Post-Modern Criticism of Monetary System and Financial Institutions

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Abstract

Monetary System represents a synonym for modern economic era and its functionality. In order to maintain economic stability it is important to keep major segments of monetary system in balance. Throughout analysis we will first emphasise on nature of money and basic characteristics of it by observing its impact on human nature to reach focal points that could negatively affect monetary system. Since world is reaching toward one unique economic space we must observe it as compact unity in order to react on time to all negative impact that could potentially destabilize international monetary system. Crucial part of the analysis will be based on uncontrolled creation of debt which represents major factor that creates instability on the global and intra-country scale. Since the debt is mostly created throughout generally implemented fractional reserve system we will try to indicate how money multiplier contributes toward debt creation and how it changes over time. Also institutions like IMF and World Bank contribute to excess debt creation by formally providing loans to counties in development that eventually sink into deeper crises. One of the most fragile segments of

monetary system is foreign exchange market whose general purpose is often misused by governments' manipulations that have tendency to provide current economic prosperity for their countries but as the final result provides global economic crises. The role of central banks is crucial in this process and we will see how it contributes to overall activities.

Keywords: Monetary System; Money; Debt, Fractional Reserve Banking; Legal Tender Laws; Money Multiplier; International Monetary Fund (IMF); Foreign Exchange Market; Purchasing Power Parity; Central Bank.

1. INTRODUCTION

Taking into consideration current position of monetary system, it has become obvious that certain aspects do not function properly with respect to conditions that provide economic stability on global scale. Due to the sophisticated nature of monetary system and financial institutions we will not be able to analyse all vulnerable aspects. As name of the paper says post modernistic approach will be applied in order to reach crucial points that destabilise system and cause temporary crises. Importance of intra-country economies should not be neglected during the analysis because of its micro economic influence that individually constitute overall picture.

Creation of new money in the information age could become one of the major issues in the upcoming period (Huber and Robertson, 2009). This creative approach by these two authors and their perception of new monetary turmoil could be useful for the analytic process and new predictions that might occur in the monetary system.

Problem of debt creation represents one of the major disadvantages that was not substantially emphasised in the past. In the last two decades we may consider International Monetary Fund (IMF) and World Bank as major causes for enlargement of external debt in most countries. Although the system looks helpful at first sight, it actually generates long term debt and produces negative consequences for the debtor. Influence of money multiplier in current monetary system, imposed by central bank is regarded as major priority and susceptible matter.

Another important segment that has ability to destabilise monetary system is unlimited and uncontrolled foreign currency exchange. It basically acts throughout inflationary changes that do not leave intra-country economy unharmed. Central Banks have tendency to manipulate system in order to prevent balance of payment and to gain competitive advantage over others. This approach generally causes instability of foreign exchange market. On the other side it may not be of crucial importance but it is one of the most common factors that cerate monetary instability on the global scale.

2. MONEY

2.1 Nature of Money

Maybe the most significant issue when discussing about monetary system is the attitude of people toward it. In order to understand systematization of the monetary process and obstacles that it meets we need to recognize psychological nature of money and general perception of the population. Taking into consideration that we live in technological age when information is highly available and people are vastly eager to participate in legislation processes, because they understand its impact on everyday life activities. Monetary system is nothing else but immanent factor that influences intra-country economies and determines future of the long term political stability.

There are many factors that influence human will when it comes to handling of money. Monetary policies created by central banks or retail banks directly participate in the decision process. Lower interest rate provides direct motivation for loans which could eventually improve wellbeing of the citizens. Importance of understanding human behaviour is equally important as monetary changes since the impact is visible on living standards. Since desire for money is not innate, but it is caused by socio-economic standards that exist over time people have developed certain addiction. Money in some opinions affect as perceptual drug which produces same psychological effect as any other psychoactive substance (Lea and Webley 2005).

In the modern era money is observed as social resource and necessity for major surviving activities. Purchasing power that money possesses enables us to fulfil desires and goals which consist of materialistic nature. All type of merchandise must be expressed within some monetary parameters, regardless of its value that will enter individual or production spending (Marx, 1890). This brings us to the point where we need to take serious dialectical approach to money. Since the monetary system sets the standards within which money is to be used and operated with, must be observe simultaneously with caution. In its essence money represents foundation of every modern society and if those foundations are not precisely adjusted throughout monetary system the society will collapse from inside.

