an excellent exposition of the pure time-preference theory of interest.

hold.[9] Investment will then be brought back in line with savings through a combination of

- increase in forced savings[10] by means of price increases (inflation),
- increase in forced savings by means of default, and/or
- investment liquidation.

Inflation reduces the spending power of money holders and default reduces the spending power of creditors. Though inflation and default represent a loss of spending power rather than an increase in savings from an individual perspective, in aggregate, however, a reduction of spending is equivalent to an increase in savings. Inflation and default thus help to force an increase in aggregate savings and reduce the discrepancy between investment and savings.[11] The nature of the adjustment process depends on the monetary system in place. The ability of the central bank to create money determines the extent to which investment and savings are brought back into line through inflation, default, or investment liquidation. For example, monetary accommodation from a central bank enables commercial banks to meet their liabilities without having to dump assets, which reduces the extent of default and investment liquidation, but increases that of inflation.

5.2 Lump-Sum Transfers to Citizens

Lump-sum monetary transfers to citizens, by contrast, do not systematically distort the credit market and the level of interest rates, because money is not issued through the granting of credit. Interest rates are determined by the demand for and the supply of funds on the credit market, not by the quantity of money in circulation in the overall economy. An increase in money lowers interest rates to the extent that it yields an increase in the supply of credit relative to the demand. But if the increase in money leaves the credit market unaffected because the new money is simply spent on the purchase of goods and services, there is no reason why interest rates should fall. An increase in money through lump-sum transfers exerts a weaker effect on interest rates than credit expansion because the new money does not necessarily and immediately reach the credit market.

First, whereas credit expansion means that new money is injected in the economy as credit supply, money brought into circulation through lump-sum transfers does

[9] See Chap. 20 on 'Interest, credit expansion, and the trade cycle' in Mises (1949), Chap. 4 on 'Price expectations, monetary disturbances, and malinvestments' in Hayek (1939), or Chap. 5 on 'Bank credit expansion and its effects on the economic system' in Huerta de Soto (2009) for an exposition of the Austrian business cycle theory.

[10] The term 'forced savings' is used in the sense of Garrison (2004), rather than in that of Hayek (1935).

[11] This also allows to understand economically the trade-off between inflation and default.

not necessarily increase the credit supply. While some recipients may choose to lend on the market the new money transferred to them, others may prefer to spend it. Citizens are indeed likely to react differently to monetary transfers as regards their position vis-à-vis the credit market. Whereas some may take the opportunity of lump-sum transfers to reduce borrowing, others may prefer to do the opposite. Cantillon (1755) even takes the view that interest rates may increase—rather than decrease—in the wake of lump-sum transfers (p. 178):

> If the abundance of money [. . .] comes from the hands of moneylenders, the increase in the number of lenders will probably lower the rate of interest. However, if the abundance comes from the hands of people who will spend it, this will have just the opposite effect and will raise the rate of interest by increasing the number of entrepreneurs who go into business as a result of this increased spending, and will need to supply their businesses by borrowing at all types of interest.

Second, lump-sum transfers exert a weaker effect on interest rates than credit expansion because the new money may enter the credit market after having stimulated the price level. If prices rise before the new money is supplied as credit, the increase in the real credit supply will be weaker. Mises (1949) describes this effect as follows (p. 553):

> If the additional quantity of money enters the economic system in such a way as to reach the loan market only at a date at which it has already made commodity prices and wage rates rise, these immediate temporary effects upon the gross market rate of interest will be either slight or entirely absent.

By contrast, credit expansion implies that the first transaction of the process of money creation is an increase in credit supply. The new money can stimulate demand and prices only after the real credit supply has increased.

To put it shortly, an increase in money hampers the coordinating role of interest rates to the extent that it affects the course of the credit market. If money is issued through the granting of credit, as it is the case in the current monetary system, then an increase in money alters intertemporal exchanges and interest rates. By contrast, lump-sum transfers make it possible to increase the quantity of money to stimulate aggregate demand and inflation without creating a discrepancy between investment and savings on the credit market. The granting of credit remains thus independent of the creation of money and the identity between investment and savings hold through the coordinating role of the unhampered credit market.

