SCHWEIZERISCHE NATIONALBANK
BANQUE NATIONALE SUISSE
BANCA NAZIONALE SVIZZERA
BANCA NAZIUNALA SVIZRA
SWISS NATIONAL BANK

Speech

Embargo
3 May 2018, 6 pm

Why sovereign money would hurt Switzerland

Swiss Institute of Banking and Finance at the University of St. Gallen (s/bf-HSG)

Thomas J. Jordan

Chairman of the Governing Board*
Swiss National Bank
Zurich, 3 May 2018

* The speaker would like to thank Petra Gerlach for her support in preparing this speech. He also thanks Claudia Aebersold Szalay, Simone Auer, Peter Kuster, Carlos Lenz and Alexander Perruchoud as well as SNB Language Services.

Ladies and gentlemen

Today, the Swiss Institute of Banking and Finance at the University of St. Gallen celebrates its 50th anniversary. Let me extend my sincere congratulations on reaching this milestone. Our financial system has evolved steadily over the past five decades. In the early years of the institute, the world was still dominated by Bretton Woods, the post-war monetary system with its fixed exchange rates and the US dollar as anchor currency. Thereafter, flexible exchange rates were the order of the day, and more recently, banks have had to face the challenges of the financial crisis.

I would like to take this opportunity today to address a topic which has also arisen from the challenges of the financial crisis – the Swiss sovereign money initiative. This initiative raises unrealistic expectations, and adoption by the people and the cantons on 10 June 2018 would have serious consequences for Switzerland. A sovereign money system would hurt our country as a whole and also make it difficult for the Swiss National Bank (SNB) to fulfil its mandate. The SNB, like the Federal Council and Parliament, therefore firmly opposes the initiative.

But what is the aim of the initiative? According to its authors, the goals are ‘crisis-safe money’ and a reduction in the burden on taxpayers. To achieve these, they propose that customers’ sight deposits at commercial banks be converted into so-called sovereign money accounts, and that ‘debt-free’ payments be made by the SNB to the state or the people. Furthermore, the initiative’s authors want to separate the creation of money from the granting of loans because they regard money creation by commercial banks as the main cause of financial crises.

Sovereign money makes lending more complicated

The Swiss sovereign money initiative testifies to a deep mistrust of our monetary system in general, and of the current credit system in particular. Yet, credit is a cornerstone of our economic system. It is the tool whereby capital that is not needed at one point in the system can be used productively elsewhere. The credit system facilitates projects – in the areas of consumption and investment alike – which would not be possible otherwise, and thereby makes our economy dynamic and flexible. This promotes growth and prosperity.

Money and credit have always been closely linked. Today, money creation and lending take place in a two-tier system, namely via the SNB and the commercial banks. The SNB provides banks with so-called central bank money in exchange for financial assets. They can hold this central bank money as sight deposits at the SNB or withdraw it as banknotes. Banks use central bank money to carry out transfers for their customers and for customer withdrawals. Equally, the commercial banks need central bank money for paying out loans. These payments lead in turn to the creation of new money in the banking system.

What exactly happens when credit is granted? The process always begins with the bank customer, for example when he or she applies for a mortgage loan. The bank then has to check whether the customer is creditworthy and whether the loan is economically viable from a risk/return perspective. Furthermore, the bank must determine whether it has, or whether it can obtain, sufficient central bank money to pay out the loan. The payment is usually made electronically by crediting the house seller's sight deposit account, which is generally held at another bank. Consequently, overall sight deposits in the banking system rise and new money is created. Although money created when a loan is granted is not central bank money, private customers' sight deposits at commercial banks have equal status in payment transactions and can also be exchanged by customers for SNB banknotes at any time.

On the one hand, payments into sight deposits – for instance customers' salary payments or proceeds of selling their house – are an important source of central bank money for banks. On the other hand, this liquidity can flow out again rapidly since customers are able to access their sight deposits at any time. Yet, it is not usually the case that all of a bank's customers simultaneously want to withdraw all of their savings or use them for payments. As a result, the bank does not need to hold ready an equivalent value of central bank money for every franc of sight deposits; it can use some of this liquidity for granting and paying out loans.