2.2 Creating New Money*

In this part we will debate on new monetary system and all possible changes necessary in order to create long term stability in the economic sector. Most of propositions are derived from the book of Joseph Huber and James Robertson ¨Creating New Money: A Monetary Reform for the Information Age¨ (Hubert and Robertson, 2009). Analysis is based on the potential reformation with respect to new standards that constitute modern information age. Since most of money in the modern era is created by banks throughout fractional reserve system such propositions seem logical. Second step is based on governments urge to spend potential money and to put it into circulation. Many academics have different opinion on this issue. Some of them consider that money should be channelled through specific public spending programs. Others think that money should be used to pay national debt. Third and most interesting suggestion is for governments to put money into circulation as interest free loans. This way government could directly help itself and also facilitate tax payers' obligation for government expenditures. Another author that proposed reform of monetary system was Ludwig von Mises. In his work he also supported idea that all future bank notes must completely be covered in gold (Mises, 1928). His reform was also related to commercial banks and various changes that need to be implemented from limitation of fiduciary media up to regulation over the banks cash balance in order to stabilize monetary system.

* Following analysis is based on the book ¨Creating New Money: A Monetary Reform for the Information Age¨ by Joseph Huber and James Robertson with the addition of authors' propositions and criticism.

3. UNCONTROLED CREATION OF DEBT

3.1 Factors of Debt Creation

Post modern period created many unpredictable situations whose effects constantly destabilise international monetary system. Throughout intense globalization processes monetary system did not stayed unharmed. Governments have daily issues that concern misjudgement and predictions of the future monetary reforms. It has become obvious that system as it is can maintain its functionality but it is a matter up to when since the world is slowly recovering from the crises and harmful impact on global economy. Whether banking can preserve its stability is an unquestionable, but major issue concerns intra-country economies since it is not desirable for many undeveloped countries to fall within global corporations that enjoy affection of banking sector. In many cases global economy does not favour corporations whose tendency toward profit is unstoppable.

On the other hand we should focus on crucial issues within monetary system and try to find key defects and shortages. One of those issues is regarded of fractional reserve banking.

Since the beginning of the previous century world has entered new era of consumerism. From one perspective consumption was blossoming while on the other side debt was accumulating. However paradoxical this sounds it represents current situation we are living in. Daily consumption of each household increases which is a positive sign, but overall debt per individual also increases. This date are standardised and well known to all government officials. The only question is how long such system will last till it entirely collapses.

3.2 Fractional Reserve Banking

Since the introduction of the modern banking system fractional reserve approach was introduced. It has a long tradition and also hazardous nature that through time proved to be instable and harmful for the economy. Although bankers lobby still enjoys all benefits of this system it is obvious that whole planet is over debt and this bubble could implode soon. As I have already said consequences would be disastrous and economy could hardly recover. Politics promoted by hegemony forces like U.S and U.K favours fractional reserve banking since those international corporations that represent those two countries usually gain greatest benefits. There have been few attempts to justify fractional reserve banking which can be placed in two distinct groups. First group is based on principle that equates irregular deposit contracts with the loan contract. Second doctrine was based on the ground of new legal concept of availability which states that bankers should carry out their investments responsibly in accordance with regulations and legislatives (Soto, 2009). These two approaches do not look convincing and they lack scientific base for proving statements. Especially first group of doctrines that equates irregular deposit contracts with loan contract. In any case depository contracts are characterised by lower interest rates which is logical because of business cycle that characterises the process. Problem is not in the fact that banks provide loans with higher interest but in the fractional reserve nature. Banks decrease their reserves which disables depositors of taking their funds from the bank at will. Furthermore bank borrows money that do not own but beside that also create new additional money from imaginary base. In most cases bankers behave according to law since the regulations are set to support their operations.

