Seigniorage Reform and Plain Money

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Seigniorage means the income a government has from creating new money and spending it into circulation. The proposal of seigniorage reform is focussed on how to create and issue new official currency. It is based on an advanced understanding of the nature and functions of money in modern information society.

Problem background

Let me begin with giving a brief account of the problems that represent the background of the proposal of seigniorage reform:
1. Chronic finance problems of public agencies
2. Commercial creation of money out of control
3. Monetary and financial instabilities of various kinds.

1. The *chronic finance problems of public agencies* are well known:
a) unbalanced budgets at high level of government expenditure difficult to cut back
b) growing unwillingness among the electorate to pay high taxes, and as a result
c) governmental debt at very high levels, difficult to stop and to reduce, and impairing government's ability to act. (Even in the U.S. that ran a budget surplus for two years, the situation is by and large still the same, and may even proof to be worse, because in addition to the high governmental debt there is now also an unheard extent of private indebtedness).

2. Less known are the problems of *out-of-control commercial creation of money* by the banking sector. The large banks have usurped, as a matter of fact, the prerogative of creating money, i.e. the right of creating and issuing the stock of currency necessitated by the economy.

In today's terms, the stock of money corresponds to the monetary aggregate called M1. M1 consists of all of the coin, banknotes and sight deposits in circulation. Coin and banknotes are the cash, whereas the sight deposits in current accounts are the non-cash. Banks don‘t produce coin (which is the traditional right of government) nor do they print banknotes any more (which has been made the exclusive right of central banks). However, banks create the sight deposits – also called checking deposits or demand deposits or overnight deposits. They do it by granting loans and printing the amount of money involved into their own credit account as a claim on the customer, and into the current account of the customer as a cash liability to them. That‘s the amazingly „weightless“ way how central banks and banks alike create modern information-unit currency ex nihilo, i.e. out of thin air.

With the development of cashless payment practices during recent decades and the speeding-up of the velocity of cashless circulation by IT technology, cash now represents the minor part of M1, whereas the share of sight deposits is growing ever faster.

In the UK 93% of the existing stock of money are now sight deposits. In the Euro area they account for 82%, in Japan for 75% and in the the US for 60%. If one considers the annual increase in M1, than the share of sight deposits is even higher – at 95-99% of the increase in M1 in the UK, 90% in the Euro area, etc.

Printing sight deposits is the cheapest and most profitable way of making money. They cause no procurement cost at all, and rather low transaction costs. Most importantly, sight deposits come with a supernormal special extra profit, because the money is lent to the customer at the normal lending interest rate, whereas the bank itself doesn't have to pay any deposit interest at all. So, instead of a normal margin profit of, say, 9% lending interest minus 5% deposit interest resulting in 4% normal margin profit, the banks realize an additional special extra profit of the 5% they are able to avoid on borrowing because they print that money themselves and don't have to take it up before they lend it.

If one wants to know how much money we are talking about, just take the existing amount of sight deposits and multiply it by the national base rate (in the UK at about 5.5% for the time being) or even by the national money market rate (in the UK the LIBOR[1] at about 6–6.5%). Some combination of base rate and money market rate, as well as different deposit rates somewhat below those, represent the interest rates banks would have to pay if they were to take up that money before lending it.

Doing, for simplicity's sake, an estimate on the basis of the national base rate, the annual special banking profits in the UK can be valued at about £ 22 billions p.a., in the Euro zone at about € 74 billions p.a.

The special banking profits from creating sight deposits are tantamount to a hidden subsidy. The hidden subsidy of £ 22 billions a year is a „free lunch" for the large banks, not however for the public agencies, the taxpayer, businesses, and private households, to whom it is the tributive burden of having to pay the interest for it.

And yet this is only a third of the picture. The missing two thirds consist of seigniorage foregone to the treasury. If one wants to get an idea of how much money the seigniorage foregone is, consider the annual increase in sight deposits, because this is roughly the income a government would have if the issue department of the central bank were to create the non-cash money and leave it to the government for spending it into circulation – free of interest and redemption by the way.

In the UK the annual amount of seigniorage foregone is at about £ 42 billions, in the Euro area at about € 160 billions. Any treasurer would certainly be happy to be confronted with the choice of opportunities these figures represent. Why then is this benign source of public income not being tapped?, particularly in view of the fact that in this case it is a real free lunch, burdening nobody, simply being the necessary annual addition to the

[1] LIBOR = London interbank offered rate

stock of currency, newly created „ex nihilo“ in the sense of monetary and financial materialism, in reality „ex conscientia“ according to professional standards.

