April 2018

s:fi KNOWLEDGE

Swiss Finance Institute Public Discussion Note

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Swiss citizens will vote in June 2018 on a popular initiative called, in German, the “Vollgeld-Initiative” (VGI). This initiative aims at a fundamental reform of the Swiss monetary system and is very technical.

The VGI has already been widely debated, but in a very polarized way. Experts from industry, government, and academia are almost unanimously against it. They have explained their views in reports, blogs, or press articles that are difficult for the public to understand. The promoters of the VGI criticize these experts and refer to economic theories that are not widely accepted in the academic community.

The aim of this brochure is to enable Swiss citizens to form their own opinions on this highly technical topic. Instead of producing another technical report, we describe the initiative in simple terms, and explain the competing views expressed by the different protagonists in a non-partisan way.

The VGI in a nutshell

The VGI has two main components: a 100% reserves requirement for banks and a reform of monetary policy, the latter based on the concept of “debt-free money”.

The 100% reserves requirement means that all sight deposits in Swiss francs (CHF) in Switzerland would have to be entirely kept as reserves at the Swiss National Bank (SNB). This implies that commercial banks would no longer be able to use a fraction of these deposits to finance their lending activities, as they currently do. Swiss money would then be entirely issued by the SNB.

The concept of debt-free money is a consequence of the observation that, contrarily to a bank deposit, which is a debt of the bank to the depositor, the money issued by the SNB will never have to be repaid. Therefore, the promoters of the VGI consider that this money should not be viewed as a debt of the SNB and could be issued directly, without having to buy gold or securities to guarantee its value as the SNB currently does. New money would simply be distributed directly to the Confederation, the cantons, and maybe even to Swiss residents themselves. This would imply a radical change in the way the SNB conducts monetary policy.

This document explains in simple terms the arguments put forward by the promoters of the VGI and confronts them with the views of its opponents, so that Swiss citizens can form truly informed opinions. We examine the likely consequences the VGI would have on financial stability, money creation, credit provision, and public finances.

The main components of

100% reserves requirement

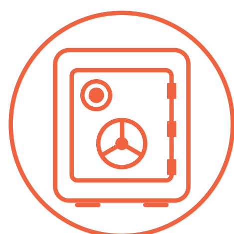
The first argument in favor of a 100% reserves requirement is that it would eliminate bank runs. A bank run is a situation in which a large proportion of the customers of a bank want to withdraw their sight deposits at the same moment. A famous example is the run on the British bank Northern Rock, which happened in 2007. If a run occurs in the current system, the bank does not have enough reserves to repay all of these depositors. It would have to sell assets quickly and may be forced into bankruptcy. With a 100% reserves requirement, this could not happen anymore: even if all the depositors wanted their money immediately, the bank would have enough reserves to cover these withdrawals.

The current system, where banks keep in reserves only a fraction of sight deposits, may also exacerbate the tendency of banks to lend too much during booms and too little during busts, creating credit cycles. Some economists argue that these credit cycles would disappear if the 100% reserves requirement was imposed, but this point is highly controversial, given that recent empirical data show a very weak correlation between money and credit.

The arguments in favor of a 100% reserves requirement are not new. They were put forward in 1933 by a group of Chicago economists as a solution to the most severe banking crisis in US history. Their proposal was called the Chicago Plan and it was meant to restore confidence in the US banking system. However, it was not adopted. US bankers convinced President Roosevelt to follow a different route to restoring financial stability. The Federal Deposit Insurance Corporation was created to insure small depositors against the failure of their bank. Strict regulatory rules were also imposed on US banks to prevent excessive risk taking.

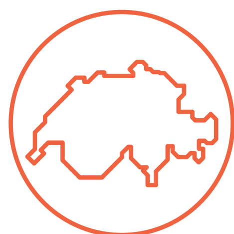
After the financial crisis of 2007–08, the idea of a 100% reserves requirement resurfaced and was advocated by influential people such as Mervyn King (then Governor of the Bank of England), Adair Turner (then the Head of the UK Financial Services Authority), Wilhelm Buiter (the Chief Economist at Citigroup), and Martin Wolf (the Chief Economics Commentator at the Financial Times). The 100% reserves requirement has recently been examined by the parliaments of several countries, in particular in the US, the UK, Iceland, the Netherlands, and Switzerland. No country has adopted it though. The Swiss VGI therefore is a first test at the ballot box.

