

GAZDASÁG & TÁRSADALOM

Journal of Economy & Society

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Freiheit als Grundlage der moralischen Verantwortung
von Unternehmen und die Frage der Haftung

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Bringing back in the monetary fundamentals of finance

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Festlegung von Lohnuntergrenzen – tariflich oder gesetzlich

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Monetary and Banking Reform Bringing back in the monetary fundamentals of finance¹⁴

Joseph Huber¹⁵

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ABSTRACT Modern economy is based on its financial system, which in turn is built upon its monetary system. This constitutes a clear functional order: money governs finance, finance governs the real economy. It is one of the elusive aspects of orthodox economics to see money as a matter of just marginal concern. To any reality-based economics (historical, institutional, behavioural, and, of course, monetarist as well as modern monetary) it is self-evident, to the point of triviality, that money is the pivotal control medium of the economy. However, current debates on the ongoing banking crisis since 2008 and the ensuing sovereign debt crisis (which in turn perpetuates the banking crisis), do not for the most part take into account the fundamental role of the monetary system.

KEYWORDS Banking Reform, Financial Crisis, Credit, Monetary Reform

Current measures of banking reform

The reform debate so far typically has focused on certain practices of investment banking and structures of financial markets, on risk management and capital adequacy rules for banks in general. On this basis various measures have been proposed, some of which have by now become established law such as the Dodd-Frank Act in the United States. A series of comparable EU directives and ordinances is passing legislation in the near future.

A first group of analyses identify as the main culprit deregulation of financial markets and the trend towards casino capitalism. In response, proposed measures aim at more supervision and a certain containment of 'casino trading'. Examples are

- Financial transaction taxes
- Converting OTC-trade into regular stock exchange dealings
- Closing down financial offshore centres.

14 This article is a revised version of the author's presentation at the 7th Annual Monetary Reform Conference, Chicago, Sep 29th – Oct 2nd 2011, org. by the American Monetary Institute.

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Another analytical focus is on inappropriate risk management and irresponsible risk taking. Measures proposed in this respect include

- Trimming of bonus systems for traders and top executives
- Interdiction of proprietary trading (Volcker rule)
- Tougher statutory provisions for rating agencies, and introduction of public rating agencies
- Interdiction of special types of securities, e.g. ‘structured products’ such as asset -backed securities in the form of good-bad-loan-sandwiches; or ruling out naked (uncovered) short selling
- Transparent accounting, in particular ruling out off-balance items such as Special Purpose Vehicles which serve as a sales channel for ‘structured products’.

A third group of reform measures starts from the assumption that the equity base of banks, seen as a safety buffer, might be insufficient for ensuring the survival of banks under stress of bad loans and loss on investment. As a handy answer to this comes

- bulking up capital requirements (bank equity) in line with the transition from guidelines Basel II to Basel III, including
- provisions for minimum liquidity lasting 30 days, and even
- a ceiling on credit creation in terms of a maximum ratio of outstanding loans to the core equity base and items in a bank’s trading book.

A fourth group of reform approaches starts from the problem of ‘too big to fail’, or ‘to interconnected to fail’ and tries to mitigate public bail-out constraints by looking for different business models for banks, including dismantling of universal banks. Such considerations have led to calls for

- the reintroduction of separate banking, originally introduced in the form of the US Glass-Steagall Act of 1933 which intended to ring-fence ‘good-guy’ commercial banks from ‘bad-guy’ investment banks. Similar proposals have now again been made by the Independent Vickers Commission on Banking in 2011
- living wills, providing in good times for an orderly bankruptcy process in the case of bank failure, thus unburdening public bail-out funds and the taxpayer.

How useful can the reform measures listed be? By and large, the list ranges from little change to significant change. E.g., a financial transaction tax certainly contributes to a government’s budget. But – as long as not prohibitive - it has little or no impact on the inner workings of the money and capital markets, i.e. it changes hardly anything.

