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Why do central banks (and money) rule the roost?

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A possible world after the “ICT revolution”

- E-money is issued by non-banking firms.
- Factors of production are directly remunerated in e-money. Third parties are willing to accept balances on the non-bank firm’s books in payment for the firm that issues e-money.
- There is no need for the issuing firm to have bank balances to back up its corresponding liability in full.
- Both the demand for currency and the demand for reserves decline drastically.

Why do central banks “rule the roost”

- Even if the demand for reserves vanishes altogether, central banks would still be able to implement monetary policy.
- Central banks can directly fix an interest rate on their liability, and consequently affect all the other rates without having to change the supply of reserves.
- Central banks can operate in this way because their liability is the economy’s standard of value.

Why does money "rule the roost"

- Kaldor's position, in the 1930's debate on the essential properties of money, relates to the current discussion.
- Kaldor argued that money "rules the roost" because it is the economy's standard of value, not for other special properties.
- Also for Kaldor the dominant interest rate is ultimately determined by the central bank, which fixes the short-term rate.

The displacement of conventional money

- If money as a standard of value were displaced by another new standard, it would cease to “rule the roost”. If the new instrument were not issued by central banks, the latter would lose their ability to implement monetary policy.
- Such a displacement meets significant obstacles. These obstacles derive from externalities and network effects that characterize money both as a medium of exchange and as unit of account.
- There is inertia due to possibly high switching costs from one instrument to another.
- There is a coordination problem. A new instrument can be more efficient than the old if adopted by a large number of agents, but no single agent knows when and if the others are going to switch to the new instrument, so that the probability of its adoption is low.
- These obstacles are stronger in the case of switching from one unit of account to another.

Money as a social relation

- If the traditional Mengerian theory of money is abandoned and money is regarded as the outcome of a complex social and economic process, it is problematic to hold that it can be displaced merely by technological innovations or by agents' "spontaneous" choices.
- Although it is conceivable that innovations produce new media of exchange (like e-money and the like), which markets spontaneously adopt, it is more difficult, if not impossible, to hold that the displacement of money as the standard of value can take place in the same spontaneous way.

Central banks as a social and historical relation

- Similar considerations can be made for central banks. Their existence and importance cannot be explained simply as the result of spontaneous market processes, but as the result of complex historical and social processes. Therefore, in the same way, their demise cannot be seen as the outcome of technological changes.
- From a technological point of view, private banks might become able to make settlements among themselves without involving the central bank. A private bank could be the settlement agent, but it would not be risk-free; the other banks would be uncomfortable about its competitive advantages.
- Banks could settle payments by transferring risk-free instruments like treasury bills. But there would be no lender of last resort in case of shortfalls, so that banks should hold large amounts of bills to guarantee that they can meet their obligations.

The central banks’ response

- Central banks do not “sit back” and watch passively the spontaneous evolution of markets. They take, or can take, measures to control their evolution of markets.
- Central banks, with the help of governments, can introduce new regulations, or adjust those already existing, to face the new situation. For example:
  - The use of conventional money can be made compulsory for certain classes of transactions.
  - It can be imposed that only ordinary banks can issue e-money.

Conclusion

- To lay emphasis on money as the standard of value and that central banks can implement effective monetary policy in so far as their liability is the economy's standard puts the discussion of the possibility of the demise of money and central banks in a more general perspective.
- Money essentially is a social relation and, as such, is characterized by features that make its displacement at least unlikely. The existence of externalities and network effects implies that the displacement of money by new instruments cannot take place through spontaneous processes, like the emerging of electronic media of exchange or other ICT-related innovations.
- The demise of money and central banks requires more than technological change and agents' decisions based on individual criteria of convenience.
- Money "as we know it" can be replaced by new instruments if a government decrees that this must happen. But why should governments and central banks promote or even accept passively processes that mean renouncing an important element of their power?