the "Vollgeld-Initiative"



Debt free money

Since 2000, the SNB has abandoned the convertibility of Swiss francs into gold. Before this date, the holders of Swiss francs could ask the SNB to be "repaid" in gold. This is no longer the case.
According to the promoters of the VGI, this implies that the SNB does not need to maintain the large reserves in gold and foreign currency that it uses to back the money it has issued. Indeed, according to current accounting rules, the money issued by central banks appears as a liability and is backed by gold and foreign currency. The promoters of the VGI argue that the accounting rules that count government-issued money as debt are obsolete, because this money will actually never be repaid to the bearer. They consider that the SNB could issue money without counterparty, and just distribute it to the Confederation, the cantons, or even directly to the Swiss people. This idea is quite revolutionary and would imply a fundamental change in the conduct of monetary policy, as we explain below.

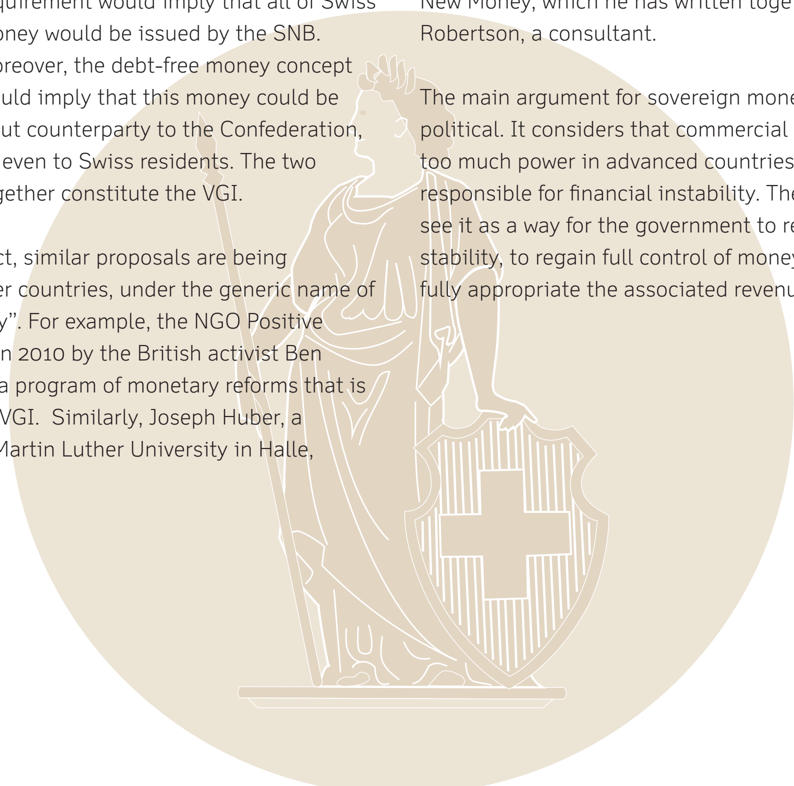


The notion of Sovereign Money

So, to wrap up, the 100% reserves requirement would imply that all of Swiss money would be issued by the SNB. Moreover, the debt-free money concept would imply that this money could be distributed without counterparty to the Confederation, the cantons, and even to Swiss residents. The two reforms taken together constitute the VGI.

As a matter of fact, similar proposals are being discussed in other countries, under the generic name of "sovereign money". For example, the NGO Positive Money, founded in 2010 by the British activist Ben Dyson, supports a program of monetary reforms that is very close to the VGI. Similarly, Joseph Huber, a professor at the Martin Luther University in Halle, Germany, defends related views in the book Creating New Money, which he has written together with James Robertson, a consultant.

The main argument for sovereign money is in fact political. It considers that commercial banks have taken too much power in advanced countries and are responsible for financial instability. The VGI's promoters see it as a way for the government to restore financial stability, to regain full control of money creation, and to fully appropriate the associated revenue.



An analysis of likely consequences t would have on...

Financial Stability

As we already mentioned, a 100% reserves requirement would solve the problem of runs on sight deposits. In the current system, this problem is tackled by another tool—namely, deposit insurance. Indeed, sight deposits up to CHF 100,000 are insured against the default of the bank that has issued them. Thus, even if a bank does not have enough reserves to repay its small depositors, these depositors have no reason to worry.

