Vollgeld: Our response to Martin Wolf

This week, Financial Times commentator Martin Wolf argued that the Swiss should vote in favour of Vollgeld- a plan to fundamentally change the way money is created. We believe this is a risky experiment

Open to ideas

We have discussed some pros and cons of Vollgeld elsewhere and Wolf raises some very valid questions. In discussing some of them, we should first emphasise that we are not against alternative setups of the monetary system per se. There are many developments, tech-related and otherwise, which prompt financials and banks, in particular, to fundamentally rethink their business models and balance sheets. Why not add monetary reform to the mix? In fact, when designing the system from scratch with today's technology and knowledge, one would probably exclude physical cash (way too easy to counterfeit and abuse) and include a form of central bank digital cash. After all, the idea that the public should have access to money at its source, and not only via an intermediary like a bank, is fundamentally appealing.

But money creation is not the source of the problem

Yet Vollgeld goes a few steps beyond introducing central bank digital cash. It strips banks of their money creation ability. This is often justified by pointing to repeated banking crises. Yet most, if not all of those crises, started with *credit*. That means they affected the *asset* side of banks' balance sheets. Crises tend to be called 'credit crises' and not 'money (creation) crises' for a reason. Money, on the other hand, is a bank *liability* and is at best a by-product, not the source, of the problem. It should also be noted that credit necessarily involves two parties: a lender and a borrower. Credit cycles are not only supply-driven but also reflect mood swings among borrowers.

Shadow banking would get a boost under Vollgeld

Wolf is well aware of all of this, of course, but notes that in a crisis (whatever its source), a bank will be rescued to protect its liabilities, in particular, deposit holders. By disconnecting deposits from bank assets, banks no longer need to be rescued. This sounds like a logical solution. However, depositor protection is just one reason for the elaborate system of bank oversight that has been erected. Credit crises show that a sudden stop in credit supply is detrimental to an economy. As depositors, we may be glad our money is safe, but if we then lose our jobs because of a deep recession, we are hardly better off.

Moreover, the most recent and severe crisis began with lending by *non-bank* entities in the US. 'Parallel banking' or 'shadow banking' is a channel starting with originate-to-distribute lenders and ending with money market funds. This channel performs functions that are normally done by banks: transforming non-liquid, long-duration and risky assets into highly liquid, short-term and (perceived) low-risk liabilities. We all know where US shadow banking ended in 2008. The point here is, Vollgeld, or any other monetary reform aimed at money and money creation, does not address the issue of the parallel banking channel mimicking banks. In fact, this parallel banking channel receives a boost under Vollgeld as traditional bank lending is curtailed and made less competitive by the inability to create money.

Strict regulation still needed

Wolf rightly states that investors will bear the risk. But is that sustainable? In a Vollgeld system, lenders will compete for funds by offering attractive terms. Yield swings may contribute to booms and busts, just as they do in bank-based lending. In addition, parallel banks will try to shape their liabilities into something that resembles money and traditional deposits as closely as possible, in terms of liquidity and perceived risk – as US money market funds started to do back in the 1970s. Investors will be lulled into believing these “near monies” are like money, also in terms of safety. A belief that will hold until the next crisis – when investors will call for bailouts (which were duly established e.g. in 2008).

So in order to avoid the proliferation of such 'near monies' and the inflation of the next credit bubble outside the regulated banking system, lenders, both bank and non-bank, will need to be tightly regulated from the start, which annuls one of the touted advantages of Vollgeld-like systems, namely less regulation.

But if we need to maintain strict regulation anyway, regardless of where money is held, why make the switch to an untested alternative setup with uncertain benefits? A system too, where the central bank has the difficult task to make crucial judgements about the pace of growth in both money and credit?

Lack of detail

As Wolf acknowledges, regulation and supervision have changed a lot over the past ten years, giving supervisors a host of new tools to prevent crises and if needed, wind down banks while imposing losses on holders of equity and debt. At the same time, Vollgeld and sister proposals at this time are lacking in detail. Do the Swiss really want to subject their large financial sector to such an unprecedented experiment? Better to first work it out in more detail, and start experiments on a more limited scale.

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