Jens Weidmann: Money creation and responsibility

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the 18th colloquium of the Institute for Bank-Historical Research (IBF), Frankfurt, 18 September 2012.

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1. Welcome

Dear

Dr Reckers

Prof Hüttl

Prof Binswanger

Ladies and gentlemen

I am delighted to be able to welcome you today to the Deutsche Bundesbank's Regional Office in Hessen. The high number of participants shows that the Institute for Bank-Historical Research has found a very attractive topic for the colloquium.

The caption for today's event is "Paper money – Public finances – Inflation. Did Goethe hit upon a core problem of monetary policy?"

I could now answer this question posed in the title with a clear yes. Indeed, Goethe already analysed the core problem of today's monetary policy based on paper money around 180 years ago, recording it in literature in inimitable fashion.

I would like to keep things short, but in order to do justice to the occasion and topic I do not want to leave it at a simple yes, but elaborate on the issues of today's colloquium.

2. Money and money creation

I wish to begin with a question which appears trivial at first glance but which, as experience has shown, is particularly difficult. What is money exactly? A succinct response from an economist would be: Money is what money does.

As money is defined by its functions, various instruments are fundamentally capable of acting as money, as long as they can be used as a medium of exchange, medium of payment and store of value.

Shells were previously used as money in some countries, for example, as were furs, salt or pearls. Livestock could also serve as money – the Latin word for cattle is "pecus" from which the word "pecunia", meaning money, is derived.

Concrete objects have served as money for most of human history; we may therefore speak of commodity money. A great deal of trust was placed in particular in precious and rare metals – gold first and foremost – due to their assumed intrinsic value.

In its function as a medium of exchange, medium of payment and store of value, gold is thus, in a sense, a timeless classic." To gold they tend, on gold depend, all things!", says Margaret in the First Part of Goethe's Faust.

However, the money that we carry around in the form of banknotes and coins no longer has anything to do with commodity money. Money has no longer been linked to gold reserves since the US dollar was removed from the gold standard in 1971.

In short: today's money is no longer backed by any real assets. Banknotes are printed paper – and the experts amongst you know that the euro is printed on paper made of cotton – coins are minted metal.

That banknotes and coins are accepted as a medium of payment in our daily lives also has to do with the fact that they are the only legal tender. However, ultimately the acceptance of banknotes is based on public confidence that it can use this paper money to make purchases.

In this sense, money is a social convention – it has no intrinsic value which comes before its use; instead, its value is created by its constant exchange and use as money. By the way, this recognition that trust is central, or even constitutive, for the properties of money is very old; it was already discussed in the 4th century BC by Aristotle in his Politics and Nicomachean Ethics.

In recent times, in particular, many citizens are asking about the origin of money: where do the central banks actually acquire the huge amounts of money that they need to give billions in loans to the banking system as part of monetary policy operations or to make other purchases? Why it is often repeated in this context that central banks have virtually unlimited firepower?

Central banks create money by granting commercial banks credit against collateral or by buying assets such as bonds. The financial power of a central bank is unlimited in principle; it does not have to acquire beforehand the money it lends or uses for payments, but can basically create it out of thin air.

The printing of money is an appropriate image here; from an economic perspective, the printing press is not necessary, as the creation of money primarily shows up on the central bank's balance sheet, on its accounts.

How does Johann Wolfgang von Goethe enter the equation when talking about the creation of money. Why have I widened the discussion further?

3. Money creation, Goethe, Faust and alchemy

Let me remind you briefly of the "money creation" scene in Act One of the Second Part of Faust. Mephistopheles, disguised as a fool, talks to the Emperor, who is in severe financial distress, and says

> "*In this world, what isn't lacking, somewhere, though? Sometimes it's this, or that: here's what's missing's gold*"-

The Emperor finally responds to Mephistopheles' subtle attempt to persuade him,

> "*I'm tired of the eternal 'if and when': We're short of gold, well fine, so fetch some then*"

To which Mephistopheles replies

> *"I'll fetch what you wish, and I'll fetch more"*

In the commotion of the nocturnal masquerade ball, he persuades the Emperor to sign a document – a document which Mephistopheles has reproduced over night and then distributed as paper money.

