Pros and cons of public money creation – Edgar Wortmann

Thanks for inviting me! Here is my response to your pros and cons question.

"The aim of the day is to reach a common understanding of both the problem with the current system and of possible improvements, the identification of common ground and knowledge gaps for further academic research."

In your paper, you jump to a certain solution, without properly analyzing/defining the problem and the cause of the problem. Here is my take on the problem.

Problem with the current system

- Money is a limiting factor, that restrains society from flourishing to its full potential.
- The monetary system craves debt, whereas society crumbles under it.
- Entanglement of public and private affairs in the financial system.
- The system is unmanageable, incomprehensible and unstable.
- The system distorts competition.

Cause of the problem

- General use of money claims (debt instruments)* as money…
- due to lack of plain fiat money to serve the monetary function…
- which compels the state to support privately/commercially issued debt instruments (near monies) to serve as money.

* Bank deposits are money claims / debt instruments. The fiat money needed to honour all monetary money claims society operates on, is non-existent. That is why the monetary system is inherently unstable.

Possible improvements

The problem with the monetary system can be solved by two main actions in tandem:

1. providing the state issued fiat money society needs to flourish to its full potential; and
2. abolition of all state aid to financial institutions and state support for monetary money claims.

Ons Geld proposes a *guided market driven transition* based on these two principals. More information in my paper: A proposal for radical monetary reform (attached), and of course on the website of citizens' initiative "Ons Geld": http://burgerinitiatiefonsgeld.nu/.

Further improvements are:

3. Repayment of *systemic debt** as monetary money claims are converted into state issued fiat money, which solves economic stagnation and reduces the interdependence of society and financial institutions.
4. Design of a plain digital fiat money system, to meet rational requirements of the money system.

* *Systemic debt* relates to the amount of (shadow) bank money in the economy. Systemic debt is accompanied by a systemic debt burden, which consists of the net interest the banking system charges on the bank money in circulation.

Fiat money has missed the ICT revolution, and is about to catch-up. Because fiat money needs no asset backing, a plain fiat money system can be insulated from market en credit risks. Plain fiat money is backed by good governance. Therefore, a plain fiat money system needs good governance by design. Good governance involves appropriate statutory standards for the monetary power and enhanced monetary management tools, which become feasible under a plain digital fiat money system, that is strengthened by real-time insight in stock, flow and allocation of all digital fiat money in circulation.

In a digital fiat money system, current concerns of a central bank lose practical relevance; interbank settlement, bank liquidity and prudential oversight will all become unnecessary for the general money system, since fiat money is not a money claim on the issuing entity, and payment with fiat money does not involve any bank balance sheet. It only involves the balance sheets of payer and payee. And liquidity is only required in the pocket of the payer. Therefore, 'new monetary management' will no longer focus on bank liquidity, but on general liquidity and adequate liquidity buffers throughout society.

Thus, a prominent and illuminating question to discuss is: *"what is the future of the central bank, if we convert to plain digital fiat money".*

Pros and cons to your model

The model presented in the working paper has some shortcomings. Most of the cons you identify, stem from the shortcomings of your own design.

Shortcoming 1 - Investment accounts

In your model "customers can transfer the money to a credit institution to generate a higher return." This resembles a bank deposit, and will sustain systemic risk, which is reflected in some of the cons you identify yourself. It is essential to define the title of the transfer. The title cannot be 'deposit', since the money is lent or invested (and not deposited). Lending and investing requires a prospectus: risks involved should be specified and transparent, and the lender/investor must not get the impression that he still holds his money. He has lent or invested

it. Institutionally the consequence of this is that prudential oversight is transformed from obscuring and levelling credit risks, in safeguarding risk transparency. The split of prudential and financial oversight becomes unnecessary and inappropriate, thereby strongly reducing the cost and complexity of financial oversight.

Shortcoming 2 - Transition

In your transition scheme, commercial banks "transfer their deposit money liabilities to the central bank". How nice for the commercial banks. But this is not the way to go! This would concentrate market and credit risk in the central bank, and expose the currency and the state to those risks.[i] Instead, bank money must be *converted* into fiat money; account holders buy state issued fiat money, with their bank deposits.

