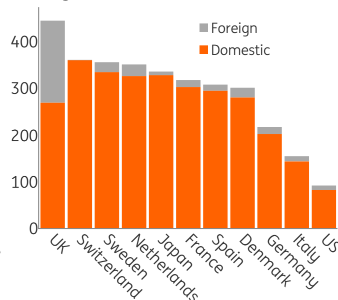
22 May 2018

Monetary reform

The Swiss Vollgeld referendum: an unprecedented experiment

Should we prepare for a Brexit-like shock?



On 10 June, the Swiss vote on a fundamental monetary reform. The probability of a "yes" may be underestimated, as was the case with the Brexit referendum. The short-term impact of a "yes" would be great uncertainty but, in the longer term, Vollgeld could hurt the economy, have important redistributive consequences and greatly increase the role of the state in the economy. The CHF will suffer from a "yes" in the short run, but conservative monetary policy and safe haven status may be a CHF positive in the longer run.

On 10 June, the Swiss vote on "Vollgeld". This referendum asks whether the Swiss want to reform their monetary system in a fundamental and unprecedented way. The referendum has received relatively little attention so far, at least outside Switzerland. This could be because the impact of Vollgeld, if adopted, is underestimated, or because the probability of a "**yes**" is not deemed to be very high. That may, however**,** be a mistake. Recent polls indicate that a rejection is not a done deal yet. Moreover, the Brexit referendum of 2016 should have taught the forecast community some modesty. The louder "the experts" recommend staying away from something, the more inclined people appear to be to gravitate towards it. As heard during the Brexit campaign, "people have had enough of experts". As "Remainers" argued their case, they got the crippling response "they would say that, wouldn't they". In this sense, the Swiss setting is not too different. The "elite", including the government, the Swiss central bank (SNB), the banks and a number of scholars, have come out against Vollgeld. If only for this reason, a "yes" vote should not be excluded – although as we have argued earlier, a rejection remains our base case.

Brexit déjà-vu? Both probability and impact of a "yes" to Vollgeld appear to be underestimated, at least outside Switzerland

Which brings us to the impact. Here too, an important parallel with Brexit is that a "yes" would herald a period of uncertainty. Vollgeld and various alternatives have been debated among economists for decades. But it has never really been tried – let alone in a developed economy with a big banking sector (see margin chart). While the contours of the Vollgeld end state are roughly clear in theory, the transition towards it is an untrodden path with various known and unknown pitfalls.

So what is Vollgeld, and why should we care?

Let's first take a step back and discuss what Vollgeld actually is. Vollgeld is closely related to various proposals with names like Sovereign money, Narrow banking, Full reserve banking. All these proposals are intellectual offspring of the 1930s Chicago Plan. The departure point is the observation that money creation, in our current financial system, is mostly done by commercial banks (by lending). While banks are licensed institutions under tight public supervision, the normative assertion is made that money creation should be a public privilege, and cannot and should not be left to private institutions. A related argument often made is that people should be able to pay their taxes in publicly issued "real" money, and should not be forced to use a privately issued money "derivative". Indeed bank deposits are not legal tender. But in practice, bank deposits are a very close substitute for legal tender, as banks are legally obliged to immediately convert deposits into cash on demand.

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Taking away money creation reverses the order of things. With money creation, banks can lend and worry about funding later. Without money creation, they first have to collect funds, and can go on to lend these funds afterwards

Under Vollgeld, banks would lose their ability to create money. Long story short, this means that when they lend, they first have to collect the funds to do so. So banks are reduced to pure intermediaries, receiving money from depositors and passing it on to borrowers. This is in fact how many people believe banks currently work, but as we have explained elsewhere, that is not the case. Banks currently create deposits as they lend. As however these deposits are usually withdrawn by the borrower, banks at the end of the day still have to find funding. So simplified greatly, taking away money creation reverses the order of things. With money creation, banks can lend and worry about their funding later. Without money creation, they first have to collect funding, and can only lend afterwards.

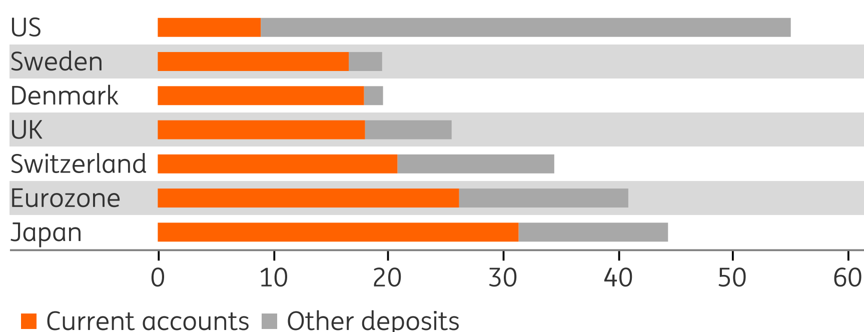
A fundamental reform with wide-ranging consequences

