What is sovereign money?

Why it must be put on the agenda and what a sovereign money system would look like

by Joseph Huber

Source: www.sovereignmoney.eu/what-is-sovereign-money as of Jan 2017

The notion of sovereign money

Sovereign money is legal tender, on hand or on account as well as on mobile storage device or in a digital wallet. It contrasts with commercial bankmoney on account, i.e. demand deposits, also called sight deposits, as used for cashless payment.

As to the wording, there are alternatives such as *safe*, *sound* or *stable* money (in various connections), *plain* money (J. Huber/J. Robertson), *pure money* (R. Striner), *chartal* money (derived from chartalism), *state* money (R. Werner), *public* money (K. Yamaguchi, M. Mellor) and, specifically in the United States, *U.S.* money (S. Zarlenga). *Sovereign money* seems best to encapsulate what it is all about. Beyond descriptive aspects, the notion of *sovereign money* also conveys the constitutional dimension of the monetary prerogative which is one of the most important sovereign rights.

Sovereign money is issued by a state authority, in Europe a national bank, or the European Central Bank (ECB). Today, sovereign money exists in the form of cash (coins and banknotes) and non-cash central-bank money, called reserves. Such reserves, though, circulate on bank accounts with the central bank only, not on customer current accounts with banks.
The lion's share of money today is bankmoney. It represents 82% of the active money supply in public circulation (M1) in euro countries. Coins account for 1%, banknotes 17%. In Anglo-Saxon countries the share of demand deposits is over 95%.

For a better understanding of what sovereign money is and what it implies, it is useful to compare it with bankmoney, i.e. the present system of fractional reserve banking. Normally, bankmoney is as liquid as sovereign money, i.e. available any time on demand. But sovereign money does in fact exist; it is the safe property of the customer who owns the money. Bankmoney, by contrast, is not money proper, not legal tender, but just a claim on money, a claim on having paid out cash, or having transferred such 'deposits' on demand. Bankmoney is but a balance-sheet item of a bank, thus basically unsafe and unstable. In a banking crisis, money in a bank account might disappear. Bankmoney, as monetary theory rightly states in this regard, is but a money surrogate we use as if it were money, in fact a cash debt, a liability of the bank to the customer.

The present bankmoney regime

For the most part, demand deposits are backed up with central-bank money, but only to a very small fraction of 1.5% in the UK, 2.5% in the euro zone, and less than 8.5% in the US. This is why the system is called fractional reserve banking. For example, for transacting 100 euros, banks in the euro area normally just need on average a 2.5% coverage, of which 1% is idle minimum reserve requirement, 1.4% cash for the automated teller machines and about 0.1% excess reserves for the final settlement of payments.[1]

Banks create demand deposits when they grant loans or overdrafts, or when they buy bonds, stocks, real estate and other assets. They pay by keying in new credits into the current accounts of borrowers and sellers. When doing so, banks normally do not even know whether they have available the small fraction of central-bank money they need to carry out those transactions. In case they run short of the residual fraction of central-bank money, they take up lacking reserves and cash on the money market or at the central bank *upon or after* credit extension. In the banks' balance sheets the credits appear as overnight liabilities to customers and other banks. The asset counterpart to this appears as loans outstanding, or as the current value of securities and real estate.

Textbooks maintain that even a 2.5% reserve would allow for controlling the banking sector's credit and deposit creation. This is upside down. In reality, banks pro-actively determine the money supply, and central banks

[1] Figures according to ECB, Monthly Bulletins, tables 1.4.2, 2.3.1–2.

re-actively re-finance the monetary facts the banks have created beforehand. Central banks always accommodate banks' demand. They may do this at higher or lower interest, which may change central banks' and commercial banks' profit margins, but not the volumes of banks' credit and deposit creation because this is highly interest-inelastic.

Problems with bankmoney

In contrast to what textbooks say, money and capital markets do not bring about a self-limiting state of equilibrium. The reason is that modern money is not 'scarce', but is fiat money which can easily be created at the stroke of a key. Banks' credit creation almost always tends to be overshooting in the course of business and financial cycles, i.e. the banking sector creates volumes of credit, deposits and debt vastly out of proportion to economic growth as indicated by GDP. This causes inflation and, particularly since the 1980s, asset inflation and financial bubbles. Economic cycles are thus pushed to extremes they otherwise would not reach. Ensuing banking and financial crises cause damage to the entire economy, including financial fortunes, real income, employment, and state coffers.

