

Zurich, 5 March 2018

Swiss sovereign money initiative (*Vollgeldinitiative*): frequently asked questions

General

Why has the SNB become involved in this political discussion in the first place?

- It is true that the SNB does not usually make pronouncements on political issues. However, it has decided to take a position on this matter as acceptance of the Swiss sovereign money initiative (*Vollgeldinitiative*) would fundamentally change the Switzerland's monetary system, create new tasks for the SNB and have a direct impact on its monetary policy.
- Generally speaking, the SNB bears a responsibility when it comes to political discussions that directly concern the monetary system and the fulfilment of the SNB's statutory mandate. In such cases, it acts on its duty to provide information to ensure that voters can make an informed decision.

Why is the SNB opposed to the initiative?

- The SNB shares the concerns expressed by the Federal Council in its dispatch on the initiative.
- The introduction of a sovereign money system would be an unnecessary experiment that would radically transform the Swiss financial system. The reform would lead to uncertainty and new risks, and would raise costs for bank customers.
- Moreover, a switch to sovereign money would entail moving away from the tried-and-tested distribution of tasks between the central bank and commercial banks. The initiative calls for the SNB to guarantee the supply of credit to the economy by financial service providers. Such a concentration of tasks would expose the SNB to political ambitions.

- The reform would entail constitutional changes with respect to monetary policy implementation that would make it more difficult for the SNB to fulfil its mandate.
- The initiative raises unrealistic expectations, particularly with regard to financial stability and profit derived from the note-issuing privilege ('seigniorage').
- The initiative would complicate the implementation of monetary policy. Under the current system, the SNB can raise interest rates if monetary policy has become too expansionary. Under a sovereign money system, however, it is unclear how a restrictive monetary policy (i.e. a reduction in the money supply) would be effected. The SNB would hardly be in a position to reclaim money from the Confederation, the cantons or the country's citizens.
- Finally, acceptance of the initiative would plunge the Swiss economy into a period of extreme uncertainty. Switzerland would have to switch to a financial system that has never been tested anywhere in the world. The initiative would weaken the international competitiveness of our country.

Monetary policy

The initiative would bestow more competencies on the SNB. Why is it unwilling to take on more responsibility?

- A central bank's mandate must be formulated realistically. The central bank also needs appropriate instruments to fulfil its mandate. In the case of the SNB, both of these conditions are met under the current system. The Swiss sovereign money initiative would, however, burden it with additional tasks as the economy's central steering body. This would jeopardise the fulfilment of the core element of the SNB's mandate – ensuring price stability.
- The initiative also raises high expectations, which the SNB would hardly be able to fulfil, in particular with regard to financial stability and seigniorage. This would be detrimental to the SNB's credibility, making the fulfilment of its mandate all the more difficult.

Would a sovereign money system make it easier or harder for the SNB to fulfil its mandate?

- Acceptance of the Swiss sovereign money initiative would make it more difficult for the SNB to fulfil its monetary policy mandate. Today, the SNB has a broad range of appropriate instruments at its disposal, which it can deploy flexibly as it sees fit.
- The initiative proposes that the entire money supply be steered centrally by the SNB – a reform that the initiative's backers believe will make the system easier to 'control'. Yet the SNB is very well able to steer the money supply under the current system. For example, the

monetary policy measures deployed over the past few years to ensure appropriate conditions have prevented Switzerland from suffering a credit crunch.

- A sovereign money system would result in a shift from interest rate targeting to monetary targeting. Interest rate targeting is, however, a key component of the monetary policy that the SNB has been pursuing since 2000. A return to monetary targeting would, from the SNB's point of view, be an unnecessary and regressive step.

Banking system and customers

Nowadays banks can create money by granting loans. Does the SNB believe banks should enjoy this privilege?

- It is correct that banks can create money (deposits) by granting loans, but not without constraints. When a bank provides a loan, it credits the amount in question to the borrower's account. The bank then has a claim on the assets side of its balance sheet and a liability (deposit) vis-à-vis the borrower on the liabilities side (balance sheet expansion). It is through this liability in the form of a deposit that money is created.
- An individual bank cannot use the granting of loans to ensure a lasting increase in the deposits it holds, since payment transactions lead to an outflow of these deposits. However, as these deposits are transferred to an account at another bank, they remain within the banking system.
- Banks' capacity to create money is already limited under the current system.
 - Loans are only granted in response to customer demand, and are dependent on economic developments and the profitability of investment projects. Banks therefore do not grant unlimited amounts of loans, since a higher lending volume goes hand in hand with greater risk, and this could jeopardise banks' profitability.
 - Through its interest rate policy, the SNB exerts considerable influence on aggregate lending and hence on the creation of deposits. A rise in interest rates leads to a drop in the demand for credit and thus the possibility of creating money. The reverse is true in the case of an interest rate cut.
 - Money creation by banks is also constrained by the regulatory framework, in particular capital and liquidity requirements.

What economic function do the banks' lending activities fulfil?

- A bank's balance sheet typically contains comparatively illiquid, long-term claims such as loans on the assets side and comparatively liquid, short-term liabilities such as sight deposits on the liabilities side. Savers want secure and readily available deposits, while investors need long-term loans to finance projects, which tend to be illiquid. The bank therefore

engages in liquidity and maturity transformation, mediating between the diverging requirements of savers and investors.

