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Why monetary system failed and How to restructure it

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Abstract

Present monetary system is based on fallacies. The purpose of this article is to highlight the pitfalls in economic thinking. The article shows that this way of thinking leads to the creation of inflation which is the root of all evil. The analysis proceeds in different approach to the contemporary theory of money. An inflation- free monetary system is introduced. Monetary system is the set of mechanisms that controls money. In this broad sense, monetary system can be divided into three different systems. Each of them has different goal; National monetary system which aims to raise sufficient funds in order to reach an optimal level of output growth that maintains full employment and satisfies the economic requirements of the community. National redistribution system which aims to redistribute funds in order to sustain individuals at or above a specified material standard of living, and enable government to provide public services. International monetary system which aims to preserve rights of parties in foreign exchange transactions.

Keywords: Monetary System, Foreign Exchange Transactions, Controls Money.

1. National Monetary System

At the age of the gold standard, money was convertible into gold, and value of the currency unit was derived from its backing material. Since the gold standard collapsed, countries had switched to full fiat money. Fiat money is state-issued money made of paper or metal of negligible cost. It is not convertible into gold. Instead, it is declared by governments to be legal tender.

In spite of the fact that present money is no longer a commodity or fully backed, directly or indirectly, by gold, money is still regarded by economists and politicians as a valued commodity. This way of thinking leads to destructive consequences.

Since the currency unit, as a commodity, gets different values during circulation, present money does not fulfill its functions as a measure and as a store of value. The currency unit does not act as a standard unit that reflects the real value of products. Money does not protect the right of its holder to obtain products of future value equals the value of the products he might acquire when he received or lent the money.

Based on viewing money as a commodity, raising funds is regarded as a process of buying money for payment to be made on spot or on credit. Payment is made on spot through retention of currency backing. Payment is made on credit through borrowing.

Currency backing involves hoarding resources that could have been invested in productive activities. Since most of money in circulation represents un-backed money issued by banks through activation of the money creation process, retention of currency backing becomes questionable.

Availability of money becomes dependent upon borrowing. Governments issue treasury bills in order to print fiat money. They borrow money from rich countries or giant financial institutions. Banks borrow money from depositors. Public and private corporations including banks borrow money through financial markets. Speculative activities are encouraged. Taxes are levied in order to settle interest on public debt and to cover cost of financial corruption.

Interests or financing charges, speculative earnings, and gains from corruption represent income from financial activities that do not directly contribute to production. More funds are raised to pay off income from financial activities. Since the supply of money in circulation expands abnormally in relation to the available supply of goods and services, the purchasing power of the currency unit declines causing inflation.

Business owners raise rate of inflation. In order to stabilize their rate of net after-tax profit, business owners consider the financial impacts of inflation as part of the cost of their products. Their payments of financing charges, cost of corruption, taxes on products, income tax, and speculative increase in prices are added directly or indirectly to the real cost of factors of production. The higher cost is the higher amount of profit. Assume profit rate is 20%, and the real cost of a product is 100 monetary units, the profit will be 20 monetary units. If cost of the product becomes 180 monetary units due to inflation, the profit will be 36 monetary units. The difference of 16 monetary units represents inflationary profit.

Inflation is a human-made phenomenon. It is the root of all evil. It is the main cause of concentration of wealth. Poor becomes poorer. Living standard of middle class declines. Those living on fixed incomes suffer a severe decline in their living standard. Living standard of rich rises. Rich generate profits from appreciation of their assets, and business owners stand to gain from inflation.

Inflation causes economic instability. Prices soar. Workers have less money to consume. Demand falls because each monetary unit buys fewer goods and services. Exports become more expensive to sell. Imports increase because they are relatively cheaper than locally produced products. Pressure for increased wages mounts to keep up with consumer prices. Unemployment rate rises as a result of the decline in output growth rate.

Inflation is responsible for financial crises and for the deterioration of the confidence in the currency. For instance, inflation is the main cause of the Wall Street Crash of 1929, the 2008 US Mortgage Crisis, the 1997 Asian Financial Crisis, 1998 Russian Financial Crisis, and the Latin American Debt Crisis. Money of innocent people is used in order to bail financial systems out.

Since output growth and inflation are conflicting, present monetary and fiscal policies are directed toward controlling quantity of money in order to prevent the probable ghastly impacts of accelerated inflation.

In summary, viewing present money as a commodity is a major pitfall in economic thinking because it leads to the creation of inflation. Present national monetary system is based on viewing money as a valued commodity.

Presentation of an alternative national monetary system

A sound national monetary system must be based on the fact that present money is anything that is generally accepted as payment for goods and services and repayment of debts. It is not a commodity. It is just a valueless medium of exchange.