Such crises are evidence of the fact that fractional reserve banking is unstable and bankmoney is unsafe. Testimony of this is deposit insurance. In a systemic banking crisis, however, deposit insurance will always be far too little, and government—in its questionable attempts to save private banks—is unable to stand bail for it all.

In the run-up to the present crisis, from 1992 to 2008 the money supply M1, for example, in Germany, grew by 189%, nominal GDP (which includes consumer price inflation) by 51% and real GDP by 23%.[2] Hence one can argue that only one eighth of the money supply increase went into real productivity and real income. Another eighth went into consumer price inflation. What happened to the remaining three quarters? They went into financial investment, ever more of it of a purely speculative nature ('global casino') without making a contribution to financing real output, while drawing on the up-market items of that output nonetheless.

Typical business areas where over-investment and over-indebtedness occur on the basis of overshooting credit and deposit creation are bull

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[2] Sources: www.bundesbank.de/statistik/zeitreihen. Deutsche Bundesbank, *Monthly Bulletins*, tables II.2.

markets in real estate, stocks, or mergers and acquisitions (hostile takeovers used to be credit-funded to 90–95%). Since the 1970s, the biggest financial investment bonanza has been the long-term hyper bubble of government bonds in almost all industrial countries. Such processes regularly entail taking up credit for immediate financial leverage; and all such processes are accompanied by speculation in interest-rate and foreign-exchange derivatives on a large scale.

There are further problems with the banks' overshooting primary credit creation, thus bankmoney creation, in particular an inbuilt bias in income distribution to the benefit of financial income at the expense of earned income. Growth of financial assets in continual disproportion to GDP expands the relative share of financial claims on the national income and thus reduces the relative share of earned income.

Money is a creature of the law, of fundamental importance for both the economy and the state

Analyses of the financial crisis and measures taken have so far considered a wide range of factors, but failed to take into consideration the monetary root cause of all those banking and financial-market problems: banks' basically unrestrained credit and deposit creation. Regaining control of the money supply is a basic prerequisite for coming to grips with the banking and financial system.

Sovereign money is in the tradition of the Currency School from the 1830–40s and the state theory of money (chartalism) since around 1900. Both are contested by Banking School teachings. The latter posit the identity of money creation and credit extension (= bankmoney = credit money), and assert this to be a purely private matter, allegedly unproblematic because money is seen as a neutral means of exchange. It may change the general level of prices and incomes without, however, resulting in structural changes of the economy, in particular regarding price relations, patterns of investment and income distribution. Markets will by themselves make sure there is an optimal supply of credit money.

Currency teachings, by contrast, require the separation of money creation from credit extension, because money is a creature of the law, and control of the money is a sovereign prerogative. This includes full control of money creation, as a function different from the creditary and other private and public uses of money in the economy.

Money is not neutral, because prior to the use of money as a medium for transacting goods and services, it is used as a medium of finance, a medium of allocation and distribution, thus a medium of economic and social control, in fact the most powerful control lever besides legal command powers. The monetary system is the foundation of finance, as finance significantly determines the conditions for the real economy. Far from being just a neutral 'veil' on the economy, the monetary system is the constitutive component of modern market economies

Sovereignty of a nation, or community of nations, includes monetary sovereignty, as a prerogative of constitutional importance such as the exclusive powers of legislation, executive government and administration, jurisdiction, the monopoly of taxation and the monopoly of force. A full sovereign money system thus is based upon the three components of a state's monetary prerogative:

1 determining a country's standard currency unit, i.e. the monetary units of account,
2. issuing the entire stock of money denominated in that currency, i.e. the official regular means of payment, and
3. taking in to the benefit of the public purse the seigniorage which accrues from creating additions to the stock of money.

In the present bankmoney regime, only the prerogative of determining the currency unit is still intact, at least for the time being. The other two elements, however – the currency itself, money creation, control of the stock of money, and seigniorage-like privileges from this – have become the private privilege of the banking sector to a very large extent.