Similarly, the measures proposed in connection with risk management and equity ratios (Basel II → III) may be useful up to a certain point. Or again they may not. They will add to regulative density, i.e. bureaucracy. They will raise

the collateral bar to retail credit. And they will probably continue to deceive banks themselves with false assessments of the risks in their credit and trading portfolio. Basel II and the solvency and liquidity rules based on it did nothing at all to prevent the banking and sovereign debt mess we are currently in. It reminds me the outstanding mathematician John von Neumann, who followed the rule 'Better about right than exactly wrong'. Basel rules tend to be *very* exactly wrong rather than being about right. Five days before filing for bankruptcy, Lehman Brothers boasted a core capital ratio of 11 per cent, nearly three times higher than demanded by the regulatory authority. Doesn't this say it all?

Moreover, equity rules seem to be plausible from a banking point of view, whereas from a currency point of view they miss the point. The value of money, its purchasing power, isn't covered by monetary collateral, but by real-economic productivity. So the political reference value for adequate volumes of money, or bank credit respectively, is GDP rather than bank equity.

Some of the measures listed will be implemented in various countries, or in fact already have been. But we observe that the probability of such measures being implemented is higher when they bring about little change, and low when significant change is involved. Furthermore, the measures are watered down in the policy process. E.g., it looks as if the bank lobby might be successful in eliminating the envisaged ceiling on credit creation from the Basel III guidelines.

Among the proposals listed, the approach with the strongest structural impact seems to be separate banking. It should be noted that any of the current *monetary* reform approaches constitutes per se a separation between customer money accounts and payment services on one side of the firewall and the loan and investment business of banks on the other side. Conventional separation approaches, however, miss this specific firewall while braking away investment banking from commercial banking (depository or credit banking, licensed to refinance at the central bank). But there is one crucial point most separate-banking proposals have so far failed to consider: as long as commercial banks can make out credit to investment banks, who use the money for dealings in the global casino, separate banking will defeat its own purpose. An effective separate-banking system has to prevent financial investors from trading on the basis of borrowed money. Neglect of the question of financial leverage on the basis of multiple credit creation by the banks within the fractional reserve system was probably the reason for the lack of effectiveness of the Glass-Steagall Act.

Bringing back in the monetary basis of finance

The case of separate banking is prototypical for today's neglect of monetary factors in financial analyses. Or to put it more simply, the failure to ask questions such as: Where does all the money come from? Why is so much money easily

available in the global casino, and not enough money for job-creating investment in real-economic goods and services? So it is high time to bring back in the monetary basis of finance – in public debate, in academic controversies, and in political agenda setting.

All of the causes identified in those analyses do have a common basis, a cause of causes so to say, a *monetary* cause of the *financial* causes of the banking and sovereign debt crisis, which is fractional reserve banking, or, in other words, multiple credit creation on a small money base of reserves. In order to create a deposit/credit of 100 units in a customer's current account it takes Eurozone banks on average less than 3 units of central-bank money, of which 1.4 units in cash, 1 unit in obligatory minimum reserves, and 0.1 units in operational balances for the settlement of daily transfer clearings.¹⁶

This disproportionately boosts credit leverage for the purposes of funding ever higher public debt as well as mere financial investment. It neglects less exciting real-economic investment, and over the years has distorted primary income distribution to the benefit of financial capital yields, and concomitantly to the detriment of income earned from work.

As a result, the money supply has grown for decades at a much higher rate than the economy. For example, in the US in the last 10 years, real GDP (price-deflated) grew by 16%, nominal GDP (price-inflated) by 45%, whereas M1 grew by 70%, broad money M2 by 80%. In Germany, from 1992 to 2008, real GDP grew by 23 per cent, nominal GDP by 51%, whereas M1 grew by a staggering 189 per cent¹⁷ – an increase in the quantity of money which clearly overshoots any sound target, even if put in a global perspective.

Until around 1980 the value of US financial assets oscillated around 450% of GDP. From then on through to the beginning of the banking crisis in 2007 it grew steeply to over 1.000% of GDP, a tremendous expansion far beyond any real-economic fundamentals.¹⁸ Long-term overshooting of the money supply in tandem with credit-leveraged trade in paper values indicates the development of a self-referential financial economy ever more detached from the real economy.

Traditionally, if the money supply overshoots it creates producer and consumer price inflation. We have become accustomed to an annual loss of purchasing power in a range between 2 to 5 per cent. This is nevertheless inflation. Over a

16 Calculated according to figures in Deutsche Bundesbank, *Monthly Bulletins*, 2011, Tables II.2, IV.2, V.3.

17 www.federalreserve.gov/releases/h6/hist; www.bundesbank.de/statistik/zeitreihen; Deutsche Bundesbank, *Monthly Bulletins*, Tables II.2.

