Money in Switzerland

On 10 June, Swiss citizens will vote in a referendum on a radical reform of their monetary system. The proposal would mean that citizens would hold their accounts or deposits in the central bank, rather than in retail banks. For the proponents of the initiative, this paradigm shift would bring an end to credit bubbles, banking crises and public bailouts of the banking system.

The idea is not new and has precedents, such as the so-called Chicago Plan, a monetary reform whose main proponent was Henry Simons, professor at the University of Chicago during the Great Depression of the 20th century. That reform proposed the establishment of a requirement for retail banks to hold a 100% reserve on their deposits, which would mean the end of the so-called fractional-reserve banking and the separation of the two main functions performed by the banking sector: managing the payments system and issuing loans.

Similarly, the promoters of the Swiss referendum believe that its reform would allow the current system's alleged tendency to generate credit bubbles and excessive borrowing to be tackled at its roots. According to this train of thought, the fact that the banking system can use customers' on-demand deposits as a source of financing to issue credit makes borrowing too easy and cheap. It is also alleged that banks grant loans that are too risky because they trust that if things go wrong, the government will come to their rescue (what is referred to as moral hazard).

Certainly, the Swiss proposal would complicate access to credit and make it more expensive, but it seems an unnecessarily extreme way of achieving this objective. Not in vain, the national central banks in the current monetary system already have sufficient tools to influence the availability and cost of credit, if they consider it appropriate (for example, by setting the reference rates or reserve ratios).

As for the problem of moral hazard, it should be recalled that the main objective of the regulatory reforms of recent years has been precisely to prevent the use of public resources to resolve future bank crises (in addition to minimising the likelihood of them occurring). To this end, for example, the minimum capital requirements have been significantly increased, and rules have been introduced for the resolution of banks experiencing difficulties which force shareholders and creditors to absorb any potential losses.

The advocates of a change of system also argue that it would bring an end to bank runs, because no one would question the safety of deposits in the central bank. However, they seem to ignore the fact that with this system, banking credit would need to be financed with non-guaranteed term deposits and debt issues, sources which would be much more volatile than the current ones (especially when faced with the option of moving funds to an account in the central bank during periods of uncertainty). Lehman Brothers did not have any insured deposits, yet it was left without wholesale financing from one day to the next – a true bank run. Given these risks, the banks, which would bear more resemblance to investment banking institutions, would be required to either maintain very high levels of liquidity, which would further restrict the supply of credit, or to rely much more heavily on the provision of liquidity by the central bank, which would significantly increase the role of the monetary authority in the allocation of resources in the economy.

The Chicago Plan or its more recent replicas might have made sense at the time of the Great Depression. Today, however, as stated by the central bank of Switzerland in relation to the forthcoming referendum, it would be «an unnecessary experiment, a reform which would bring uncertainty and new risks, in addition to an increase in costs for banking customers».

Enric Fernández
Chief Economist
30 April 2018