Opinion **Free Lunch**

Treat money as the public good it is

Opponents of Swiss initiative have not shouldered their burden of proof

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The Swiss referendum system has proved to be a useful incubator of radical economic ideas. Two years ago, a proposal was unsuccessfully put to voters to introduce a generous universal basic income. And next week, the Swiss will vote on a proposal that, if passed, would transform the economy even more radically than UBI would have done.

The so-called "Vollgeld" or "sovereign money" initiative — covered at length by my colleague Ralph Atkins — aims to require private banks to back clients' deposits fully with central bank reserves. Put differently, they would abolish the fractional reserve banking practised virtually everywhere, under which private banks can create deposits when they issue loans over and above the cash, currency and reserves with the central bank that they possess in assets.

The Vollgeld promoters are right about two big things. The first is that in a fractional reserve system, the amount of money circulating in an economy is largely determined by private banks and their decentralised, profit-maximising decisions about how much to lend. The broad money supply consists almost wholly of bank deposits created *ex nihilo* by private institutions, rather than government-issued money. Just making more people realise this is itself a benefit of the referendum campaign. (Free Lunch has described this phenomenon in our analysis of the Bank of England paper that remains the best explanation of how money is created by banks.)

The second is that if we had to design a system for managing the economy's money supply from scratch we would never opt for what we have today. A stable and appropriate size of the money supply is a deeply important public good. It is a public good in the general sense that the government is rightly held responsible for it; but it is also a public good in the technical economic sense in that it has properties which mean it will not be adequately provided by privatised free markets. Suffice to note that profit-maximising private banks have an incentive to expand lending when money supply growth is already too high and retrench when monetary stimulus is most needed. In other words, they create credit cycles. They also have no incentive to take into account the effect their money creation has on others.

Full reserve backing — essentially nationalising the money supply — must in principle be superior, at the very least because it would give central banks more tools to manage the economy. Central banks today determine the amount of "base money" (cash and central bank reserves) but have no direct control over "broad money" — what we use to pay for goods and services in real economic transactions. Having such control would allow them to both keep doing what they do at the moment (target interest rates or using more unconventional tools such as securities buying) and to try bolder monetary instruments such as directly managing the amount of broad money in circulation or issuing "helicopter money". And in a crisis, banks would no longer be endangered by deposit runs, since deposits would be fully backed by the central bank.

The Vollgeld initiative is thus of a piece with earlier considered proposals for comprehensive reform of the fractional reserve system, such as John Kay's call for narrow banking or Lawrence Kotlikoff's proposal for what he calls limited purpose banking.

These considerations do not by themselves seal the case for reform. But they do mean that the burden of proof is on those who oppose the change. So far they have not fully shouldered it. (Those behind the initiative may have over-reached, however, because their proposal seems not only to require full-reserve banking but also provide for direct monetary financing of the government and state control of credit allocation. These are conceptually distinct from full-reserve banking and should be decided separately.)

The head of the Swiss central bank, Thomas Jordan, has come out strongly against the proposal saying it "would hurt Switzerland". Some of his chief arguments, however, are contradictory. On the one hand, he argues that full reserve backing would interfere with banks' ability to lend, they could only lend out funds deposited with it for such purposes, rather than as liquid deposits. Such "maturity transformation" — funding long-term loans with deposits redeemable at short notice — is the essence of banking. Jordan rightly says that if the initiative passes, banks would instead have to solicit funds on the understanding that they would be used for long-term loans.

At the same time, however, he argues that savers would be hurt because reserve-backed deposits would be less well-remunerated. But the latter is precisely what would attract savers to fund the former. If they do so with greater understanding of the risk, that should make for better market pricing of credit. And maturity transformation would not end, banks would just look more like mutual funds whose investors may withdraw money on short notice so long as not too many others try the same.

What is clear is that full reserve requirements would hurt the current business model of banks. But that cannot be an argument against a reform that is otherwise in the public interest.

Other readables

- Pedro da Costa highlights the dissonance between the Federal Reserve's willingness to tighten monetary policy and its own report, which finds that 40 per cent of Americans feel they are living on the edge economically. His tentative explanation is that looking at averages makes it easy to overlook the precariousness of those at the low end — a point we made in yesterday's Free Lunch.