18 *Trader's Narrative*, November 7th, 2009. *The Economist*, March 22, 2008. Different delimitations lead to different levels, but similar proportions, e.g. in Ashok Vir Bhatia 2011: Consolidated Regulation and Supervision in the United States, *IMF Working Papers*, No.23, 2011, p.8.

ten year period it erodes between a quarter and over half of the purchasing power of monetary assets. Even more important has now become what is sometimes referred to as ‘monetary inflation’, more commonly known as asset inflation and asset price inflation. In every bull market, holders of stocks, related securities, and owners of real estate see the upward trend as a welcome increase in value while failing to recognise the asset-inflationary bubble it most often is, and the havoc it can create when it eventually bursts.

Credit-leveraged financial speculation, though, is not the only culprit. Overstretched government expenditure is at least as important a cause for the overexpansion of the money supply. Whenever a government incurs new debt, a corresponding amount of new bank money (demand deposits) is created, which adds to the disproportionate growth in the money supply. The mechanism of funding government debt with new bank money is somewhat different according to currency and country, but the effect is the same.

Public budgets tend to be in the red because governments habitually spend more than tax revenues would allow for. The reasons for this are lobbyism and political clientelism (next elections always lying ahead), high levels of welfare expenditure, partly also high levels of military expenditure, moreover high levels of subsidies, and of late very high levels of government bail-out funds for banks and, in the Eurozone, for governments threatened by insolvency, including banks exposed to them. As a consequence, a mountain of public debt is continually building up, restraining governments’ ability to act. Meanwhile, public indebtedness has passed critical thresholds which forces politicians and bankers alike to recognise the fact that these levels can no longer be sustained – belatedly so. Banks have thoughtlessly funded any mountain of public debt for decades. Now, in the aftermath of the US mortgages-triggered banking crisis which was caused by the same MFIs, they all of a sudden demand usurious interest rates of governments whom still yesterday they have lured into ever higher debt.

The phenomenon of over proportional growth of the money supply is known in economics as the ‘Marshallian K’, but widely disregarded. K, strictly speaking, is the ratio of the money base M0 to nominal GDP, but can also refer to the ratio of M1 or M2 to GDP. Historically, K has on the long-term average risen ever since bank money in the form of banknotes and demand deposits began to spread. At first, in the course of the industrial revolution in the 19th century, banknotes, mostly from private banks, replaced coin as the most important means of payment. This evoked the controversy between the British Currency- and the Banking-School in the 1840s, which was decided in favour of the currency approach by Peel’s Bank Charter Act 1844. As a result, private banknotes were phased out in most countries in the decades before World War I. The right to issue banknotes became the prerogative of national central banks some of whom were set up in the process.

Central banks' control of the money supply, though, wasn't complete even then, because the proportion of demand deposits, the means of cashless payment, was already high at over a third of M1.¹⁹ In the course of the 20th century control over the money supply by the central banks was steadily undermined as a result of the development of cashless payment practices and the common use of current accounts, further enhanced by IT systems as well as instant cross-border flows of currencies and capital.

Central banks are still supposed to control the money supply. But as a matter of fact they have ceded the prerogative of creating money to the commercial banks. Seen in this context, the mission of monetary reform is rather simple: doing away with commercial bank money in favour of chartal money, in a way similar to the monetary reforms of the 19th century when private commercial banknotes were phased out in favour of central-bank notes or government banknotes.

The eventuated loss of any effective control of the money supply now recurrently leads to those speculative bubbles in migratory hot spots around the world caused through overshooting leverage provided by bank money. Banks' business behaviour is strongly procyclical, resulting on balance in a long-run oversupply of money. This pushes business cycles as well as financial bull and bear markets to their extremes, fosters inflation and, ever more importantly, creates asset bubbles and drives up asset price inflation in equities, real estate, and commodities. This involves ever higher degrees of leverage, ending in over-investment and over-indebtedness which then discharge into severe crises ravaging entire nations. The process also threatens the by now vulnerable banks, the safety of bank deposits and the maintenance of payment services – which in turn puts pressure on governments to bail out the banks, thereby creating an extra mess of untenable public over-indebtedness as well as so-called 'quantitative easing' which props up banks in the near term, but tends to devalue the currency and to trigger again asset inflation (leveraged financial speculation).