However, the main source of fragility of modern banks is not their sight deposits (as it was in the previous century), precisely because of deposit insurance. It is, rather, the wholesale short-term debt issued by banks and held by professional investors, including other banks. These investors, who are not insured, may suddenly stop lending to a bank if they suspect it may have solvency problems. Such a "wholesale run" is what happened in 2007 to the British bank Northern Rock. The run on retail deposits, which was heavily publicized, came after the run on short-term debt. Wholesale short-term debt is an important source of funding for the banks in the current system, but it is also a source of fragility, as the Global Financial Crisis of 2007–09 has shown.

The 100% reserves requirement would not apply to short-term debt. The promoters of the VGI are aware of this problem. To tackle it, paragraph 2 of article 99a of the VGI mentions that the SNB would have the power to set a minimum duration for the debt issued by commercial banks. This would have a strong impact on the functioning of the Swiss interbank market and may ultimately create refinancing problems for the banks that need liquidity.

Following the Global Financial Crisis, the Basel Committee on Banking Supervision introduced new regulations (in the context of the Basel III accords): liquidity requirements, for limiting the fragility generated by wholesale short-term financing by banks, as well as countercyclical capital requirements aimed at stabilizing credit cycles and avoiding real estate bubbles. These regulations have been reinforced by the Swiss authorities and transposed into Swiss legislation.

It does not seem that the 100% reserves requirement would do a better job at promoting financial stability than the regulatory system currently in place in Switzerland. Moreover, the VGI would have to be accompanied by restrictions on short-term debt issuance by banks. This would put Switzerland in a singular position vis-à-vis other advanced countries.

Facts & Figures

The figure on the right shows the evolution of base money, the money issued by the SNB (M0, in red) and total money (M1, in blue) in Switzerland over the period 1984–2017, in millions of CHF. It is remarkable that base money, after remaining stable for the whole period 1984–2007, has increased dramatically since 2008. By contrast, the money issued by commercial banks (essentially the difference between the two curves—i.e., M1-M0) has decreased steadily: over time Swiss banks create less and less money, while the SNB creates more and more.

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Money creation

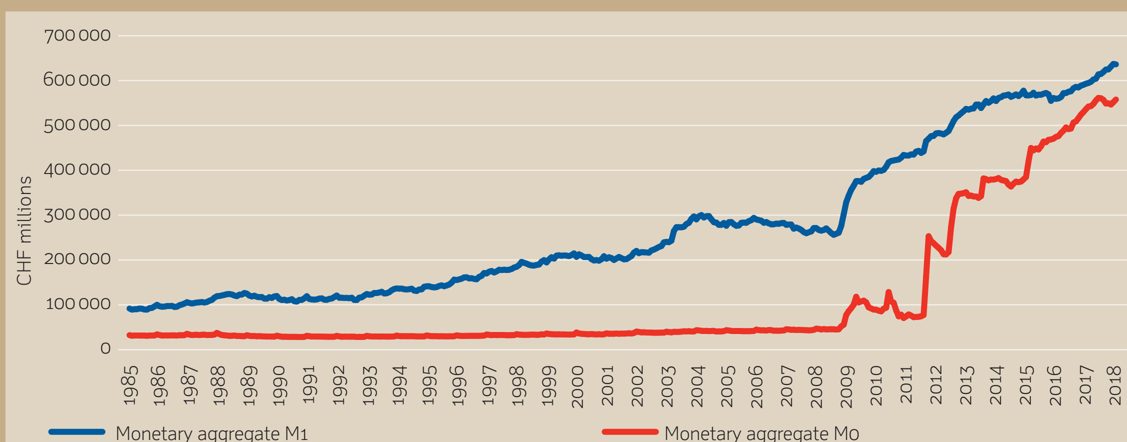
In the current system, money is created by the SNB (when it prints new bank notes) and by the banks (when they grant credit to their customers). Since bank notes only represent around 10% of total money, we will focus on the more significant part—namely, the money created by commercial banks.

To be concrete consider the following situation. Mr. B (for buyer) wants to purchase a flat and borrows CHF 100,000 CHF from his bank (which we call Bank B). Initially, this only affects book entries of Bank B and its customer and does not necessitate external funds.