Basic traits of a sovereign money system

The dysfunctions and illegitimate privileges of the present bankmoney regime require a monetary reform which phases out bankmoney in favour of a money supply that exclusively consists of sovereign money. Such money ought to exist as a liquid asset only. In no balance sheet whatsoever would it appear as a liability. It would circulate freely among banks and nonbanks alike. M0 and M1 would no longer exist, just one integrated money supply M, easy to handle and to keep control of. M2/M3/M4 would no longer be 'monetary aggregates', but short-term capital items. The terms money, currency (on hand, on account or in digital wallet) as well as legal tender and lawful money would be largely identical.

To achieve this, the coin monopoly of the treasury should be assigned to the central banks as monetary state authorities, and the banknote monopoly of the central bank will have to be extended to money on bank account in public circulation, to mobile money stores and digital wallets. Thus, a full money or currency monopoly in accordance with a state's unimpaired monetary prerogatives comes into existence.

Central banks will then be a fourth branch of government, i.e. the independent monetary power, complementing the legislative, executive and judicial powers. Quite a number of national banks today are formally in a position that already comes close to this—without, however, being able to live up to their task because their efforts are undermined to a large extent by the realities of the bankmoney regime based on bank-led fractional reserve banking.

Banks' deposit creation would be brought to an end – either immediately on a set date or gradually over a certain transition period. Banks could no longer pour large amounts of additional bankmoney into the 'irrational exuberance' of financial-market bonanzas. Business and financial cycles would still exist, but remain on a moderate path.

Sovereign money is safe money. It cannot disappear anymore. In a banking crisis there would be no threat of payment services breaking down. Insolvent banks, no matter how big, would no longer have to be rescued in order to prevent a standstill of economic transactions.

In the long term and for the biggest part new money will be issued by transferring the amounts involved to the treasury, whence the money will be spent, not lent, into circulation. This represents genuine seigniorage, which is comparable with the historical prerogative of coinage, free of interest and redemption, and thus debt-free. In the short term and for the smaller part, the central bank may loan new money to the banks if required. This creates interest-borne seigniorage. Either way, additions to the stock of money have to be determined under *monetary* criteria, while *fiscal* considerations are none of a central bank's business.

Among the criteria a central bank should observe are
- the growth potential of the economy at full capacity
- relative stability of domestic levels of consumer prices, interest rates, exchange value of the currency, balance of payments

- relative stability of asset prices and ratio of financial assets and debt to GDP, that is, keeping an eye on an economy's financial carrying capacity.

The division of powers between government/parliament (fiscal power), central bank (monetary power) as well as between these two and the banks and other financial institutions (wider financial market functions) will be developed further. The central bank's task is to provide the money and keep control of the stock of money, to make sure that there is neither too much nor too little money, thus ensuring that the banks and the economy can work at optimal capacity utilisation. The business of banks and other financial institutions is to finance all kinds of activities, without however the banks creating themselves the money on which they operate. Banks will no longer be able to lend or spend money without having taken it in or up before—from their customers, from other banks, on the open money and capital market, and ultimately, if need be, from the central bank.

The profit from creating new money, the seigniorage, will no longer be forgone to the public purse. Money creation can thus benefit better balanced budgets and the taxpayer. Seigniorage would be higher than today. If we assume that money supply and economic output ought to develop roughly in step, then 1% of economic growth would come with an increase in the stock of money of about the same rate. By present measures, 1% of economic growth would allow the funding of 1–2 per cent of *total* public budgets (incl. social security), depending on a country' size of government spending.[3]

In addition to the regular seigniorage which accrues from increases in the stock of money, a transition from bankmoney to sovereign money would furthermore entail a huge one-off seigniorage. Similar to when private banknotes were phased out and replaced with central-bank notes in the 19th century, an analogous transition today has to substitute sovereign money-on-account for bank-created demand deposits. This will be a continuous process over several years, depending on maturities of loans outstanding.

Measured by current figures in industrial countries, such a substitution would phase out an amount of largely 'void' bankmoney and replace it with a comparable amount of sovereign money of the order of about 30–70 per

[3] Cf. J. Huber 2017: Sovereign Money. Beyond Reserve Banking, London: Palgrave, 176–79.

cent of *total* public debt, depending on the country.[4] The one-off substitution seigniorage thus offers a historically unique opportunity to pay down sovereign debt to a considerable extent—with no need for negative deposit interest or inflation, and without expecting 'haircuts' of creditors or imposing devastating austerity measures on nations involved.

[4] Ibidem.