Under conditions of almost unrestricted creation of bank money the model of self-regulating financial markets is bound to fail. Particularly, the Efficient Financial-Market Hypothesis EMH after E. Fama turns into a mere banking-school ideology which does not stand the test of economic facts. Far from reaching equilibrium, the financial markets overshoot and derail over and over again.

In order to work properly, the financial economy needs to rely on a stable and equitable monetary system, with a well-measured money supply adequate to the real growth potential of the economy. So far measures of monetary reform have been widely neglected in the policy discourse. But it is in the irrefutable nature of things – particularly the untenably high levels of financial leverage and, now

19 E.g. Swiss National Bank, Historical Time Series, No.1, Feb 2007, tables 1.3, 2.3.

overshadowing everything else, the problems of over-accumulation of sovereign debt – that one will have to come back to the monetary basics.

A new monetary reform movement in the making

The history of monetary reform in the last hundred years knows great names, starting with Silvio Gesell (*free money* 1910s), C.H. Douglas (*social credit, national dividend* 1920s) and the full-reserve approaches of the 1930s, in particular, after Frederick Soddy's first publication on the matter in 1926, *100%-banking* as conceived of by Henry Simons, Frank Knight, Milton Friedman and others (the so-called Chicago plan), and *100%-money* as worked out by Irving Fisher. Similar ideas were put forward by a number of other economists, e.g. Ludwig von Mises, Walter Eucken, Kenneth Galbraith, James Tobin, Maurice Allais, and Giacinto Auriti. Despite the renown of these academics, the analysis of the monetary system and the reform ideas they put forward never took hold in the orthodox mainstream. As a consequence, textbooks lack a proper analysis of the functioning and the effects of fractional reserve banking.

It was only at the onset of the banking crisis and sovereign debt crisis in 2007/08 that heterodox thinking in financial economics and policy gained fresh impetus (Peukert 2011). As one result of this, a new monetary reform movement has been taking shape. New initiatives were set up, older ones found more attention – among them *Prosperity* and the Bromsgrove conferences in Scotland, the *American Monetary Institute* in the United States, *Monetative* in Germany, the *Vollgeld Initiative* in Switzerland, *Positive Money* in Britain and New Zealand, *Sensible Money* in Ireland, *Centro Studi Monetari* and *Programma per la riforma monetaria* as well as *moneta@proprietà* in Italy, *Vivant* in Belgium, *osonsallais* in France.²⁰ They are out to bring about monetary reform top down, whereas several hundred complementary-currency communities across the world are engaged in changing the system bottom up (Kennedy & Lietaer 2004, Kennedy 2011, Lietaer et al. 2012) .

The names chosen by the Swiss *Vollgeld* initiative and the German *Monetative* initiative are straightforward about the goals of the envisaged reform. *Vollgeld* is brief for 'fully valid legal tender', i.e. money which also in its cashless form, as digital money, is not just a claim on money which it re-presents, as is the case with

20 www.monetary.org. - www.monetative.org. - www.vollgeld.ch. The NGO behind is *Monetäre Modernisierung e.V.* - prosperityuk.com. - www.positivemoney.org.uk. / .nz. - www.sensiblemoney.ie/home. - <http://studimonetari.org>. - www.prim.it. - www.monetaproprieta.it/site. - osonsallais.wordpress.com/2010/02/22/christian-gomez-100-money. - www.systememonetaire.be.

banks' demand deposits, but is money in and of itself.²¹ The aim is to ensure full control of the money supply as well as full seigniorage to the benefit of the public purse by phasing out bank-created demand deposits on current accounts and completely replace them with *Vollgeld*. In 2000, on behalf of the New Economics Foundation, Huber and Robertson further elaborated the approach under the heading of *seigniorage reform* (Huber & Robertson 2000).