However, when Mr. B actually buys the flat, he asks his bank to transfer CHF 100,000 to the account of Mr. S, the seller, at Bank S. This transfer must be funded. If Bank B does not have excess reserves, it will borrow this amount from another bank. The banking system (but not Bank B alone) will have created CHF 100,000 in new money. But this is only temporary, because Mr. S will only keep, say, CHF 10,000 in his sight deposit account and will invest the rest in a more lucrative savings account. In this operation CHF 90,000 of newly created money will be destroyed.

Bank B will only grant the loan to Mr. B if this is profitable. This depends on the refinancing cost of the bank, which is influenced by the SNB through its monetary policy interventions. The SNB sets the interest rate at which it lends to banks and injects or absorbs liquidity in the banking system to match money supply and money demand. By controlling the short-term interest rate, the SNB influences the profitability of credit provision by banks, and thus the total volume of credit to the Swiss economy. Since credit influences money (as we saw above) the SNB also indirectly impacts money creation.

The promoters of the VGI argue that the control of total money would be more direct if their initiative was adopted. Money creation would be entirely determined by the demand for sight deposits by households and businesses. However, the promoters of the VGI want the interest on sovereign money to be kept at zero. This might create some difficulties because interest rates are the main instrument of monetary policy. The VGI’s promoters may have in mind a targeting of the quantity of money, as was done by the SNB before 2000. Nowadays, most central banks in the world have abandoned this quantitative targeting: they directly control interest rates and not the quantity of money.



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Credit provision

If the VGI was adopted, the banks would no longer be able to use the sight deposits of their customers to finance their credit activities. All of these sight deposits would have to be kept as reserves at the SNB. The banks would have to entirely fund their loans to the public using other resources, such as by issuing debt or equity. The VGI contains transitory dispositions (article 197, ch.12) aimed at avoiding a disruption of the credit market at the time the 100% reserves requirement would be adopted. The SNB could simply recycle the new funds it has received from depositors and provide the banks with the loans they need to finance their credit activities. If the interest rate charged by the SNB on these loans corresponds to the rate previously paid by banks on the interbank market, the profitability of banks would not be altered and credit provision would not be impaired. This would guarantee a smooth transition.

If the SNB would continue providing risky loans to the banks after the end of the transition period, this would allow the SNB to directly control the total volume of credit to the Swiss economy by setting the interest rate on its loans to commercial banks. In principle, the SNB could thus control separately the quantity of money in circulation and the total amount of credit to the Swiss economy. This would obviously give a lot of power to the SNB. It would also expose it to the risk of default of private banks.

Moreover, the draft constitutional provision implies that such a situation cannot become permanent. This means that the banks would have to find other sources, such as long term debt and equity, for financing their credit activities. This would increase the cost of credit to the private sector.

The consequence of this evolution is that we are currently very close to 100% reserves. The figure on the right shows the evolution of the ratio of sight deposits to bank reserves during the same period. The 100% reserves requirement means that the blue curve would have to coincide with the red line, which is indeed currently the case.

After growing steadily during the period 1984–2004 (reaching values in excess of 7) the ratio M1/M0 has plummeted and is now close to one. Hence, the money created by banks is almost fully covered by central bank money today, which is economically equivalent to the VGI. Of course this situation might change in the future. However, even if one is convinced by the arguments in favor of the 100% reserves requirement, it does not seem to be an urgent preoccupation, since the banks have spontaneously chosen to keep almost all of their customers' sight deposits in reserves at the SNB.

