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Proposals for Monetary Reform and the Eurosystem

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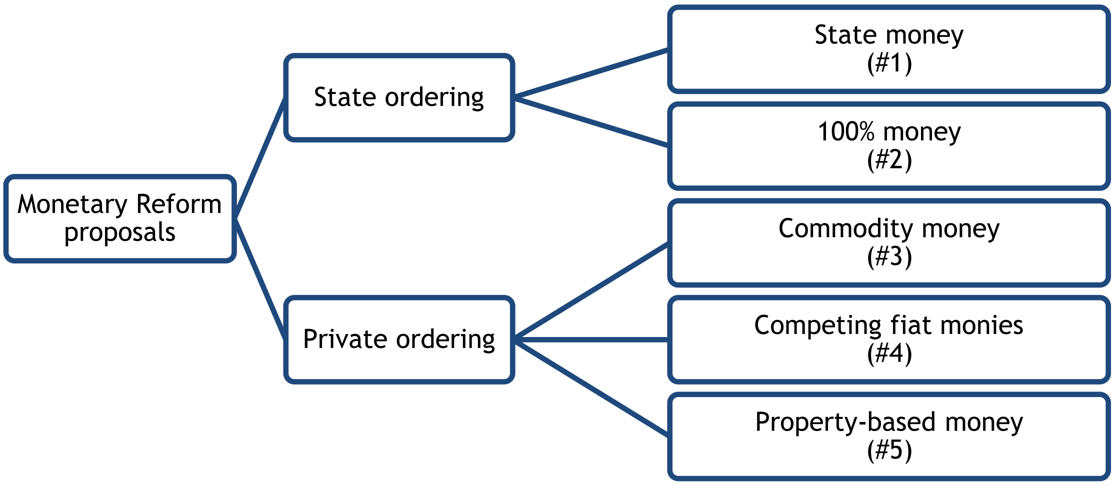
The global financial crisis (2007) and the European sovereign debt crisis (2012) triggered profound changes in the conduct of monetary policy by the leading central banks that have not been able to be reversed. Interest rates have remained at near-zero levels and outright asset purchases have become the main policy tool. The scale of interventions has been substantial and the central banks of the Eurosystem have become dominant purchasers and holders of government bonds. Policies that had begun as selective liquidity enhancing interventions developed into central-bank led economic management programs not seen since the 1970s, reversing the market-based consensus reached in the 1990s after a series of painful reforms. The 1990s consensus had emphasised central bank independence; market-based interest rates and prices for government debt; and the prohibition of central bank financing of government deficits.

The scale and nature of interventions has triggered renewed calls for the current system to be more fundamentally reformed. This view is supported by ongoing events that have put the long term sustainability of the Eurosystem into question and have shown that the issues inherent in the original design of the Eurosystem are yet to be resolved. The discussions around the repayment of Italian government debt held by the Eurosystem being the most recent example. In the following, this Bulletin article discusses the five most important monetary reform proposals within the context of the Eurosystem: (1) state money, (2) 100% money, (3) commodity money, (4) competing fiat monies, and (5) property-based money. While proposals (1) an (2) emphasise state interventions, proposals (3), (4) and (5)

[1] This Bulletin article builds on Decker (2017).

seek to achieve a market-based, private ordering of monetary arrangements (see Figure 1).

Figure 1. Overview of monetary reform proposals.



In the state money view (proposal #1), money is created as a result of expenditure decisions by the state. Central bank money is to all intents and purposes interchangeable with government debt. From this derives the concept of fiat money as 'pieces of paper issued by the government' with legal tender status (Friedman 1987, p. 7). The central bank must act as a monetary authority and is guided by general social and economic considerations. Hence, in the state money view, the ongoing outright purchases of Euro member government debt conducted over the past years by the Eurosystem appear appropriate. These purchases have contained sovereign bond spreads between German government bonds and securities of peripheral Euro area member countries and have protected private institutions, in particular banks that have held high levels of potentially unserviceable government debt. The state money view argues that if central bank money and government debt are interchangeable, then government debt should not be subject to liquidity and default risks. Bond holders should be protected by the state's unlimited capacity to monetise its debt and its ability to socialise losses by inflation. In this view, a sustainable reform of the Eurosystem therefore requires the creation of European state money. This would be implemented via a European Treasury, the issue of Euro bonds and a European monetary authority that monetises and stabilises the price of government debt.