In English there are a number of terms with the signification of *Vollgeld*, a common word usage not being settled yet. One such term is *genuine money*, another one introduced by Dyson is *positive money*, related to the reform campaign of the same name. In earlier papers I used the term *plain money* (Huber 1999). In connection with the draft of an American Monetary Act Zarlenga has chosen the term *U.S. money*.²² This underlines the U.S. government origin of the money. In an international context it would be less applicable. Yamaguchi speaks of *public money* (Yamaguchi 2011). This points to established generic terms such as *chartal money* or *state money*. Finally, and with particular reference to constitutional law and the legal foundations of money, *sovereign money* might be the appropriate term of choice (Wray 2011). Current monetary reform approaches, after all, are about monetary sovereignty and about issuing additions to the money base debt-free through sovereign issuance.

There are, however, different systems of chartal or sovereign money – and in fact, as will briefly be discussed further below, the historical 100%-approaches, also known as full-reserve banking (Hart 1935, Fischer 1935, 1997), are different from plain money (*Vollgeld*) - not in spirit and purpose, but in the operational design applied. Plain money, i.e. fully valid legal tender, is operationally different from full reserve in that plain money doesn't involve reserves any more, since it *is* the reserve. Huber/Robertson avoided the term *100%-money*, because they want to replace the reserve system rather than retain it in the form of a full-reserve regime.

The meaning of *Monetative*, then, is 'the monetary state power', analogous to the legislative, executive and judicial powers, thus a monetary authority separate from and independent of other state powers, in charge of the official currency and with full control of the money supply.²³ The current monetary reform initiatives as quoted above all argue the case for a modernised *currency* approach to monetary policy, as opposed to *banking* practices, thereby referring *mutatis mutandis* to

21 The term *Vollgeld* was coined by myself in: Joseph Huber 1998: *Vollgeld*, Berlin, Duncker & Humblot. – 2011: *Monetäre Modernisierung. Zur Zukunft der Geldordnung*, Marburg: Metropolis, 2. Auflage.

22 *Presenting the American Monetary Act*. <http://www.monetary.org/wp-content/uploads/2010/11/amacolorpamphlet.pdf>.

23 The term *Monetative* was coined by Bernd Senf, *Der Tanz um den Gewinn*, Kiel: Verlag für Sozialökonomie 2004, 64.

the historical controversy between the Currency School and Banking School in the 19th century. Thus a clear distinction is drawn between money and credit. Money is a common means of payment, thus a common good which ought to be common property. Under modern conditions, where any amount of money can be created at discretion, the money needs to be legal tender; and the prerogative of issuing money should be exclusively in the hands of a public monetary authority. That authority is the trustee of a nation's currency, defending its exchange value and its domestic purchasing power, creating, if necessary, additional money in accordance with real economic potential, and ensuring full seigniorage from the creation of money. A sovereign state, or a community of states, in addition to its legislative, administrative and judicial sovereignty, should also have monetary sovereignty and not be at the mercy of banks.

The banks' business is *not money, but finance* - by carrying out payment services, granting loans, or by organising public offerings or arranging for private equity. Creating the money for those activities, however, should be none of a bank's business. The money system is part of the legal and institutional order, which lays down rules with regard to questions such as: Who has the right to create money? Who has control of the quantity of money in circulation? Who is entitled to benefit from the seigniorage which accrues from creating money? These are questions of constitutional importance.

The answers given to these questions by monetary reformers today from all parts of the world run along the same lines and include the same or quite similar policy designs. They share a critical analysis of the existing fractional reserve system, and thus also share certain key elements of their reform agenda, particularly

1. extending the state monopoly on banknotes to include digital money on account as well as mobile money, and conferring responsibility for the entire stock of money to an independent monetary authority, a monetary state power
2. putting an end to the creation of bank money (demand deposits) which is credited into the books on a fractional reserve basis, thus ending fractional reserve banking
3. spending new money into circulation through public expenditure, thereby ensuring full seigniorage to the benefit of the public purse.

As to the latter point one might raise the question why not continue the issuance of new money by central-bank credit to banks, given that the treasury will get the entire central-bank revenue anyway? The answer is that genuine seigniorage from creating *money* is a different concept to seigniorage from creating *credit*, or creating *debt* respectively. Seigniorage from credit is an extra margin profit from interest payments on a principal that has to be redeemed. By contrast, genuine seigniorage from creating money is an amount of money to be spent into circulation, free of interest-bearing debt. Should it be necessary, as an exception,

to reduce the money supply, this can be done through open market operations, or even by charging the government account with the central bank. Furthermore, genuine seigniorage from creating money is higher in times of growth (and then higher than interest payments on credit), and lower in the downturn of economic cycles. Seigniorage from credit is always high, thus in the downturn of a cycle much higher than desirable. Moreover, if the entire stock of money was issued as central-bank credit, interest payments on it, on top of interest on existing deposits, would drive up the general level of interest (a non-issue right now in a time of crisis, but clearly a problem in normal times).