3.3 Influence of Money Multiplier

The system operates in a way that central bank prints additional amounts of money which is infiltrated into the process of further multiplying. Since the banks cooperate with central bank in coherence money is printed in accordance to the directions that follow banks operations and needs. In order to infiltrate new money into the market central banks simply purchase additional assets. Reserve rate held by the banks are determined by the central bank rules and legislatives in cooperation with government. When new money is printed it instantly increases banks potential deposits that they can further lend by again increasing money supply. According to the studies in United States each additional dollar created by the Fed will generate new $8.5 with respect to M2 money supply (Johnson, 2010). M2 money supply is crucial indicator when evaluating amount of money in the market and inflation. It includes checking accounts, currency, saving accounts, retail money market funds and time deposits.

In the economic terminology money multiplier is denoted with (m). It shows simple variation and change in money supply (M) compared to the change in monetary base (MB).

$$M = m * MB$$

Money multiplier expresses the value of the monetary base that was increased in the money supply. In this post-modern monetary system money multiplier is always higher than 1 which also is directly correlated with increase in inflation. Since the banks operate under fractional reserve system money multiplier is one of the crucial variables that affect monetary system.

When evaluating money multiplier it is important to include variety of factors. Few of the main variables are reserve ratio (r), currency in circulation (C), checkable deposits (D) and excess reserves (ER). During the analysis it would be enough to posses these numbers that are usually presented in the central banks report in order to calculate currency ratio (c) and excess reserve ratio (e) to be able to calculate simple money multiplier.

$$c = \frac{C}{D} \qquad e = \frac{ER}{D}$$

After calculating excess reserves and currency ratio we will be able to calculate simple money multiplier. We call it simple because in this equation only M1 (money supply) is used because it gives us easier approach for explanation of it functionality unlike M2 where we would need to take into consideration retail money market funds and time deposits.

$$m = \frac{1 + c}{r + e + c}$$

3.4 Foreign Exchange Market

Foreign exchange market represents one of the most volatile segments of international monetary system. Due to its nature and characteristics fluctuations in exchange rates directly influence intra-country economy. Exchange rate is an expression of one currency price in terms of other (Mishkin, 2010).

$$e = \frac{\text{domestic currency}}{\text{foreign exchange}}$$

Since level of trading has reached its peak on the international scale especially in the last few years, issue of foreign exchange market became more important for stability of international economy. Foreign exchange market enjoys certain kind of autonomy since it is completely decentralised and independent of most government regulations. Unlike stock exchange where all dealers are gathered at one place foreign exchange market functions on the principle of few hundred banks that trade among themselves. It is another characteristic that result in new doubts regarding the functionality of the system. We can differentiate two major types of exchange rate transactions. Spot transactions are most common type of exchange rate transactions and it is based on immediate exchange of banks deposits. On the other side we have forward transactions where transactions of bank deposits occur in the future (Mishkin, 2010). Forward transactions are unpredictable due to intensive fluctuations among exchange rates which can cause high gains or losses for one of the participants. Trading parties use forward premium that show approximate measurement of market expectations in the future. In its core it is a difference between spot price and future forward price.

$$f_m = \frac{F_{m-e}}{e}$$

Fm is the forward exchange rate while e represents number of days from the starting point. If $f_m > 0$ it means that more primer currency will be necessary to purchase foreign exchange e days from now than today (Ickes, 2006).

4. CONCLUSION

Through analysis we have seen that international monetary system is extremely fragile ad that change in any particular segment can destabilize overall economic wellbeing. Money itself has certain impact on human behaviour that can be manipulated with different means. Stability of monetary system also depends on attitude of general population toward banking sector. Fractional reserve system is one of the most prominent segments whose functionality is questionable. We have seen that fractional reserve system does promote uncontrolled creation of debt that generally is not favourable for stable economic environment. Money multiplier as one of the most important measurements of money supply proved to be inefficient and unreliable. Foreign exchange market as most autonomous segment of monetary system constantly suffers of manipulations enforced by governments that tend to promote economic efficiency. In order to maintain global stability it is important to introduce new independent institutions that have capabilities to monitor and control monetary behaviour of developed countries whose currencies are widespread.

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