One point I would like to stress here is that money creation is not a privilege through which commercial banks can feather their own nests. A bank can grant loans when there is customer demand and it has central bank money at its disposal. To this end it is important that other customers are prepared to hold sight deposits at the bank. Here the bank is in competition with other banks. If the bank is not competitive, customers will be unwilling to apply for loans or hold sight deposits there. In granting loans, the bank also takes a business risk. Thus, banks do not 'create money out of thin air'. Rather, their money creation is the product of intermediation between savers and borrowers, and is made possible by the fact that customer sight deposits do not have to be fully covered by central bank money.[1]

Sovereign money would radically change our current system. In a sovereign money system, a bank is no longer permitted to use its customers' sight deposits to finance loans. Instead, it is obliged to call solely on investors who provide it with money for loans on a more long-term basis. These may be customers with savings deposits, investors on the capital market, other commercial banks, or even the SNB, which can grant the bank a loan. Because sovereign money impairs the useful intermediary function played by banks in the monetary system today, lending would become more difficult and complicated – to the detriment of customers, be they savers or borrowers.

[1] For more on maturity transformation as a traditional bank function and its importance to the economy, cf. Jordan, Thomas J., *How money is created by the central bank and the banking system*, speech held at the Zürcher Volkswirtschaftlichen Gesellschaft, Zurich, 16 January 2018.

The initiative's undeliverable promises

Financial stability

So, what benefits do the initiative's authors see in sovereign money? They want to separate the creation of money from the granting of loans because they believe this will enhance financial stability. To achieve this goal, they call for customers' sight deposits to be held in so-called sovereign money accounts as off-balance sheet items, just like securities custody accounts are today. This offers security in as far as this money is not at risk should the bank fail. However, barring the banking system from creating money is the wrong approach to take.

In financial crises, savers and investors lose money for two reasons: first and foremost, because their pension funds and direct investments such as stocks, bonds and real estate lose value, and also second, because taxpayer money has to be used to rescue banks. Financial crises occur when risks are underestimated and price expectations of investments are exaggerated. This can lead to credit and asset price bubbles which sooner or later burst. When banks do not hold enough equity capital to absorb the losses they incur, they fail.

Sovereign money would do nothing to change this situation. Risks can be underestimated and future returns overestimated in a sovereign money system too. Even without recourse to sight deposits, banks can grant loans which are too risky, hold too few provisions for times of crisis and become insolvent if a bubble bursts. Moreover, a key problem in the financial crisis was banks' heavy reliance on short-term financing from the money market. These interbank loans proved to be a less stable source of financing than private customers' sight deposits; in fact they dried up at the very start of the financial crisis in 2008. Sovereign money would not help to eliminate this risk of instability either.

There are other, far more effective approaches to stave off credit and asset price bubbles than sovereign money. The significant increase in the capital and liquidity requirements for banks in the aftermath of the financial crisis is one such approach. Macroprudential tools such as the countercyclical capital buffer are an additional means of strengthening our financial system. But a liberal economic system entirely devoid of crises is an illusion. To prevent crises altogether would ultimately mean to constrain the economy to such an extent that our prosperity would be significantly impaired in the longer term. However, it is possible to limit macroeconomic risks to an acceptable level using appropriate regulatory measures. This is where we have directed our efforts since the financial crisis and we are continuing to work closely on this with other parties at national and international level.

'Debt-free' payments to the Confederation, cantons or citizens

The initiative is likewise not able to deliver on its second promise to reduce the burden on citizens through 'debt-free' payments by the SNB to the Confederation, the cantons or the people. Although 'debt-free' payments seem attractive at first glance, they will not bring any financial benefit to the people in the long term, despite what the initiative's authors would have us believe. A sovereign money system will not turn the SNB into a cash cow.