You might conclude that just reversing the order in which lending and obtaining funds occur, is not a great change. And in fact, proponents of Vollgeld tend to argue that at the bank storefront, little will change. We beg to differ, however. Removing the banks' money creation ability has many complicated consequences, of which we discuss a few important ones below:

The introduction of sovereign money means Swiss banks will lose 20% of their funding. Savings deposits that could be converted into sovereign money are another 13% of funding

1) Availability and pricing of bank loans. Banks will no longer be able to fund loans with sight deposits. This means Swiss banks will lose their most stable source of funding, comprising 20% of their balance sheet (Figure 1). While in the transition period the SNB may extend loans, in the longer term banks will have to finance their lending using savings deposits, wholesale funding (bonds and loans) or central bank loans. These are more expensive sources of funding than sight deposits (which often carry no interest), moreover competition for these scarce funding sources will intensify. This will hurt bank profitability and higher funding costs will also be expressed in lending rates. Ultimately, lack of affordable funding could induce banks to reduce lending volumes.

Fig 1 Home currency deposits as percentage of bank balance sheets



Current accounts = included in M1. Other deposits = included in M2.
Source: Macrobond, ING

Sovereign money will reduce credit supply and increase its price, hurting especially households and SMEs with no access to alternative sources of finance

Higher lending rates and restricted supply will especially hurt households and SMEs, as these borrowers have limited access to alternative sources of funding. Of course, it could be argued that cheap and abundant supply of credit was a problem in the pre-2008 developed economies, and that a correction is in fact welcome. But it is one thing to build a new system from scratch with more scarce and expensive credit supply; but to impose these constraints on the current, globally interconnected system in which credit plays such an important role, is a very different story. Rate hikes could hurt Swiss economic activity, while supply constraints could cripple otherwise successful enterprises.

With risks like these, taking away money creation seems like an overreaction to the (in itself real) problem of potential credit oversupply. It appears more sensible to give safeguards already in place a fair chance. In the current system, supervisors already

have micro- and macroprudential tools at their disposal to correct any credit volume or price imbalances they identify.[1]

The transition to Vollgeld constitutes a redistributive policy, favouring savers over borrowers

2) Increased costs for sight deposits. While sight deposits usually don't pay interest, depositors also don't pay the full costs of maintaining a safe and efficient payment system. These costs are absorbed by banks. After monetary reform, sight deposits are SNB liabilities, and banks are no longer able to generate interest income by allocating deposit funds to loans, and using part of this income to maintain the payment system. Instead, the costs for maintaining and innovating the payment system will likely be charged directly to depositors, or the central bank will absorb it (reducing taxpayer revenues). Savings deposits may pay higher rates in this system (see bullet 1 above), but this may not compensate for the increased sight deposit costs, and moreover, it means a redistribution from people with a sight deposit (virtually all adults) to savers (a subset).

There is a reason 2008 constituted a "credit crisis" and not a "money (creation) crisis'. Money creation was not the problem. Banning it will not eliminate the occurrence of crises.

3) A sovereign money system may still experience crises. Proponents argue that monetary reform addresses the "too big to fail" (TBTF) problem and will greatly reduce or even eliminate the occurrence of financial crises. It is true that with sovereign money, deposit guarantee schemes are no longer needed, the payment system can be disentangled from lending, and runs on sight deposits should be a thing of the past (provided that confidence in the sovereign remains). However, the 2008 crisis was called a "credit crisis" and not a "money (creation) crisis" for a reason. In fact, the crisis centred around the non-bank lending channel in the US. In this channel, lending was funded not with new money created, but ultimately with non-money short-term liabilities (sometimes called "near-monies"). Such channels are vulnerable to "wholesale bank runs", with short-term financing suddenly drying up. Sovereign money does nothing to address this vulnerability. Worse, by eliminating money creation as a funding instrument, it may even increase the financial system's reliance on such near-money financing. While failure of such financing channels may no longer hurt the payment system, banks may still experience a run on their savings deposits. Also, a sudden stop in credit provision to the economy can have detrimental effects as well.

Under sovereign money, the role of the state in the economy (through the central bank) is much bigger. Central banks themselves are not keen on this additional power

4) A bigger and more political role for the central bank. In the current system, private lenders assess client suitability and credit risk. This is their core business. Under Vollgeld, the central bank may need to build this expertise itself. It may not have to evaluate individual borrowers, but under Vollgeld legislation it does have to "ensure the supply of credit to the economy" (as a whole). This would add a central planning characteristic to a market-based economy. Central banks are already struggling with their newly acquired macroprudential mandates in the current system, afraid to make wrong assessments and cause booms or busts. Most central banks will be reluctant to accept a far greater role in the economy – the SNB is no exception to this. In addition, the distribution of "debt-free" money should clearly reflect policy choices and decisions about it should rest with the government, not with a technocrat institution like the central bank.