6 The Role of the Monetary System

The separation of money and credit calls, in principle, for the abolishment of the fractional reserve banking system and for the adoption of a 100 percent reserve system.[12] The creation of currency substitutes by commercial banks through the

[12]This section is based on Baeriswyl (2015).

granting of credit would be prohibited. In a fiat currency system, the entire creation of money would correspond to the creation of currency by the central bank.

In a growing economy, the quantity of money must increase for the price level to remain stable. The idea of separating the creation of money from the granting of credit is not new. It was one of the aims of the 100%-Money plan advocated by Fisher (1936). In line with the arguments elaborated above, Fisher recognises that the pursuit of price stability by a central bank in the fractional reserve banking system brings about unintended consequences because the increase in money takes place into the credit market (p. 139):

> . . . even when the price level is, for a time, successfully stabilized under the [fractional reserve] system, the very effort to accomplish this by manipulating the rates of interest, in the face of the handicaps of that system, necessarily requires some distortion of the rate of interest from normal, that is, from the rate which the mere supply and demand of loans would have produced.

In other words, Fisher argues that the relationship between money and credit makes the pursuit of price level stability challenging because this relationship requires distorting the credit market to achieve this target. As a solution, Fisher's proposal sets out to reduce the discrepancy between investment and savings arising from credit expansion (p. 111):

> The growth of the country would be largely registered by the growth of savings and investments and these two (savings and investments) would keep more nearly synonymous than they are now; for the correspondence between them would not be so much interfered with as it is now—that is, interfered with in boom times by loans unwarranted by savings, and in depression times by savings hoarded instead of invested.

Equivalently, Fisher highlights that, in his plan, interest rates would remain unmanipulated by monetary expansions (p. 140):

> Interest rates would seek their level in a natural way according to the supply and demand of loans, and real rates would not be perverted by misbehavior of money.

Fisher was not alone to address this concern during the debate in the 1930s. The issue of the identity between investment and savings was generally raised by scholars, as illustrated by Angell (1935), another influential proponent of the 100 percent reserve system at that time (p. 24):

> [An increase in money] has the result that interest rates are kept lower than they otherwise would be, that some investment is being undertaken which cannot support itself over time or which is ill-advised in other ways, and that a subsequent painful and wasteful readjustment must take place.

In brief, these authors recognise the unintended consequences of the pursuit of price stability in the fractional reserve system and calls for the separation of the creation of money from the granting of credit. This aim can be reached when the central bank injects money through lump-sum transfers to citizens, as discussed above.

By contrast, modern proponents of the 100 percent reserve system, such as Benes and Kumhof (2013), promote their 'Chicago Plan Revisited' on the opposite ground that the central bank can better engage in credit expansion by lowering interest rates

in negative territory. The aim of their plan is not to leave interest rates and the credit market unhampered by monetary injections, as Fisher (1936) does, but to strengthen the central bank's control over the credit market. For instance, Benes and Kumhof (2013) states (p. 10):

> ... because the interest rate on treasury credit is not an opportunity cost of money for asset investors, but rather a borrowing rate for a credit facility that is only accessible to investment trusts for the specific purpose of funding physical investment projects, it can temporarily become negative without any practical problems. In other words, a zero lower bound does not apply to this rate.

Their plan, thus, allows the central bank to overcome the liquidity trap in the fractional reserve system and to foster credit expansion further. This strengthens rather than weakens the relationship between money and credit. Although such an attempt may succeed in stimulating the economy in the short run, it exacerbates intertemporal discoordination and weakens economic stability in the long run.

Adopting a 100 percent reserve system is thus not enough to implement the separation of money and credit. It moreover requires that the central bank puts money into circulation through lump-sum transfers to citizens, rather than through the granting of credit to financial intermediaries. Only then would the credit market remain unhampered by monetary injections and the interest rate regain its coordinating role between investment and savings.

7 Some Additional Aspects

This section discusses some additional aspects related to the implementation of lump-sum monetary transfers to citizens by a responsible central bank. It deals with the differences from and similarities to monetary targeting, the reduction of the quantity of money, central bank independence, the accordance of lump-sum transfers with capitalism, and their relation to fiscal policy.