Switzerland's prosperity is determined not by the way money is created but by the output the country generates.

What is meant by 'debt-free' payments? In the current system, the SNB creates money by purchasing foreign currency and investing it, or by granting banks loans. Every franc of central bank money which enters circulation in the economy in this way therefore has a countervalue that yields profit over time. The SNB takes stock at the end of each year and distributes part of these profits to the Confederation and the cantons. If the SNB had to pay out money 'debt-free', as called for by the initiative, it would be giving money away without receiving an equivalent amount in return. However, the SNB would not be able to earn income on the money it gives away. In a system with 'debt-free' payments, we would therefore be unable to make an annual distribution to the Confederation and the cantons.

It is important to recognise that economically speaking, the two approaches are ultimately equivalent. We can distribute the profits on our investments every year, or we can give newly created money away, but then no longer pay out any profits. In other words: Under established practice today we distribute the interest on our capital, while under a sovereign money system we would be selling off the family silver, as it were. 'Debt-free' payments would not make our country any richer.

The initiative's authors also suggest that, with the introduction of sovereign money, the SNB would be able to redirect the profits that banks currently earn from money creation to taxpayers. This idea is based on the assumption that, by creating money, banks are filling their own coffers. But, in reality it is all the banks' customers – private individuals as well as companies, savers and borrowers – who benefit from the creation of money by banks. Loan conditions are more favourable and the terms on sight deposits are better than they would be under a sovereign money system. Since banks have to compete with each other, they are left with only enough of the profits from money creation to enable them to remain in business.

In a sovereign money system, money creation would be centralised at the SNB, from where the corresponding profits would be distributed. But total profits would be no higher than under the current system. For the general population then, the whole thing would be, at best, a zero-sum game.

Damaging effects of sovereign money

The fact that the Swiss sovereign money initiative promises too much is only one issue. Even more serious is that adoption of the initiative would have profound implications for Switzerland on three levels, namely the real economy, monetary policy and economic order.

Real economy

The initiative would negatively impact the real economy through lending because banks would no longer be able to draw on sight deposits. Instead, they would have to attract liquidity from other sources. A key such source would be savings deposits. However, since savings – like any funds which investors forego for an extended period – are more expensive than sight deposits that can be withdrawn at any time, borrowing becomes more costly in a sovereign money system.

The Swiss sovereign money initiative affects us all directly, as borrowers and savers. Of the loans granted in Switzerland, 94% go to households and SMEs; 86% are mortgages. Equally, savers would be adversely affected. Their sight deposits in so-called sovereign money accounts would not earn interest and services would be more expensive, so they too would lose out.

Sovereign money would be like throwing grit in the gears of our credit system. Banks would not be able to react as flexibly to the demand for credit, and this would reduce consumption, investment and ultimately prosperity in our country.

Monetary policy

A sovereign money system would also complicate the implementation of our monetary policy. The ‘debt-free’ issuance of money is based on an outdated idea of managing money supply and fails to recognise the advantages of the modern implementation of monetary policy. The issuance of ‘debt-free’ money would technically correspond to monetary targeting and would therefore be like turning the clock back to the last century. The fact that all major central banks today practise interest rate targeting is no coincidence but is built on the pertinent experience of the last decades. Interest rate targeting is superior to monetary targeting and guarantees a flexible supply of liquidity to the economy, particularly during times of crisis.[2]

Furthermore, it is fundamentally unclear how the SNB could absorb liquidity in a sovereign money system if the money supply had previously needed to be significantly expanded. How can you reclaim money you have just given away?

Just how difficult that would be – and how far sovereign money would complicate our work – can be illustrated by taking the example of our monetary policy during the last financial crisis. Over a very short space of time, we created a vast amount of money; initially to ensure liquidity in the banking system, and thereafter to counter the massive upward pressure on the Swiss franc. This led to a significant expansion of our balance sheet. How would we have proceeded in a sovereign money system? We would probably not have reacted so decisively given the difficulty of reducing liquidity once it has been created in a sovereign money system, which can therefore lead to higher inflation further down the line. A weaker monetary policy reaction would have exacerbated the negative consequences of the crisis for the real economy.