Throughout civilized history the creation of official currency has been the exclusive right of public bodies such as the treasury, or the parliament, or the central banks since they have become the national monetary authorities. Leaving that prerogative to the large commercial banks at the expense of the taxpayer and the customer is illegitimate. Official currency – circulating from hand to hand, from account to account respectively, being anonymous as a means of payment, not particularly belonging to somebody – is a public good the value of which should add to the common good, and should itself not be subject to money-making. The practice is unjust and disfunctional also because of the large volumes involved. The real-economic disadvantage of the special banking profits *and* seigniorage foregone is the total of both: at present an annual disadvantage of about £ 60–70 billions in the UK, and € 230–240 billions in the Euro area.

3. Monetary and financial unsafety and instability of the existing fractional reserve system

Banks act procyclically. This is quite natural, everybody behaves like this, more or less so. When the economic situation or customers are thought to be good, banks tend to be risk-taking and relatively free-spending, and when the economic situation or customers are thought to be bad, banks tend to be more risk-averse and tight-fisted. Since the banks now create almost all of the money, the supply of money tends to fluctuate procyclically in exactly that way. In consequence, there is recurrent procyclical overshooting or shortage of the supply of money and capital. This is one of the main factors of financial instability, and as such a main cause of real-economic periods of excessive boom and bust.

Today’s fractional reserve system, with its mixed money base and its double non-cash circulatory system, is actually a mixed blessing. Seen in historical perspective from a legal and monetary point of view, it represents a muddled transitional stage in-between the traditional metal-money ages where it comes from, and the future of purely information-unit fiat currency where it is heading for. At its present stage, the reserve system has become non-transparent and difficult to understand (even most bankers don‘t). The quantity of money is impossible to control, and the system is prone to instability and crisis. Moreover, deposits in banks continue to be unsafe. In an individual bank failure, most of the deposits are at risk. In a general banking crisis, the ability of central banks to act as lender of last resort becomes invalid – which can be seen in all of the countries that had to go through severe financial crises during the past decade, from Mexico, Brazil and Argentina, to Russia and South East Asia.

The reform proposal

Having presented the above list of problems we certainly don‘t claim that segniorage reform would be a cure-all to any monetary and financial difficulty that might exist. Nevertheless, seigniorage reform, as we propose it, would definitely solve the problems of monetary safety, control of the quantity of money, legitimacy of the creation of money, and it can considerably contribute to solving problems of government finance as well as wider problems of financial and economic stability.

Seigniorage reform consists of two elements which can be seen as two sides of the same coin. The one side of it is fully restoring seigniorage. The reform will ensure, actually for the first time in modern history, that a democratically legitimized public authority – such as the issue department of a central bank – will have the exclusive right of creating and issuing *all* of the money that mounts up to the stock of official currency.

The issue department of a central bank would decide regularly how much money is needed, pursuing discretionary rather than rule-related policies. Central banks should be in a position of strong institutional independence. Under normal conditions, neither parliament nor government should have a right to force decisions out of it. Technically, the issue department would prepare its decisions, quite similar to how it is done today, on the basis of

(a) monitoring economic growth (creation of money oriented towards the growth potential of GDP)
(b) interest rates (higher/lower rates indicating stronger monetary demand/supply) as well as
(c) taking into account the weekly and fortnightly statistical reports of the banks and the structure and volume of their borrowing and lending transactions.

The issue department would transfer the newly created money to the treasury. The government would in turn decide how to use the „free lunch“ of seigniorage – whether to spend it, say, on education, or income allowances, or to pay back governmental debt, or to reduce taxes (e.g. by granting annual seigniorage tax credits), or any combination of such possibilities.

The other side of seigniorage reform is to make sure that banks will be able to continue with everything they do now, except creating sight deposits. Creation of sight deposits by the banking system must be ruled out.

This twofold goal of seigniorage reform – restoring the public prerogative of creating money, and putting an end to the creation of sight deposits by the banking system – can be achieved by two legal measures combined with a technical measure, all of which are surprisingly simple, and easy to implement.