The question of whether to issue new money as genuine seigniorage or as interest-bearing credit to banks, can be handled pragmatically. Long-term additions to the stock of money are the major component of increases in the money supply and should be spent into circulation by government expenditure. If need be, however, for whatever reason, the central bank could of course step in and provide money on a loan basis directly to the banks.

Some differences between current monetary reform approaches

Besides the basic key elements of monetary reform today there are some differences between the various monetary reform groups. They agree on wanting to introduce sovereign money, but some among them, as well as researchers and journalists writing on the subject, are not so clear about whether to bring it about in the form of a plain money system or a full-reserve system. Some, hence, are not so clear about technical details with regard to accounts and balance sheets. Then there are various preferences regarding the targets on which to spend new debt-free money. And there are divided views on the institutional status of the envisaged monetary authority, in particular whether it should be an independent central bank, or a currency board or monetary board under the roof of the treasury.

On what purposes should newly created money be spent?

A difference of minor importance is about the purposes on which newly created money should be spent – on a basic income, or on health programs, education, or infrastructure, or reducing public debt, or cutting taxes, or as an unspecified contribution to the budget. It is of course always stimulating to imagine what you would do with money if you had it. Huber/Robertson have concluded that this should be left open to the government of the day. As a matter of fact seigniorage can be used for any public purpose.

As an alternative to government expenditure, however, one can imagine paying newly created money out as a per-capita share, as a citizens' dividend. The American Monetary Act also foresees this in the form of a one-off measure in the beginning of the transition from banks' demand deposits to sovereign money. In

Europe that would amount to an annual payment on the order of 600 to a 1.000 euros to every citizen, and US-citizens would get about 900–1.400 dollars. This is not exactly a fortune, but no doubt it would be popular. Hixson writes about such a scheme in Maryland from 1733 on, until 1751 when parliament forbid colonial bills on the intervention of British bankers (Hixson 1993). As Zarlenga observed, grievances over the oppression of colonial bills in favour of motherland coin and banknotes might have been a much bigger reason for the War of Independence than was the import tax on tea (Zalenga 2002).

Who should be entitled to create sovereign money: Central bank, or treasury, or parliament?

A difference between the American Monetary Act and European reform programs relates to the institutional status of the money-creating body. In European countries, including Britain, the obvious institution to assume this function is the national central bank, or the European Central Bank respectively. Most European central banks are nationalised, or are state-owned by a majority, and are governed under public law.

The status of the banks-owned Federal Reserve (Fed) in the United states is different. The American Monetary Act proposes to nationalise the Fed and integrate it into the Treasury. The issuance of money would be conferred to a monetary board, also under the roof of the Treasury. Such an arrangement could possibly collide with the supposed independence of both the monetary board and the market policy of the central bank, and could be a bar to the proper execution of their decisions. In America, one doesn't seem to be bothered about money being printed by the parliament, or by the Treasury on behalf of the parliament. Article 1, section 8 of the US constitution assigns 'the power to ... coin money' to Congress. Americans had positive experiences with colonial bills before they were banned. Continental bills then helped to finance the War of Independence. (Over-issuance and thus ruin of that currency was attributed to English counterfeiting). During the Civil War the 'greenback' as well as Confederate demand notes did something similar (Zalenga 2002). To Americans, the necessity of a central bank is far from self-evident.

In Europe for the most part people did not have such patriotic experiences with governments who print money, and the idea of it is associated with rather negative connotations. This may explain why in Europe the concept of independence of monetary policy and central banks has gained somewhat more hold than elsewhere. European reform programs lay stress on *neither* government *nor* parliament having a say in a central bank's decisions on the level of money supply it deems necessary; much less banks and other financial institutions. Parliaments make laws, but do not administer justice. By analogy, parliament's task is to provide a legal framework for the monetary system, the banking sector and financial markets, but should not create money itself, or become engaged in

the banking business to any important degree. This is why most European authors prefer the concept of an independent central bank in terms of a constitutional division of powers. However, much as the institutional arrangement matters, one can certainly concede that different institutional arrangements can achieve the same purpose.