For money to be acceptable by the community, as a medium of exchange, money must be recognized to be valid for meeting financial obligations, exchangeable for any other commodity, and fully backed by valuable things.

In practice, these conditions are satisfied. On the one hand, declaration of issued fiat money as legal tender and the confidence in the banking system ensure the validity of money for repayment of debts and the exchangeability of money for products. On the other hand, national output valued at national monetary units is the real currency backing.

The main objective of a sound national monetary system is to raise funds that are enough to realize the target output growth without producing inflation.

Since inflation is the result of the increase of quantity of money over quantity needed for output growth, funds can be freely raised if money supply is growing at the same rapid that is justified by the growth of national output. Accordingly, monetary policy should be directed toward raising sufficient funds in order to reach an optimal output growth without inflation. Instead of controlling **quantity of money**, discarding inflation requires controlling movement of money to restrict the use of money in productive activities.

Looseness of present monetary system cannot help controlling movement of money. Funds are raised by the monetary authority and all banks. Money is available in form of banknotes, coins and deposits in different banks. It circulates in hands of individuals, public entities, private entities, and the government. Part of money is hoarded, and another part is invested abroad. Money is used in productive activities as well as in inflationary financial activities. Effective control of movement of money requires transformation into a closed monetary system.

According to the closed monetary system, funds are raised and money is circulated within the governmental monetary authority (MA). Cash money in local currency is recalled for cancellation. Cash money and banking deposits are retained by MA in unrestricted interest-free current deposit accounts in the name of the money owners. All payments are made by transfers between the accounts within MA. Available banking instruments can be used for withdrawals including electronic transfers and debit cards. The role of banks is limited to finance productive activities

MA exclusively provides all banking services in local and foreign currencies, issues prepaid smart cards to be used by consumers for paying sundry expenses, and raises funds to finance real productive activities through banks.

Under the supervision of MA, a bank acts as an intermediary to study financing needs, manage and control the use of funds provided by MA. All receipts and payments are made by transfers between the accounts within MA.

A bank invests money in local currency in private and public productive projects, or trading deals, alone or with other partner or partners. A partner may be a consumer or a member of private or public sector, and his investment in the project may take the form of tangible or intangible assets. A bank may take collaterals from the partner to cover any future misconduct.

A Current Capital Finance contract translates the relationship between the bank, the partners, and MA. It shows the initial capital of the project, the minimum capital share which should be maintained by every partner. MA is a partner liable to cover the shortage in the cash flow of the project. The contract also shows the profit share of each party in return for his efforts or work. Net profit, or loss, is distributed in proportion to the total daily invested capital.

2. National Redistribution System

Money received by members of the society in both private and public sectors represents the national income. The necessity of redistribution system arises from the shortage of some incomes. Incomes of some individuals are not sufficient to cover their cost of living. Income of government may not be sufficient to cover cost of public services.

A government is liable to keep up all members of society at or above a specified material standard of living. Taxation is regarded by economists as the tool for redistribution of income among the members of the community.

A government is also liable to serve all members of the community. Public services have to be paid for. Public revenue mainly includes proceeds from sales of services that can be charged to the beneficiaries and net profit from public investments. In most countries, public expenditure exceeds public revenue. In order to cover the deficit in government's budget, a country borrows money and/ or imposes taxes.

Socialism failed to realize its objective of equality through public ownership of the factors of production. Capitalism and what so called Islamic system failed to narrow the income gap through applying social security programs, providing free or below cost public services, and granting public assistances such as unemployment compensation, housing, and food stamps.

Presentation of an alternative redistribution system

A financial security system is introduced to replace both present public finance system and redistribution system. It is based on a principle of "Nothing for free". Rich have the need and interest to maintain social stability in order to continuously acquire contributions of others in building the society. In return, they have to recognize the right of others to be compensated by them for the natural differential in personal capacities. Every individual receives public services. In return, he is liable to pay for his share in the deficit of government's budget.

According to the financial security system, a wealth duty is levied on those whose incomes exceed the standard cost of living in order to cover the deficit in the incomes of those whose incomes are less than the standard cost of living. Unlike taxes, wealth duty is not public revenue. A government collects wealth duty from those who have to pay it and distributes it to those who deserve it.

The deficit of government budget is distributed evenly among individuals. It is charged to all members of the society.

The appendix on last page translates the accounting effect of both national monetary system and redistribution system. It shows that all movements of money including raising funds become through deposits with MA.

3. International Monetary System

For money to be acceptable as a medium of exchange in international trade and transactions, it must be fully backed by a universally accepted commodity. Historically, Gold is the universally accepted commodity.