First, sigh deposits need to be transformed from the mere money claims/liabilities they are at present into positively existing units of non-cash currency. The corresponding legal measure is this: In the banking laws, the article on the issue of banknotes needs to be amended as to include non-cash money in addition to banknotes and also coin. In this way, sight deposits would obtain the status of legal tender. The law would thus catch up on the common practice that sight deposits in current accounts are already used as if they were official money – which they aren't yet, as long as they haven't been declared to be positively existing units of legal tender.

The second legal measure is to declare the current accounts in a bank to be *money accounts* exclusively ascribed to the customer. In the same way as we have coins in the pocket, and banknotes in our wallet, customers will have non-cash legal tender in their money account. This isn't the case today either, even if it looks like this. Not only are today's sight deposits mere money claims/liabilities instead of being information-unit currency, but also the „containers" of sight deposits, the current accounts, are part of the banks' balance sheet, i.e. they belong to the bank, as they belong to the customer at the same time. If the settlement of a customer's money order involves payment of reserves, than these reserves don't flow from customer to customer; instead, they flow from the operational account of the bank in charge to the operational account of the receiving bank.

That's why the legal act of declaring current accounts to be money accounts needs to be combined with a technical measure of accountancy: the current accounts will be taken off the banks' balance sheet, so that they exist separately, as off-the-balance items seen from the banks' side, like e.g. stocks and security deposit accounts a bank manages for its customers. The booking entries in the future money accounts just regard the customer, no longer the bank. Money accounts and cashless payment orders can certainly be managed by the banks, as a service to the customer. But the money account of the customer will no longer be of a bank's business, i.e. no longer be part of the banks' balance sheet. [2]

When a bank wants to grant a loan, it will have to make sure to have borrowed the money it is going to lend. If the bank borrows from its own customers, this will no longer be represented by replacing a current account liability with a longer-term liabilitiy on another account, but it will include a *real* transfer of money from the customer's money account to the bank's operational account with the central bank, from where the money will then be *paid out* to the money account of the person or institution who takes the loan from the bank.

Existing clearance of payment systems can still be used, in completely the same way as today with regard to bank-to-bank transactions. Clearance of payments from customer to customer, from customer to bank, and from bank to customer may need some technical adjustment.

[2] Banks' current account liabilities will nevertheless continue to exist for a while – as liabilities to the central bank (which should have created these means of payment in the first place). As customers will redeem their loans to the banks, the banks will pass on that money to the central bank, so that the remaining current account liabilities of the banks to the central bank will be extinguished on both sides of the central bank-bank-relationship and be phased out step by step.

Advantages

The advantages of seigniorage reform are manifold. We tried hard to find also some possible disadvantage, a search in which we didn't succeed so far. A possible coalition in favour of seigniorage reform can include almost everybody because everybody can expect to gain from it – except the large banks who would lose the special profit from creating sight deposits.

Seigniorage reform is a simple incremental reform, easy to implement. It represents an obvious next step in the evolution of the monetary system. It is not about overthrowing what exists, but just a slight though important restructuring of long-established institutions and practices. The proposal actually allows to keep almost everything in the existing system as it is, if this were the political will.

Further advantages include the obvious benefits to the government budget. This in turn can leave to the taxpayer more of their income, thus contributing to a higher stock of national capital, particularly in the hands of private households and small and medium-sized businesses.

The stock of currency will be debt-free, i.e. the money base of the economy were neither burdened by interest nor by pay-back. This would result in a lower overall level of interest, with an accordingly higher overall level of investment and employment.

The sight deposits in money accounts would completely be safe money for the first time.

The stock of currency in circulation will be stable under any circumstance, and its increase will also be stable or continous, transmitting itself into stabilizing effects on the real economy.

The quantity of the stock of currency would be fully under the control of the issuing monetary authority (the issue department of the central bank, as we suggest). Insofar as the quantity of money is a particularly important contributory factor to inflation, that inflationary factor will be fully under control, again for the first time, in complete contrast to the present muddled system in which the central banks have lost control over the quantity of money, and the commercial banks print as much money as they think creditworthy, with considerable recurrent effects of accelerating inflation, or aggravating deflation (as it recently happened in Japan).

Plain money

The monetary system which results from seigniorage reform and which is also the monetary basis for it, can be called a system of *plain money*.[3] In today's fractional reserve system there is *mixed money*, from mixed sources, with a mixed legal status of validity, and a double non-cash circulatory system via operational accounts (central bank reserves) and current accounts

[3] A paper on Plain Money can be read or downloaded at www.soziologie.uni-halle.de/huber under „Publikationen/Puclications".