Plain money or full reserve?

Finally, current monetary reform approaches seem to differ somewhat regarding the notion and the operational status of money. In a plain money regime, putting an end to the creation of bank money (demand deposits) can be achieved in a simple and smooth way: Customers' current accounts would be taken off the banks' balance sheet and run separately in their own right as money accounts.²⁴ Banks can continue to manage customers' money accounts, as a service, just like a custody account of securities which is also managed off the bank's balance sheet. As a consequence, bank money on central-bank account and customer money on account would not be co-mingled any more, and banks would no longer be creators of 80–95 per cent of the money supply, simply custodians and brokers of money entirely created by the central bank.

Cashless transfers of plain money into a money account *are* a flow of central-bank money in public circulation. An inflow of plain money is not just a bookkeeping entry as a result of interbank clearings. Plain money is actual money in itself. It is central-bank money on any bank or customer account; it does not *re-present* money which is elsewhere, notably in a *bank* account with the central bank – which, however, is the case with any approach to full-reserve banking.

There is a certain unresolvedness among monetary reformers on whether the existing *fractional reserve* system should be developed into a *full-reserve* system or into a *plain money* system. Some clarification on this question might sooner or later be required. Monetary reform as conceived of by the American Monetary Institute, the *Monetative* approach as well as the Positive Money Campaign represent plain money approaches, even though the latter keeps the money on a bank's aggregate customer transaction account at the central bank. In an individual current bank account then there is still not money, but an entry documenting the amount of money a customer owns in the aggregate transaction account. This nevertheless represents a plain money regime since neither the aggregate customer transaction account at the central bank nor an individual customer account at a bank are part

24 The booking item 'overnight liabilities to customers' would be re-declared as a transitional post 'old-credit liabilities to the central bank'. As customers redeem outstanding credit, the banks would pass those payments on to the central bank – where they would be extinguished as an 'old-credit claim on bank-created demand deposits' and immediately re-issued as plain money, be it as a rule through genuine seigniorage by way of government expenditure or as an exception by way of central-bank credit to banks.

of a bank's balance sheet, but are run off-balance on behalf of the customers. The customers' money and the banks' own money are completely separate from each other. In a bank failure customers' money will not be held hostage.

Under full-reserve banking, entries into a customer account remain a demand deposit, just a credit, a claim on money, certainly covered 100% by central-bank money, nonetheless a money surrogate for non-cash public circulation, a technical substitute for central-bank reserves which continue to be confined to interbank circulation. In a 100% regime, demand deposits continue to be part of the banks' balance sheet, and customers' money remains co-mingled with the banks' assets and liabilities.

100% approaches have still to be resolved details of accounting and clearing. E.g. who should be responsible for ensuring 100% reserves: the banks that create a credit, or the banks that receive a cashless payment?, ex ante or ex post?, and when exactly, e.g. on an immediate individual (itemised) basis or an aggregate daily or monthly basis? How would that 100% reserve relate to a bank's operational balances (a bank's own means of payment)? And what about conventional minimum reserves?

Moreover, there are transition problems with the full-reserve approach, in particular: How to scale up today's 3–5% reserve to a 100% reserve by way of traditional refinancing against bills of exchange and other securities?, and how to do that without a significant increase in the general level of interest? And if the transition was achieved gradually, by spending new demand deposits into circulation in parallel with new reserves by way of government expenditure, before discontinuing banks' multiple credit creation, this would backfire and in effect greatly augment the banks' operational reserves and thus the money multiplier for credit creation.

Plain money by contrast, does away with split circulation and the different status of reserves, interbank demand deposits, and customer demand deposits. A plain money system doesn't need 'reserves' any longer since plain money is the reserve in and of itself. In fact, *all* of the existing money would be 'reserves' in the sense of being central-bank money, or treasury money respectively, including the money in your current account. The notion of 'reserve' itself would be obsolete. Monetary aggregates M0 and M1 (omitting, by the way, interbank demand deposits) would be rendered pointless. There would simply be one single quantity of money M, created and controlled by one single public institution, freely circulating in any bank and customer account – a system easy to implement and to run in comparison to a full-reserve system.