This results in a liquidity drain from the commercial banks, which is compensated by special temporary fiat money lending facilities to those banks. Repayment of public en private debts during the transition (*elimination of systemic debt*) does not stem from transfer of assets to the central bank, but from repayment (set-off) of the credit offered by the state to the banks, to counter the liquidity drain. It would not be logical to use this for anything other than repayment of bank loans, which would ameliorate bank equity ratio's, and significantly reduce the interdependence of society and the banking system.

Shortcoming 3 - Runs for safety

You presume potential runs for safety (away from risky assets). That suggests high elasticity of state issued fiat money; it is created on demand, in return for financial assets, like the central bank currently operates. This would further concentrate market and credit risk in the central bank, and expose the currency and the state to those risks. It would not enhance financial stability, but increase volatility.

Instead, after the transition, the fiat money stock must be rather inelastic, and not responsive to 'runs for safety'. It must, however, provide liquidity and sufficient liquidity buffers throughout society under normal circumstances, to sustain the real economy, and to prevent panics and other financial crises from affecting the money system.

Shortcoming 4 - Disregard of market and credit risks

In your model, market and credit risks are concentrated in the central bank. In fact, you are creating a super bank (probably a bad bank), that absorbs the risks of commercial banks.[ii] This puts the currency at risk and runs contrary to free competition and good governance of the money system.

On page 6 you explicitly state: "Because central bank money is not subject to credit risks it needs no government guarantees (…)". However, your model would not work at all, without government guarantees. For instance, in your model, the central bank holds the power to create

the national currency. That is the ultimate government guarantee. Your model makes the currency prone to credit and market risks, of which financial insiders can take advantage, at the expense of society, and the currency itself. Public and private affairs remain entangled, as they currently are, which is irreconcilable with good governance and undistorted competition.

Shortcoming 5 – Disregard of the fundamental difference between credit money and fiat money

A plain fiat money system is not backed by assets, but by good governance. This requires that the state does not issue fiat money as a bank does. A bank issues bank money, in return for something, for instance a promise to pay back, which is capitalized as a financial asset. The bank does not ask itself how much money society needs. It just looks at the financial assets that are offered in return for the money, and if it seems profitable, the bank creates the money. Bank money is backed by financial assets, that reside on bank balance sheets. Fiat money is backed by good governance, which does not reside on any balance sheet. It is a design requirement of the fiat money system.

Issuance and use of bank money coincide. Bank money is not first created and lent or spent thereafter. It is created (in the form of a money claim) as a result of lending or spending. This is exactly which we seek to counter, because lending and spending by money creation increases financial instability and puts the currency at risk. Good governance of the money system requires a caesura between the power to create money and the power to lend or spend it.

Shortcoming 6 – Lending fiat money into circulation

You rightly state that: "public money strengthens the transmission of information in a market price signal". You pair this however to a con: "it reduces the ability of the money supply to respond in a decentralized manner to legitimate increases in investment opportunities." This however depends on your system design, which apparently lacks the monetary instrument of supplementary fiat money lending to financial institutions, for real-economy investment.

Interest rates, with strengthened information transmission, are a potent source for new monetary management. The Monetary Authority does not set the interest rate (as the central bank does), but responds to it, by providing fiat money lending facilities to financial institutions, earmarked for real economy investment, at interest rates that cut off excessively high market rates. This provides the flexibility the real economy needs, and supports the decentralized assessment and allocation-function of financial institutions, when the money supply apparently is too tight.

Shortcoming 7 – Focus on the payment system / disregard of broad money

You focus on the payment system. That leaves most of the money system and the main source of financial instability unaffected. The scope should encompass the entire money system.

You link the extent of the one-time conversion to M1. I think M2 is a better proxy. It is likely that the public will convert most bank deposits it currently regards as money, into fiat money, as state backing of bank deposits is completely removed. Of course, part of M2 will continue to be lent/invested for profit seeking, and will remain a mere money claim. However, we must include the money markets, that need risk free liquidity as well. Those markets should be served by plain fiat money in the first place as they (and related interwovenness) pose the biggest thread to financial stability. All in all, your estimation of the free fall of seigniorage (6000 B in the Eurozone) is conservative, and your scope for the transformation inappropriate.

In general

In my opinion, your reasoning regarding public money creation is not entirely sound, partly because you seem to be much inclined to use of concepts typical for bank money, and underestimate the fundamental difference of plain fiat money, and important conceptual consequences thereof.[iii] I recommend a multi-disciplinary follow-up. Most of all, the legal discipline should take its part in your research. After all, bank and fiat money are both legal constructs.