(banks‘ sight deposits), with cash having become an irrelevant exchange form of non-cash; technically a non-transparent system, almost impossible to control, hence unsafe and unstable, and also unfair, to put it mildly, with regard to the special banking profits.

Plain money, in difference, is fully valid legal tender in any form (cash, e-cash, sight deposit). Plain money takes full advantage of the fact that modern money, sice the metal-money ages are over now, no longer represents physical valuables. The units of today‘s currencies just represent *information* about economic value. They give an amout of purchasing power equivalent to that value. The value comes from the productivity of the real economy, whereas the currency units as such (the means of payment) are created „ex conscientia“. In the case of plain money, the currency comes debt-free from a single, democratically authorized source, thus making sure that the value of it is yielded for the common good. And all of the currency is part of one integrated money circulation (instead of the existing double non-cash circulatory system). Plain money constitutes a simple and robust system, easy to understand, to handle, and to keep control of.

Impact on the banking business

Seigniorage reform is far from being a threat to banking. Also the profitability of banking is not at stake, simply that part of banking profits which represent the supernormal special profit from creating new sight deposits. For all of the rest, the banking institutions and the financial markets can stay the same. Their everyday practices and procedures would continue as if nothing had happenend. Nothing will be expropriated, no one’s monetary possessions, including the banks‘, will be touched.

Seigniorage reform is about keeping and fully restoring a nationalized stock of money. It is not, however, about nationalization of banking. Under conditions of seigniorage and plain money, banking can be a completely free enterprise.

As far as customers will keep more of their income and will be able to accumulate a higher level of own capital, they will certainly become better banking customers than they are today. In this way, the loss of the illegitimate special banking profit could to a certain extent be compensated for by a higher volume of business to generally better-off customers.

Competition among banks and the efficiency of banking would clearly gain from seigniorage reform, because it puts an end to the oligopolistic advantage the large banks do have in the present reserve system. The ability of the smaller banks to create sight deposits is more restricted because, having less customers, a smaller geographic radius, and less turnover in payments in and out, the smaller banks need much more reserves in order to carry out their activities than the large banks of nation-wide and international standing with many millions of customers and many billions in turnover, which makes them practically almost independent from central bank reserves, particularly since minimum reserve policies have almost completely been abandoned. In this respect, seigniorage reform would contribute to a fairer competition between smaller banks and large banks. And that's why seigniorage reform, if properly communicated, may even find the tacit support of the small and medium-sized banks and other businesses in the financial services sector.

Furthermore, the structure of what is nowadays considered to be a bank will become clearer. Today, banks fulfill at least five functions. These don't need to exist „under one roof" (so-called universal banks). The different functions can also be carried out in separate businesses, and this is partly already the case:

1. Banks serve as *currency exchange*. They exchange foreign currencies, they exchange coin, notes and sight deposits, and old against new coin and banknotes.
2. Banks take in money by borrowing and depositing, and banks grant loans. In my view, *borrowing and lending* is and should remain the core business of a bank.
3. Banks *create money* in the form of sight deposits as a parallel means of payment denominated in the currency of the central bank where they are licenced to refinance (as central banks create the operational deposits of banks) .
4. To their customers, banks render the *service of account management and cashless payment* (as central banks manage the operational deposits of banks).
5. Banks are engaged in so-called *investment banking* – a collective term encompassing a number of different financial activities, including the financial handling of mergers and acquisitions, initial public offerings and underwriting, brokerage and portfolio services to customers, and nostro business, which sometimes turns into overt speculation, as banks in most countries are also important shareholders, bondholders, and foreign exchange holders on their own account.

It remains to be seen how far these functions will continue to be carried out „under one roof" or whether the functional differentiation will lead step by step to separate businesses. Seen from the standpoint of seigniorage reform and plain money, two things are definitely clear: Banks must stop to create sight deposits. And the service of managing money accounts and cashless payments can perfectly be done by specialized separate businesses – be that divisional profit-centers within traditional banks, or newly set up businesses. These would certainly be more effective and more cost-efficient than what we have today where the banks are actually not directly interested in the service of account management, though it gives them indirectly the illegitimate priviledge of making money out of nothing, thus acquiring for private profit what has always been a public good.