Immediate advantages of monetary reform

Notwithstanding certain institutional and technical differences between current monetary reform approaches, all of them would bring about the same important advantages:

First, money on account could no longer disappear and would thus be safe. Bank failures would not be disruptive to payment services. Governments could safely let banks go under and would not have to bail them out, the more so, if accompanied by obligatory insurance schemes on savings and time deposits.

Second, bounds would be set on the banks' procyclical over- and undershooting of the money supply. Before running into a stage of 'irrational exuberance' markets would run short of fuel in the form of all too cheaply and almost limitlessly available leverage. Business cycles and financial-market cycles would normally take a more moderate course.

Third, the monetary authority would have full control of the quantity of money and would thus be able to dampen consumer or asset price inflation by managing the money supply in accordance with the potential of real-economic growth.

Monetary reform will not undo the financial crisis and its negative results. But it would immediately help a lot to reduce government debt, namely, fourth, by debt-free seigniorage and, fifth, by a large amount of one-off transition seigniorage.

The day that monetary reform would come into effect, old bank credit would continually be phased out and be replaced with new digital central-bank money or government money. Most of the replacement would happen within a time span of about three to five years according to the range of maturities of outstanding debt. The new money that has to be phased in represents a large one-time transition seigniorage, and it can be used to redeem public debt to a considerable extent.

In most industrial countries, public debt could be cut by half or more. E.g. in 2010, demand deposits within the European Monetary Union amounted to 3.912 billion euros, in fact half of total public debt of about 7.850 billion euros.²⁵ In the United States in 2010 the figures were 1.829 billion dollars for M1, which is slightly more than a tenth of the total government debt at 17.500 billion dollars; but equal to Europe's proportion of half of public debt if broad money M2 (which is normally referred to in the US) at 8.814 billion dollars is taken as a basis.²⁶

Apart from the one-time transition seigniorage there is the annual seigniorage from newly created money corresponding to the growth potential of the economy. This provides the regular steady flow of seigniorage most of which is foregone today to the benefit of commercial banks. To get an idea of how much money the seigniorage forgone represents, one has to look at the annual addition to the stock of money.

In recent years the annual increase of the monetary aggregate M1 in the European Monetary Union amounted to 200–350 billion euros. In the United States the annual increase in M1 was of the order of 90–230 billion dollars, and the

25 ECB Monthly Bulletins, tables 2.3.1, 5.2.1, 6.2.1.

26 http://www.usgovernmentspending.com/national_debt. www.federalreserve.gov/releases/h6/hist/h6hist1.txt

annual increase in broad money M2 was of the order of 300–750 billion dollars. That was certainly too much money, representing an overshooting supply. An adequate money supply would in the long run roughly increase at the same rate as real GDP, or be somewhat higher. But even if the creation of new money kept within the bounds of grounded economic potential, and would thus be, say, just about half of recent increases, the annual addition to the stock of money would still be enough to contribute about 2–6 per cent to the overall public budget of each nation, depending on the volume of government expenditure and economic growth.

Kaoru Yamaguchi summarised the presentation of the National Emergency Employment Defense Act (NEED act, H.R. 2990), which adopts the reform program of the American Monetary Institute and was introduced by Dennis Kucinich, at a US congressional briefing in July 2011 by saying that monetary reform ‘can liquidate debt without triggering recession, unemployment and inflation.’²⁷ A significant reduction of sovereign debt through one-off transition seigniorage as well as the benefit of regular seigniorage on the order of 2–6 per cent of total government budgets, these are two promises to overcome the sovereign debt crisis on which monetary reform actually would deliver immediately.

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27 Kaoru Yamaguchi (Dishisha University, Kyoto, Japan), On Monetary and Financial Stability under a Public Money System. Modeling the American Monetary Act Simplified, Paper presented at the 30th International Conference of the System Dynamics Society, St. Gallen, Switzerland, July 22 - 26, 2012. Yamaguchi's results have now been confirmed by a study of IMF-researchers Jaromir Benes and Michael Kumhof, *The Chicago Plan Revisited*, IMF Working Paper, WP/12/202, 2012.

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