A step even further towards the state domination of monetary affairs is proposed by the "100% money" movement (proposal #2). Originally formulated in the aftermath of the 1930s Great Depression, the scheme has gained the support of a number of prominent academic economists and is the basis of a Swiss reform initiative, with an unsuccessful referendum held on this issue in June 2018. The 100% money scheme extends the state authority over the creation of all important means of payment including bank deposits. In this scheme, banks can no longer create sight deposits in credit contracts but are reduced to intermediaries of pre-existing state money.

State money is created by the issue department of the state-owned central bank (acting as a monetary authority) and brought into circulation by government expenditure, thereby ending the chronic budget problems of public agencies. The supporters of the 100% money scheme also argue that the monetary authority could counteract boom and bust cycles by its command over the money supply, which would no longer be determined by private banks, but would be fully controlled by the state (Huber 2004).

By contrast to the 'state money' and '100% money' proposals, the reform proposals in the commodity money tradition (proposal #3) pursue a vision of 'money without the state' and emphasise the private ordering of monetary affairs. The supporters of commodity money seek to abolish the privileged status of central banks, remove government intervention from monetary affairs and abolish the system of banking based on fractional reserves. A well-known proposal is the 100% gold dollar supported by the leading proponents of the Austrian school of economics. The scheme includes the liquidation of the Federal Reserve System and a legal requirement for a 100 percent backing for all bank demand claims (Rothbard 1962, pp. 61, 69-70). The emergence of 'crypto currencies' has given renewed support to this movement as these commodities are seen by some as modern alternatives to gold.

Another proposal produced by the Austrian school is free and denationalised banking. The scheme seeks to implement competing fiat monies by abolishing central banks as monopoly providers of irredeemable money and transferring this privilege to a number of competing banks (proposal #4). In this scheme, it is assumed that market forces will favour those banks that best secure the value of their currency with reference to a basket of commodities. Private banks are expected to outperform state-owned central banks, making the latter obsolete (Hayek 1976).

An important but lesser known reform proposal (#5), with an emphasis on private ordering, is implied in the concept of 'property-based money', which was developed by a team of German economists in the 1990s (Heinsohn and Steiger 2013). In this view, money is created when a creditor, such a bank (private or central), issues promissory notes (money) to a debtor as part of granting a secured loan. Money is a derivative or monetisation of property because it is backed by the capital of the creditor and the collateral posted by the debtor. Historically, periods with sound money coincided with monetary systems that created money on this basis. Heinsohn and Steiger argue that the concept of fiat or state money fails to recognise the principles of sound money creation and that state money is a characteristic of command economies and regimes with monetary mismanagement and high inflation.

The implied reform proposal works within the existing central banking framework and formulates a number of principles for the creation of sound central bank money (Heinsohn and Steiger 1996, 2013; Stadermann 2010), which can be summarised into five rules:

- *Rule 1: No government financing* – a central note-issuing bank must not monetise state debt or provide direct loans to governments;
- *Rule 2: Sufficient capital* – a central note-issuing bank requires capital and should not take risks out of proportion with its capital;

- *Rule 3: Sound collateral* – money should be created against sound, marketable collateral in transactions between unrelated third parties;
- *Rule 4: Low-risk refinancing operations* – refinancing operations should be conducted through short term secured credit or repurchase operations. Outright asset purchases should be limited to foreign exchange operations backed by designated capital; and
- *Rule 5: Market interest rates* – central banks should follow rather than lead the market on interest rates.

Consequently, the central bank in this view does not act as a monetary authority. It is foremost as banker's bank, run like a privately-held concern and implementing its mandate with a narrow focus on refinancing property at market interest rates. This precludes the central bank from holding large positions of government debt or monetising government debt. The German Bundesbank and Swiss National Bank provided the template for this type of central banking.