During the age of the gold standard, the British pound sterling was the universal reserve currency. After World War II, the US dollar was given this status by international treaty according to which the Fed was committed to hold enough gold to honor all its outstanding currency in gold at $35 per ounce. In 1971, the Fed abrogated its responsibilities to honor dollar for gold entirely.

Nowadays, the Fed has been inflating the dollar massively, reducing its purchasing power, and causing other countries to hold other currencies as reserves. At the absence of international monetary system, retaining reserves in currency of another country or in form of a basket of currencies of other countries involves currency and country risks.

The international monetary system failed because it was based on unreal commitment. No one can fix **price** of gold because gold is naturally a commodity with variable market price.

Presentation of an alternative international monetary system

A sound international monetary system must be based on the fact that is price of gold is unstable and no one country can hold responsibility to continue honors its currency for gold at fixed price.

A new independent universal currency can be considered for international trade and transactions. Price of each unit of the universal currency is set to be equal to a certain **quantity** of gold. Unlike domestic money which is a medium of exchange fully backed by national output, universal money is a medium of exchange fully backed by gold.

The universal currency can be issued by an independent universal bank. The universal bank sells universal money to central banks in exchange for the appropriate quantity of gold. Delivery of universal money can be made in form of banknotes or credited to the interest-free unrestricted current account of the central bank with the universal bank. It is the responsibility of the universal bank to honor universal money for the appropriate quantity of gold. For the universal bank, price of gold is irrelevant.

Value of the universal currency is dependent upon the market value of gold. A country may fix the exchange rate of its currency against the universal currency, or consider the floating exchange rate against the universal currency.

At present, it may be difficult to implement the system on universal scale, but it can be adopted by a group of countries or on regional scale.

It is the responsibility of the government to control foreign exchange transactions in order to retain its balance of payment and balance of trade in good shape.

Advantages of the alternative monetary system

In addition to getting rid of inflation and its devastating consequences, the alternative monetary system has many advantages. The target of optimal output growth can be reached. Issuance of money, borrowing money, taxation, and retention of currency backing will be avoided. Stealing, smuggling and hoarding of money will be discarded. The purchasing power of domestic currency will reflect real prices of products. Rights of money holders will be protected. Foreign currency risk will be eliminated. Savers will shift back toward the direct investments in productive activities. Profits of the monetary authority from finance through banks will add new source of public revenue. Since all receipts and payments are made through the monetary authority, the system will provide an effective tool that can be used to combat financial corruption, prevent tax evasion and eliminate procrastination in paying debts.

4. Conclusion

The alternative monetary system benefits all people, but it is not in favor of corruptors and will be confronted by those who dominate both productive and financial markets.

The views expressed here are undoubtedly drastically different from the views of other researchers. However, financial distress is increasing and people will, sooner or later, realize the truth and make concert efforts to gradually embrace an alternative monetary system that would reflect fair economy, and advance the needs of humanity as a whole.

Appendix

Accounting Entries in Monetary Authority Books

Details	Debit Account	Credit Account
Recall Cash for Cancellation		
Receipt of cash		
	Currency issued	Deposits- Depositor
Recall Banking Deposits		
Receipt of Banking deposits		
	Deposits – Bank …	Deposits- Depositor
Collecting Present Banking credits		
	Deposits - Debtor	Deposits – Bank …
Withdrawals of Depositors		
Withdrawals - Transfers		
	Deposits – From depositor	Deposits – To depositor
Issuance of Smart Cards		
	Deposits - Card Holder	Deposits – Holders of cards
Payments by Smart Cards		
	Deposits – Holders of cards	Deposits – Seller
Investments through Banks		
Receipt of partner's capital		
	Deposits - Partner	Project 1 – Bank (A)
Payments for material		
	Project 1 – Bank (A)	
		Deposits – Seller
Payments for labor		

	Project 1 – Bank (A)	Deposits – Worker
Receipt Project revenue		
	Deposits – Payer	Project 1 – Bank (A)
Refund of partner's capital		
	Project 1 – Bank (A)	Deposits – Partner
Distribution - Profit for work		
	Project 1 – Bank (A)	
		Deposits – Partner
		Deposits – Bank (A)
		Profit & Loss Account
Distribution – Profit for capital		
	Project 1 – Bank (A)	
		Deposits – Partner
		Profit & Loss Account
Distribution – Loss		
	Deposits – Partner	
	Profit & Loss Account	
		Project 1 – Bank (A)
Wealth Duty		
Charge Wealth duty		
	Deposits - payer	Wealth duty
Distribute Wealth duty		
	Wealth duty	Deposits – receiver
Transfer profits from investment		
	Profit & Loss Account	Deposits – public treasury
Charge of deficit in Gov. Budget		
	Deposits - Depositors	Deposits – public treasury