The SNB is likely to adopt a conservative, hence deflationary, money supply policy

5) Restrictions on monetary policy. The SNB would have to shift from its current rate (price)-based monetary policy to a quantity-based one. As the money it issues is supposed to be "debt free", handed out as a gift to the government or to citizens directly, the central bank cannot acquire assets when issuing money. In other words, the SNB would issue "helicopter money".[2] This means that, should it want to absorb liquidity at some point in time, it cannot do this by selling assets. It could still issue

[1] Also see remarks made under bullet 4 below.

[2] This at least is what the legal text proposed by Vollgeld states. In other explanations however, the SNB seems to keep the possibility to buy securities or FX reserves. It is unclear what conditions would apply though.

longer-term liabilities in exchange for money, but it misses an important tool in its toolbox. In addition, as the SNB amasses liabilities (money) without acquiring assets in return, its capital position will worsen (which central banks don't like, but is not necessarily a fundamental problem). With all these consequences in mind, the SNB is likely to err on the side of caution, adopting a conservative, hence deflationary, monetary supply policy.

A helicopter money issuing central bank will also generate less interest income. Interest income is normally transferred to the government. The loss of interest income from helicopter money issuance however is permanent and builds over time. The central bank (or depositors) will also incur costs to maintain the payment system.

So in sum, Vollgeld would increase the role the central bank plays in the economy, which would be a marked move away from the market-led economy Switzerland is (and most developed economies are) nowadays. It would have redistributive consequences, as borrowing becomes more expensive while saving may yield more. More restricted credit supply could severely depress economic activity. It is highly uncertain whether the system becomes more stable, as the role of non-bank lending – which was in fact at the epicentre of the 2008 crisis – is increased.

Is a fudge still possible if the Swiss vote "yes"?

A "yes" would first and foremost herald a period of great uncertainty. As with Brexit, the overarching goal sounds like a clear one, but when looking closer, lots of questions pop up for which answers have yet to be provided. The referendum text prescribes a maximum of three years for the monetary reform to come into force. Until then, the SNB has all its tools available to conduct monetary policy and intervene in the FX-markets, insofar necessary. It should therefore be able to handle any short-term market reactions. The reform's consequences, and market reactions to it, should become visible as the details of the reform are worked out.

Experience with the previous "mass immigration" referendum suggests the Parliament might try and water down the implementation of Vollgeld. This strategy comes with political risks though

Like with Brexit, working out those details will open up Pandora's box. The law has to be written by Parliament, which therefore has a degree of flexibility in the way to write down the law. Since the Parliament has come out against Vollgeld, it will most likely try and mitigate the consequences of it. It could try and argue that Vollgeld is not compatible with existing national law or international treaties, and use that as an excuse to water down or even completely set aside the initiative.

A previous referendum "against mass immigration" can serve as an example here. The initiative was adopted by referendum in February 2014. The EU responded that migration quota countered the agreement on free movement and suspended negotiations on Swiss participation in the Erasmus and Horizon 2020 programmes. The Swiss Parliament went for a creative solution. In December 2016, it passed some laws favouring employment of Swiss nationals before foreigners, but it stopped short of outright immigration quota. In reaction, the backers of the initial initiative have called for a renewed referendum and are currently in the process of collecting the 100,000 signatures necessary to call one. This experience shows that indeed the Parliament can and does take the liberty to interpret referendum results, but always at the risk of facing a new referendum.

Pivoting back to Vollgeld, the initiative has very explicitly indicated which constitution articles should be changed and how. Parliamentary attempts to water down Vollgeld therefore are likely to motivate its backers to start another referendum. Therefore, from a political perspective, a narrow victory for Vollgeld would leave more wiggle room for Parliament, as the odds of a second referendum collecting enough signatures would be

small. A resounding Vollgeld victory on the other hand would bind Parliament more strongly to the legal texts proposed by the Vollgeld initiative.

Implications for the Swiss franc of a "yes" to Vollgeld

Uncertainty will weigh on the CHF in the short term, but deflationary SNB policy and safe haven status may be a positive for CHF in the longer run

In the short run, the uncertainty of re-wiring the monetary and banking system in Switzerland would probably be negative for the CHF. Wider credit spreads and more limited access to credit should pose headwinds to an economy already suffering persistently low inflation. Some models put EUR/CHF fair value at 1.50 and we would say the uncertainty could see EUR/CHF rise above 1.30 from near 1.20 today.

The situation over the longer term could be entirely different however. Spooked by the prospect of helicopter money, negative equity and the inability to reduce money supply when needed, the SNB may prefer a conservative monetary policy, limiting the creation of CHF. Moreover, the prospect that every Swiss franc would be held at and backed by the SNB could, once the dust has settled, deliver a more positive re-assessment of the CHF as a safe haven currency.

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