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National currencies and global imbalances: the structural roots of major economic crises

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OUTLINE

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INTRODUCTION

The global financial crisis originated from two structural flaws in the workings of bank-based payment systems:

a) domestic level: loans-to-deposits causal chain is not enough to avoid macroeconomic imbalances (affecting the money–output relationship);

b) international level: national currencies as objects of trade (explaining global imbalances).

➲ Money, banks, and payments are at stake!

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1. THE MECHANICS OF PAYMENTS

- What is money?

"Views on money are as difficult to describe as are shifting clouds." (Schumpeter 1954/1994: 289)

"The definition of money can still be regarded as an almost unresolved issue." (Bofinger 2001: 3)

"What we need is a theory that treats money […] as what it really is, namely a medium of exchange." (Niehans 1978: 16)

"The real problem is not one of classification but of a better analytical understanding of the functions of a medium of exchange." (note 39)

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1. THE MECHANICS OF PAYMENTS

- How does money fulfill its means-of-payment role?

"Every transaction involves three parties, buyer, seller, and banker." (Hicks 1967: 11)

"Money therefore only comes into existence the moment a payment is made. *At that moment, in one and the same act, money is created, the borrower becomes a debtor to the bank and the agent receiving a payment becomes the creditor of the same bank."* (Graziani 1990: 11)

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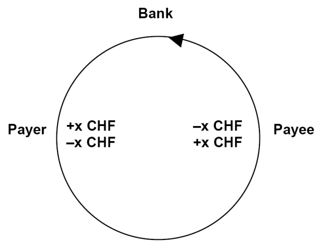
1. THE MECHANICS OF PAYMENTS

- The emission of the means of payment by the bank



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1. THE MECHANICS OF PAYMENTS

- The result of a payment through the bank (*tabula rasa*)

Bank			
Assets		*Liabilities*	$\Delta M = +x$
Loan to the payer	+x CHF	Deposit of the payee	+x CHF

➲ The loans-make-deposits mechanism increases the relevant monetary aggregate (or "money supply"), which then "circulates" until the loan is paid back!

1. THE MECHANICS OF PAYMENTS

- In a nutshell…

"There is thus a constant circulation of debts and credits through the medium of the banker who brings them together and clears them as the debts fall due. This is the whole science of banking as it was three thousand years before Christ, and as it is today." (Innes 1913: 403)

2. MONETARY–STRUCTURAL DISORDERS

- Within the domestic economy

* The loans-make-deposits mechanics of bank payments:

- is sound for payments on the factor market, as it does not affect the money–output relationship ($\Delta M = \Delta Q$);
- but originates "extra money" on the financial market, as it gives rise to new bank deposits to which no new output corresponds ($\Delta M > \Delta Q$).

➲ No CPI inflation, as these deposits are spent on real or financial assets rather than on the goods market!

2. MONETARY–STRUCTURAL DISORDERS

- Example: bilateral credit lines on the interbank market

Bank A			
Assets		*Liabilities*	
Loan to bank B	+*x* m.u.	Deposit of bank B	+*x* m.u.
Deposits (into bank B) Securities (sold to bank B)	+*y* m.u. –*y* m.u.		

Bank B			
Assets		*Liabilities*	$\Delta M = x+y$ $\Delta Q = 0$
Deposits (into bank A) Securities (sold to bank A)	+*x* m.u. –*x* m.u.		
Loan to bank A	+*y* m.u.	Deposit of bank A	+*y* m.u.

2. MONETARY–STRUCTURAL DISORDERS

- In the inter-national economy

* No national currency is a means of final payment:

- payment finality obtains when *"a seller of a good, or service, or another asset, receives something of equal value from the purchaser, which leaves the seller with no further claim on the buyer"* (Goodhart 1989: 26);
- any national currency is a promise of payment when it intervenes in an inter-national payment, as the payee's country is left with a claim on the payer's country.

2. MONETARY–STRUCTURAL DISORDERS

- National currencies as I.O.U. of inter-national debt

Banking system of importing country A (BS_A)			
Assets		*Liabilities*	
Loan to the payer	+y MA	Deposit of BS_C	+y MA

Duplication

Banking system of exporting country C (BS_C)			
Assets		*Liabilities*	
Official reserves (+y MA)	+z MC	Deposit of the payee	+z MC

2. MONETARY–STRUCTURAL DISORDERS

- **In the inter-national economy**

*** The "non-system" for inter-national payments implies:**

- ***"deficits without tears"*** **(Rueff 1963: 322) for any key-currency countries;**
- ***"payment deficits"*** **(Machlup 1963: 256), as there is no payment finality between countries.**

➲ National currencies considered as objects of trade!

➲ Source of *"exorbitant privilege"* & global imbalances!

2. MONETARY–STRUCTURAL DISORDERS

- **Indeed…**

"If I had an agreement with my tailor that whatever money I pay him returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him." **(Rueff & Hirsch 1965: 2)**

2. MONETARY–STRUCTURAL DISORDERS

- **To be sure…**

"[T]he huge liquidity denominated in US dollars that exists as a result of the enormous US current account deficit cannot but be «recycled» in the local financial sector, providing the means for the creation and then bursting of bubbles that may ravage the local economy." **(Rossi 2009: 2)**

2. MONETARY–STRUCTURAL DISORDERS

- **In a nutshell…**

"The desirable goal of reforming the international monetary system, therefore, is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies." **(Xiaochuan 2009: 2)**

3. STRUCTURAL–MONETARY REFORMS

- **Principles for a new inter-national monetary order**

*** Payment finality for every inter-national transaction between any two countries (represented by their NCB).**

*** Emission of supranational money by an inter-national settlement institution (to be used by NCBs only).**

*** Vehicular use of supranational money, transferring the property rights on (current or future) output, from one country to another (to avoid "duplication" and contain global imbalances).**

3. STRUCTURAL–MONETARY REFORMS

- **Principles for domestic monetary order**

*** Divide the book-keeping of any banking institution in two functionally distinct and separate «departments» (similarly to the 1844 "Bank Act" (reforming the BoE)):**

- **«Issue department» (to record money emissions);**
- **«Banking department» (to record financial operations).**

*** Make sure all financial market transactions are "always and everywhere" recorded in the «Banking department» of monetary and financial institutions.**

3. STRUCTURAL–MONETARY REFORMS

"The Bank of England performs two operations of banking, which are quite distinct, and have no necessary connection with each other: it issues a paper currency […] and it advances money in the way of loan, to merchants and others. That these two operations of banking have no necessary connection, will appear obvious from this, that they might be carried on by two separate bodies, without the slightest loss of advantage, either to the country, or to the merchants who receive accommodation from such loans."
(Ricardo 1824/1951: 276)

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CONCLUSION

A twofold structural reform in banking is necessary to avoid further systemic crises:

a) at international level a settlement institution for NCBs is required to avert any payment deficits (and thus limit global imbalances);

b) at the domestic level banks' business has to be framed within an issue and a banking department (to avoid issue of "extra money" by monetary and financial institutions).

➲ Money, banks, and payments are the key for reforms!

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