Still, I much appreciate your paper, as it reflects growing recognition and appreciation of monetary reform. I have a list of more detailed feedback. If you like, I'll be glad to share and discuss this with you.

Pros en cons to public money creation

The following are my main pros and cons to public money creation. These pros are based on the transition to a digital fiat money system, as explained in my paper: A proposal for radical monetary reform (attached).

Pros

- Disentanglement of public and private affairs in the financial system.
- Improvement of the system for supply and allocation of money; *enabling society to flourish to its full potential*.
- Enhanced competition on money and capital markets (and in payment services)
- Enabling sound and scientifically calibrated monetary management, based on real-time insight in stock, flow and allocation of digital fiat money.
- Reinforcing and maintaining the resilience and stability of the money system.
- Strongly reducing the interwovennes of financial institutions and society.
- Strongly reducing the complexity of financial oversight.
- Shift from financial exploitation to 'good stewardship'.
- Resolution of political and economic debt related deadlocks.
- Mobilization of all available resources and human capacities to improve living standards.
- Precondition for a just society with equal opportunities and social welfare for all.

- Establishing the primacy of democracy.
- Making money serve society.

Cons

- A power shift, which implies a struggle.
- Potential misuse of power by dictatorship.
- Unforeseen adverse side effects.

The societal benefits of transition to a plain fiat money system are incredibly big, and undoubtedly out-weight all costs and adverse side effects involved. The risk of dictatorship will always loom on society. And the chances of dictatorship will increase every day we continue with the current deficient money system. These chances reduce considerably, as we convert to plain fiat money, and enable society to prosper to its full potential.

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[i] You state: "The freeing up of 6000 B in transition occurs when all banks transfer their deposit money liabilities to the central bank and transfer a similar amount in assets as well. (...) In this process the central bank receives a large amount of assets. (…) the received assets can be safely used to reduce public or private debt, to increase spending, or to reduce taxes."

This implies that the central bank takes over commercial bank assets, which it should sell, to free up the 6000 B. Undoubtedly that is a heavily loss-making activity, at the expense of the central bank / the national currency. For commercial banks, it generates large windfall profits. It is the ultimate way to clean up their balance sheets. In the process, no fiat money is created and no seigniorage is received, and the central bank is unlikely to be able to sell the assets at all. It transforms in a giant monolithic bank, that keeps itself afloat at the expense of the national currency. No societal advantage is to be expected from this.

[ii] Ibidem i.

[iii] You should not morph a plain fiat money system into a bank credit system. That makes you end up with senseless strategies to uphold the idea that the money stock should be on the balance sheet of the issuing entity/entities. It should not. This inclination to bank balance sheets, stems from the confusion of money and credit. If money is lent, a balance sheet relationship comes into existence. Since almost all bank money is lent into existence, we are used to regard money as financial assets (money claims). Some economists are so accustomed to this, that they have difficulty to understand money as anything else than a balance sheet relationship (financial asset).

Digital currencies, like bitcoin, may alter this. Bitcoin is not a liability of the issuing entity. It is a pure means of payment, which ultimately settles debt, and does not concentrate debt on any balance sheet, of any (banking) institution. It is privately issued fiat money.

Fiat money can be transferred by lending. That results in a money claim of the lender, and a liability of the borrower. This money claim is a financial asset, but does not represent the fiat money. The same applies, if fiat money is spent into circulation. The goods bought with the money may be capitalized on the balance sheet, but do not represent the money with which those goods were bought. After payment, no balance sheet relationship remains. The goods have been paid for.

In the transition to a plain fiat money system, bank deposits (and other monetary money claims) are converted, to a certain extent, determined by demand, into fiat money. Bank account holders buy this fiat money with bank deposits. There is no transfer of liabilities to the central bank. The issuer of fiat money however, receives 'reserves' (central bank credit) in return for the fiat money, which drains reserves from the banking system. As this is compensated by lending of fiat money to the banks, a money claim appears on the balance sheet of the issuing entity. To the extent of this money claim, public and private debts with the banking system can be instantly repaid, which ameliorates bank equity ratios and reduces the stifling interdependence of society and financial institutions.