7.1 Differences from and Similarities to Monetary Targeting

Managing the quantity of money transferred to citizens may resemble, at first sight, monetary targeting, as pursued in the last decades of the previous century by several central banks such as the Swiss National Bank or the Deutsche Bundesbank. These central banks were used to implement monetary policy by setting a growth target for monetary aggregates. Yet, the management of monetary aggregates was part of the credit-money economy as well as the management of interest rates nowadays. Whereas managing monetary aggregates focuses on the quantity of money injected into the credit market (through the granting of credit by commercial banks), managing interest rates focuses on the price of credit.

Lump-sum monetary transfers to citizens differ from these strategies in that money is not injected into the credit market. Monetary policy is conducted by managing the quantity of money transferred to citizens, rather than managing the quantity of money created through the credit-granting process by commercial banks.

Lump-sum transfers are nevertheless similar to monetary targeting in that the central bank conducts monetary policy by targeting the growth of money in circulation. Each year, or each quarter, the central bank decides on the increase in money transferred to citizens. Stabilising policy is achieved by increasing or decreasing the growth of monetary transfers.

7.2 Reducing the Quantity of Money

When money is injected into the credit market, the quantity of money expands with the granting of loans, and contracts when loans are repaid. By contrast, money injected through lump-sum transfers does not naturally shrink at any time in the future. The central bank can nevertheless reduce the quantity of money by issuing short-term bills or long-term bonds. In doing so, it substitutes non-monetary papers for money.[13] Issuing non-monetary papers entails however a subsequent increase in money equivalent to the interest paid on these non-monetary papers. While money decreases with the issuance of non-monetary papers, it increases more than it has decreased when non-monetary papers and interest payments fall due. The government might also help reducing the quantity of money by returning to the central bank part of the money raised through taxation or through debt issuance. The quantity of money in circulation would decline with the monetary transfers from the government to the central bank.

Whether the permanent nature of money injected through lump-sum transfers represents an advantage or a disadvantage depends on one's perspective. The general opinion prevailing today in the central bank community is that the contraction of money that goes with the contraction of credit (debt-deflation spiral) is highly detrimental to the economy and to the control of inflation. Figure 1 plots the development of the broad monetary aggregate M3 since 1969 in Switzerland, in the United Sates, and in Germany. Although the quantity of money in circulation contracts when the volume of bank loans shrinks in the current monetary system, the broad monetary aggregate M3 has hardly declined for any significant period of time, not even during the disinflationary episodes in the 1980s. The only exception is found in Germany between 2008 and 2011. Yet, the arsenal of measures taken by central banks since the outbreak of the recent financial crisis has aimed precisely at counterbalancing this mechanism and at preventing the deleveraging of the economy and the contraction of money in circulation. Therefore, the fact that money injected through lump-sum transfers does not automatically vanish at a later date should be

[13]Note that this withdrawal process would then affect the credit market.

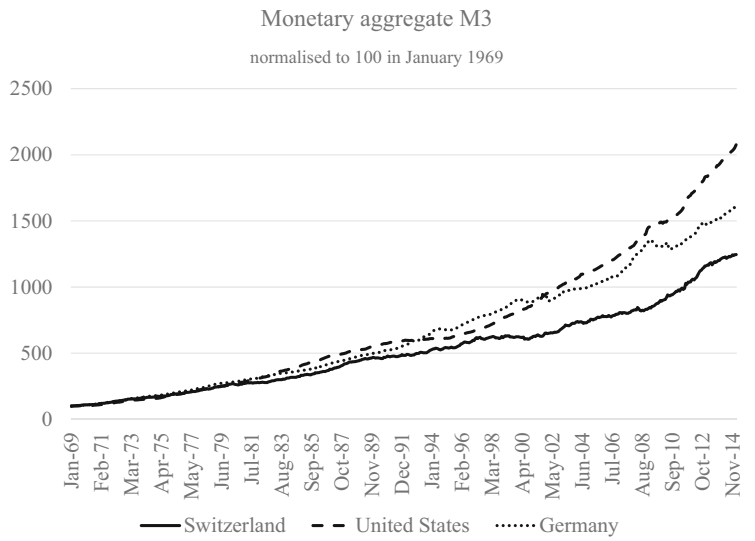

Fig. 1 Monetary aggregate M3 in Switzerland, in the US, and in Germany (sources: SNB, Fred, ECB)

considered an advantage rather than a disadvantage of this process, because it spares central banks the need to intervene to prevent a contraction of money.