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Public finances

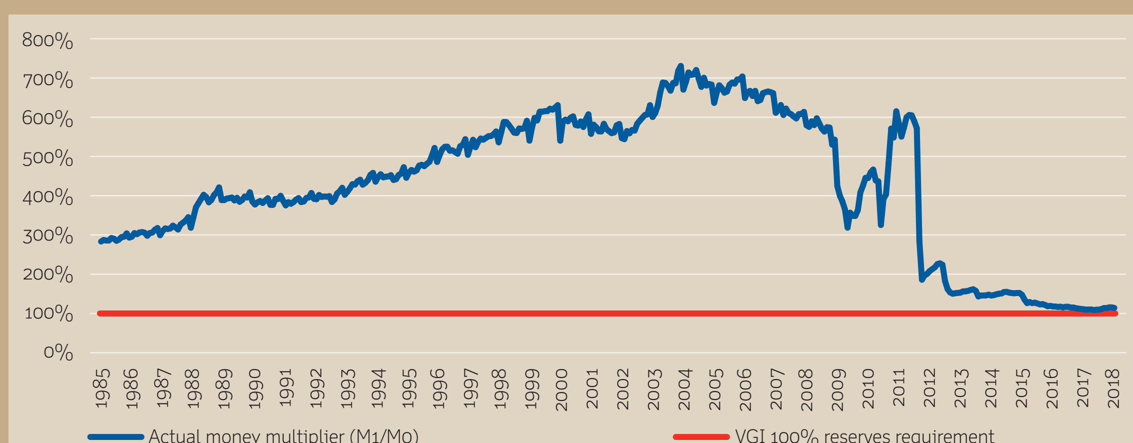
In the current system, the money created by the SNB is essentially invested in foreign securities. This allows the SNB to manage the exchange rate between the Swiss franc and major currencies. The revenues generated by these investments, net of the operating costs of the SNB, are distributed in the form of dividends to the Confederation and the cantons, who are shareholders of the SNB.

With the VGI, the money created by the SNB would not be used to buy securities but would be directly distributed to the Confederation and the cantons. What would happen to the existing reserves of the SNB is not specified by the VGI, but some commentators have evoked the possibility of investing them in a sovereign fund.

Ultimately, this discussion boils down to two questions:

1. Should the money created by the SNB be spent immediately by the government or be put in reserves?
2. Should these reserves be controlled by the SNB or by a sovereign fund?

These questions are obviously more of a political than of an economic nature. However, two economic considerations should be kept in mind. First, foreign reserves give flexibility for the conduct of monetary policy, especially since the management of the exchange rate is a major preoccupation of the SNB. Without reserves, which could no longer be built up under the debt-free money approach, the SNB would not be able to implement a restrictive monetary policy if it was needed in the future, for example for fighting inflation. Second, rating agencies and financial analysts often use the volume of foreign reserves as an indicator of the capacity of a central bank to resist speculative attacks. An insufficient volume of foreign reserves is considered a sign of fragility. It is true that the Swiss franc currently benefits from investor confidence in the Swiss financial system and from the good prospects of the Swiss economy. However, this might change in the case where the reserves of the SNB would be sold to finance government expenditures.



Conclusion

The Vollgeld-Initiative will soon be at Swiss ballot boxes. While similar ideas have been discussed in several countries, they have never come so close to a political decision that would lead to implementation. Acceptance of the VGI, advocates and opponents agree, would fundamentally reform the Swiss monetary system.

The VGI opens a number of important and very technical issues. We have endeavored to shed light on these issues, hoping to help readers build an informed opinion. We stayed clear of the sometimes ideologically tainted arguments of advocates and opponents of the VGI.

In a nutshell, the VGI's advocates promise greater stability of the banking system and a "fair" distribution of the revenues from money creation. Opponents challenge these promises and criticize the implied shift of power toward the state and, within the state sector, the shift of funds from the SNB to government. In any case, technological innovations such as the blockchain and crypto-currencies are currently revolutionizing the organization of monetary systems. It is hard to predict how money creation will be conducted in a near future.

Swiss citizens should have a say on the repartition of monetary powers between the government, the SNB, and the private sector, especially in this fast-changing world. However, it would be dangerous for Switzerland to embark alone on a reform whose consequences are largely unknown, while our neighbors and competitors stick to the system of fractional reserve banking that has been in place for several centuries.

Information Event

"Vollgeld-Initiative – Consequences for the Economy and Monetary Policy"

Date: 16 May 2018
Time: 17.45 h door opening, starts at 18.00 h (until 19.00 h)
Location: Landesmuseum Zürich, Museumstrasse 2, 8021 Zürich
Language: German
Registration: www.sfi.ch/vgi

Speakers:

Prof. Dr. Thomas J. Jordan
Chairman of the Governing Board, Swiss National Bank

Prof. Dr. Jean-Charles Rochet
Swiss Finance Institute Professor at the University of Geneva

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