- The bank thus bears both credit risk and liquidity risk. Due to the large number of depositors and borrowers, these risks can be diversified. Moreover, banks have an advantage over individual savers in that they are better able to assess and monitor borrowers. This also opens up access to loans for parts of the economy that cannot raise funds on the capital market and would hardly be able to finance their projects without a bank, i.e. households and SMEs.
- Under the present system, banks charge higher interest on loans than they grant on deposits. But this is not synonymous with risk-free profits. The interest spread compensates banks for the credit and liquidity risks assumed, for services linked to customer deposits, and for the assessment and monitoring of borrowers.

Would the costs for bank customers be higher or lower under a sovereign money system?

- They would be higher – for two reasons. First, no interest would be paid on sovereign money accounts. However, the banks would have to continue providing services for payment transactions and would pass these costs on to their customers.
- Second, the credit supply would tighten and become more volatile, and thus more expensive. Mortgage interest paid by households would therefore rise.

Financial stability

The SNB has a legal mandate to contribute to the stability of the financial system. The initiative's backers claim that sovereign money would prevent bank failures and thus enhance financial stability. From this perspective, would sovereign money not be beneficial?

- If banks no longer had sight deposits available to finance lending, they would either grant fewer loans or look for other sources of finance, such as the interbank money market, that are less stable. And yet, bank financing via the interbank money market proved to be particularly vulnerable during the global financial crisis. Shadow banks could also play a bigger role in financing loans.
- The initiative does not solve key financial stability problems. Sovereign money would not eliminate banks' liquidity or solvency risks, nor would it resolve the 'too big to fail' issue. In this respect, capital requirements and other regulatory measures which have been taken since the financial crisis are more effective.

- A sovereign money system would not prevent credit cycles or asset bubbles in real estate and financial investments; while lending may reinforce such asset bubbles, it does not cause them. Asset bubbles and credit cycles are primarily caused by exaggerated price expectations and a propensity to underestimate risks.

Would sovereign money not prevent bank runs and thus strengthen financial stability?

- Under the current system, banks promise to convert customers' sight deposits (deposits at commercial banks) into central bank money at any time. However, the volume of customer deposits is in fact greater than the volume of banknotes and sight deposits that the banks hold at the SNB. This is not generally a problem because it is rare for all customers to withdraw money at the same time. Banks can therefore finance long-term loans via short-term sight deposits.
- A situation when all customers want to withdraw their money at the same time is called a bank run. The bank concerned may become illiquid even if it is solvent.
- Bank runs are extremely rare and the SNB can prevent them by lending illiquid banks additional central bank money.
- A sovereign money system could not eliminate all forms of bank run. Sovereign money could only prevent bank runs on sight deposits because all sight deposits would consist entirely of central bank money.
- Yet bank runs occur not just when customers convert their sight deposits into cash. They may also withdraw other short-term savings such as time deposits and savings deposits. Banks would be able to hold such short-term liabilities in the sovereign money system and could, for example, finance ten-year mortgages using savings deposits with a three-month notice period. If all or many customers were to close their savings accounts at the same time, the result would be similar to a conventional bank run.
- Runs on time and savings deposits could even become more frequent in a sovereign money system because they would occur more easily. While customers today have to convert their savings into cash in the event of a bank run, under a sovereign money system they would be able to shift it electronically at the click of a mouse into sight deposits backed by central bank money. Depending on risk sentiment, investors would reallocate their savings and time deposits into sight deposits and vice versa. This would make the demand for sovereign money and credit financing more volatile.

Seigniorage

Sovereign money means that seigniorage could be distributed in its entirety to the general public, i.e. the state and its citizens. What's wrong with that?

- Already in today's two-tier system, a large proportion of seigniorage is generated at the SNB. The SNB earns this seigniorage because, thanks to its note-issuing privilege, it can finance assets on highly favourable terms via banknotes in circulation and sight deposits, and these assets generate income. A large share of seigniorage is absorbed by the profit distribution to the Confederation and the cantons and therefore benefits the general public.
- The proponents of the initiative believe that the SNB could pay out an additional CHF 5–10 billion to the Confederation and the cantons. They argue that seigniorage under a sovereign money system would be based on a much larger amount of central bank money.
- However, it is difficult to estimate how much public demand there would be for sovereign money and therefore how much central bank money there would be. Since it involves a fundamental change in the system, it cannot be assumed that customers would hold all their existing sight deposits at commercial banks as sovereign money, particularly if it earns no interest.
- Moreover, the SNB's profit opportunities would diminish. The SNB currently earns income on its assets and passes this on to the Confederation and the cantons through its distributions. Since a growing economy demands more money, under the current system both the cash liability item (specifically sight deposits held by banks and banknotes in circulation) and asset items (foreign currency investments or repo balances) at the SNB increase over time.
- If the SNB were to put money into circulation 'debt-free', that is without purchasing foreign exchange or increasing liquidity via repo operations, the cash liability item would grow and the equity liability item shrink – and ultimately turn negative at some point. Assets would no longer increase, thus compromising the ability of the SNB to make a profit.