7.3 Central Bank Independence

Lump-sum monetary transfers do not call central bank independence into question. The benefit of central bank independence has been discussed extensively within the current money-credit economy and remains valid when money is injected through lump-sum transfers. The central bank should decide independently on the increase in money necessary to fulfil its mandate of price stability.

There is no clear reason why the threat to independence should be more severe with lump-sum transfers to citizens than with credit expansion. On the contrary, since the benefit of money creation is more evenly distributed across society, the incentive to lobby the central bank gets weaker. Historically, the purpose of central bank independence was to prevent the government from taking political advantage of monetary expansion at the expense of individuals. Groups of citizens who lobby the central bank are likely to have less influence on this body than the government, industries or commercial banks. Some may fear that political groups will seize the opportunity of lump-sum transfers for providing each citizen with a basic income. Such a proposal would, however, be subject to the usual democratic processes.

7.4 Capitalism

Lump-sum monetary transfers to citizens are more compatible with the principles of capitalism than credit expansion because they yield a more evenly distributed benefit of the creation of money across society, and because they leave the credit market and interest rates unhampered.

Capitalism can be defined as an economic system in which the allocation of resources results from the free exercise of private property rights. The ex nihilo creation of money is fundamentally at odds with the nature of capitalism because it reallocates resources through a kind of misappropriation for the benefit of the first recipients of new money. Reallocating resources by means of money creation is not the result of the free exercise of private property rights. Allais (1999) summarises the redistributive effect of the creation of money in these terms:

> In essence, the present creation of money, out of nothing by the banking system, is similar—I do not hesitate to say it in order to make people clearly realize what is at stake here—to the creation of money by counterfeiters, so rightly condemned by law. In concrete terms, it leads to the same results. The only difference is that those who benefit from it are different people.

By distributing new money evenly across society, lump-sum monetary transfers to citizens entail fewer redistributive effects than credit expansion, and are thus less at odds with the principles of capitalism.

7.5 Are Lump-Sum Transfers a Fiscal Policy Tool?

Lump-sum monetary transfers to citizens are sometimes assimilated to fiscal policy because these transfers are made by the central bank, a state body, or because these transfers are made at the expense of the seigniorage that would otherwise be paid out to the government.[14] This argumentation is questionable for two reasons. First, lump-sum transfers to citizens come only for a small part at the expense of government seigniorage because the bulk of money in circulation is created by commercial banks in the current monetary system rather than by the central bank. Thus, although substituting credit expansion for lump-sum transfers to citizens reduces government seigniorage, it reduces to a much greater extent the benefit that commercial banks and recipients of bank credit reap from credit expansion. Second, the seigniorage is the outcome of the creation of money and is, thereby, driven by monetary policy. The fact that seigniorage flows into the government budget does not mean that monetary policy should be equated with fiscal policy.

[14]Unconventional measures taken by central banks, such as quantitative easing, may share some fiscal aspects because the central bank purchases government bonds or because taxpayer money is put at risk.

The following delimitation between fiscal and monetary policy seems more sensible. Both fiscal and monetary policy entail a redistribution of resources across agents. They differ from each other in the way in which resources are taken from some agents and given to others. Fiscal policy redistributes resources through taxation, monetary policy through money creation. In view of the creation of money necessary for implementing lump-sum transfers, there is no doubt that they belong to monetary rather than fiscal policy.

8 Conclusion

A central bank distributing money to citizens! At first sight, this proposal may seem far-fetched. However, as the quote from Murray Rothbard at the beginning of the paper suggests, a closer look at the functioning of the current credit-money economy reveals that lump-sum monetary transfers to citizens are more benign than credit expansion. First, lump-sum transfers are more effective at controlling inflation because they stimulate economic sectors more evenly and raise the price of a broader range of goods than credit expansion. Second, lump-sum transfers do not manipulate the credit market and interest rates, and, thus, do not contribute to building up intertemporal discoordination and financial imbalances. There are therefore good reasons for a responsible central bank to prefer lump-sum transfers to citizens over credit expansion and interest rate manipulations, whose success in increasing aggregate demand and inflation is mostly uncertain but whose unintended consequences are only too well understood.

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