Quite apart from that, it is doubtful whether we would even have been able, in a sovereign money system, to react as we did because the initiative limits the number of tools we would

---

[2] As regards the SNB’s shift from monetary targeting to interest rate targeting, cf. Meyer, Hans, *On monetary policy in the new year*, speech held at the University of St. Gallen, St. Gallen, 20 January 2000.

have available. Interventions in the foreign exchange market, which have played a central role in combating the overvaluation of the Swiss franc, would not actually be allowed under a sovereign money system. When we intervene in the foreign exchange market, we exchange new Swiss francs for foreign currency instead of giving them away. The creation of money in the context of foreign exchange market interventions is thus not 'debt-free'.

Economic order

Another problem is that the Swiss sovereign money initiative is etatist and imposes an unnecessary burden of responsibility on the SNB and disempowers the private sector. This does not fit in with the Swiss concept of the state and runs counter to proven principles of economic order. In order to achieve its aims, the initiative also does not shy away from providing for the possibility of general restrictions in economic freedom. This is clearly set out in the second sentence of the proposed article in the constitution.

Adoption of the initiative would impose additional tasks on the SNB. The SNB today has the clear and appropriate mandate to ensure price stability and has a large degree of flexibility in fulfilling it. Under the sovereign money system, the SNB would have to assume tasks which far exceed this mandate. The initiative imposes two additional tasks on the SNB: first, making 'debt-free' payments and, second, guaranteeing the supply of credit to the Swiss economy. The latter is problematic because it could lead to a conflict of interest between price stability and credit supply. Above all though, it means that the SNB would have to decide precisely who should receive the loans.

Yet, the SNB has no information advantage over banks, which make this decision today in a competitive environment, taking into account the local circumstances and needs of various industries. The new division of roles would therefore be inefficient and would turn the SNB into a central authority steering industrial policy. Just imagine companies in a particular industry, be it automotive suppliers, the textile industry or the hotel trade, struggling to obtain loans. How should the task to ensure credit supply be interpreted? Would the SNB have to step in where, under the current system, no loans would be granted? A centralised, state-controlled credit supply does not befit our federalist, business-friendly country and would jeopardise the Swiss success model.

The 'debt-free' payments to the Confederation, the cantons or the people are also fraught with problems from an economic order perspective because the SNB would then be directly involved in the debate on distribution issues. Who should get how much? Such decisions are a matter of fiscal not monetary policy. 'Debt-free' payments would politicise the SNB and would detract from our ability to perform our real task of ensuring price stability.

Conclusion

Ladies and gentlemen, the financial system has evolved steadily over the years since the Institute of Banking and Finance at the University of St. Gallen was established. The authors of the Swiss sovereign money initiative want to convince voters that a transition to sovereign money would just be another minor change to the system. This is misleading. Adoption of the initiative would represent a tectonic shift in our monetary and economic system, which has developed over a period of many years. Furthermore, the uncertainty in the transition phase would be enormous.

The initiative is aimed at ensuring financial stability. This is a noble goal and one which the SNB shares. But there are far better ways of achieving this than sovereign money. The initiative's goal of fully nationalising money creation is flawed and would hurt the Swiss economy as a whole. The idea of 'debt-free' payments is dangerous: The initiative would encumber the SNB with added responsibilities, which would inevitably expose it to a higher level of political influence. There is a high risk that this could lead to excessive inflation. The legal and institutional framework in which the SNB has hitherto operated has stood the test of time. It ensures a fair balance of independence and democratic control. Today the SNB is protected from political influence and this enables it to pursue an effective monetary policy in the interests of the country as a whole.

Given all these considerations, sovereign money is an unnecessary and dangerous experiment, which would inflict great damage on our country. Thank you for your attention.