This narrow model of central banking as a refinancer of property includes the central bank's responsibility as a lender of last resort (LOLR), i.e. to advance money against sound collateral in a crisis. However, a central bank cannot directly recapitalise banks nor provide non-banks with the missing loan security required for fresh loans. Only the state can assist or restructure failed institutions and establish lawful ways to restore the citizen's capacity to enter into debt. The model therefore assumes that the state is ready to act as 'proprietor of last resort' (Heinsohn and Decker 2010). This reflects a view where direct transfer payments, temporary state ownership or even a redistribution of property are preferred over indirect central bank assisted bail-outs. Ultimately, the state's financial capacity is underpinned by its power to raise taxes rather than the presumed access to the printing press.

There are different configurations of how a common currency could be implemented on this basis. For instance, a scheme with a single European central bank (as the monopoly issuer of Euro notes) and the demotion of the current national central banks to mere branch offices could be devised. An alternative is a federation of independent national central banks that issue Euro-denominated notes. Notes would identify their issuer and banks would mutually accept each others notes at par. However, in order to safeguard sound money principles (rules 1-5) wide ranging powers would need to be exercised over the individual national central banks. Moreover, as was pointed out many years ago, a successful system would also require a lead central bank that discharges LOLR responsibilities and acts as the central monetary institution on behalf of the system (Heinsohn and Steiger 2002, 14-15). This institution must be backed by a strong European treasury 'implying some form of strong European tax' (Spethmann and Steiger 2005, 63). Both, the required LOLR function on behalf of the system and the central fiscal authority were critical elements missing in the original design of the Eurosystem.

The assessment of the different monetary reform proposals suggests the following consideration:

1. State money approaches are a characteristic of command systems to organise war efforts or totalitarian regimes. Keynesian methods of economic management

that combined monetary and fiscal policy emerging from Word War II and its aftermath resulted in the misallocation of resources and became discredited in the 1970s Great Inflation;

2. 100% money is likely to constrain the elasticity of credit as payment instruments would be allocated by a central authority. This would be expected to constrain economic development, reduce competitiveness, lead to the emergence of money substitutes and would drive the creation of funds into the unregulated sector. Lower fiscal discipline would be imposed on the government sector;
3. Commodity money combined with a prohibition of fractional reserve banking and a 100% backing of bank deposits is at odds with the principles of a property-based economy, which seeks to monetise its assets and tries to avoid the physical transfer of possession. Mandating commodity money would impose limitations on civil liberties and property rights, retard economic development, lead to the emergence of money substitutes and would drive the creation of funds into the unregulated sector;
4. Competing fiat monies would require private entities to be granted the privilege of issuing irredeemable money. This could only occur with significant regulatory oversight and negates the advantage over the current central bank model; and
5. Property-based money where central banks act within a narrow mandate as a refinancer of property remains an attractive alternative. However, this model requires backing from a central government treasury ready to act as the proprietor of last resort.

Neither commodity money, 100% money nor competing fiat monies are feasible reforms for the Eurosystem. The recent development path has been towards a state money system. This is reflected by the large Eurosystem government security holdings and the emergence of the Eurosystem as the *de facto* LOLR to Euro area governments. As argued above, state-money systems are neither desirable nor sustainable in the long term. The successful implementation of a European common currency with property-based money would require a lead central bank and a strong European treasury, both facing well known political and constitutional complexities even for a sub-set of member countries. An alternative path is the re-establishment of national currencies. The analysis of available monetary reform options for the Eurosystem therefore supports Poland's decision to retain a national currency.

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The statements expressed herein reflect solely the opinions of its author.

This article is part of Special Bulletin Series of the Institute for Western Affairs titled "The euro - opportunities and threats". The analyses and opinions featured therein concern the functioning of the Economic and Monetary Union, its possible transformations and the consequences of Poland's possible adoption of the single currency and of remaining outside of the eurozone. In its subsequent issues, the Bulletin will shed light on the above issues from a variety of perspectives.

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