Those involved are quite taken by the initial success of this measure. The Chancellor is delighted to announce

> "*See and hear the scroll, heavy with destiny,* – (referring to the paper money that has been created) – *that's changed to happiness our misery"*

He reads, *"To whom it concerns, may you all know, This paper's worth a thousand crowns or so"*

A little later, Mephistopheles stirs up the general elation even further by saying

> *"Such paper's convenient, for rather than a lot Of gold and silver, you know what you've got. You've no need of bartering and exchanging, Just drown your needs in wine and love-making."*

Those concerned are so overjoyed by this apparent blessing that they do not even suspect that things could get out of hand.

In the Second Part of Faust, the state can get rid of its debt to begin with. At the same time, private consumer demand rises sharply, fuelling an upswing. In due course, however, all this activity degenerates into inflation, destroying the monetary system because the money rapidly loses its value.

It is very striking that Goethe throws light in this way on the potentially hazardous connection between paper money creation, public finances and inflation – and thus on one core problem of uncovered monetary systems. This is all the more remarkable given that Faust and Goethe are not generally immediately associated with economics, especially not with such central areas of conflicting monetary policy priorities.

The fact that Faust can indeed be interpreted in economic terms has been demonstrated, not least, by Professor Adolf Hüttl, who used to be Vice-President of the former Land Central Bank in Hesse. I am delighted that he is in attendance here today. Back in 1965, he wrote a very insightful article in the Bundesbank's staff magazine about "Money in the Second Part of Goethe's Faust".

In the mid-1980s, while teaching in Sankt Gallen, Professor Hans Christoph Binswanger – who I am pleased to say is also here today – took a similar line and brought out a book entitled "Money and Magic: a Critique of the Modern Economy in the Light of Goethe's Faust".

Binswanger's thesis is that Goethe was portraying the modern economy with its creation of paper money as a continuation of alchemy by other means. While traditional alchemists attempted to turn lead into gold, in the modern economy, paper was made into money.

Indeed, the fact that central banks can create money out of thin air, so to speak, is something that many observers are likely to find surprising and strange, perhaps mystical and dreamlike, too – or even nightmarish.

4. The responsibilities of an independent central bank

If central banks can potentially create an unlimited amount of money out of thin air, how can we ensure that money remains sufficiently scarce to preserve its value? Does this ability to create money more or less at will not create the temptation to take advantage of this instrument to create additional leeway short term, even at the risk of highly probable long-term damage?

Yes, this temptation certainly does exist, and many in monetary history have succumbed to it. Taking a look back in time, this was often the reason for establishing a central bank: to provide those in power with free access to seemingly unlimited financial resources.

However, such government interference in central banking, combined with the government's large demand for funding, often led to a strong expansion in the volume of money in circulation, causing it to lose value through inflation.

In light of this experience, central banks were subsequently established as *independent* institutions, with the mandate to safeguard the value of money, in order to explicitly keep the government from co-opting monetary policy.

The independence of central banks is an extraordinary privilege – it is, however, not an end in itself. Instead, its primary purpose is to use its credibility to ensure that monetary policy can focus unhindered on preserving the value of money.

Independent monetary policy combined with policymakers with a well-functioning, stability-oriented compass are a necessary – but not a sufficient – condition for preserving the purchasing power of money as well as public confidence in it.

Of course, it is important that central bankers, who are in charge of a public good – in this case, stable money – bolster public confidence by explaining their policies. The best protection against temptation in monetary policy is an enlightened and stability-oriented society.

5. Conclusion

I will end my overview of Goethe, Faust and paper money here. You have probably noticed that the building we are in reflects, in many respects, the connection between Frankfurt, Goethe, money and Faust, in particular the sculptures and paintings. This type of architectural art was primarily the idea and initiative of Professor Hüttl.

On that note, I would like to turn over to the other speakers, who will speak about the topic of today's colloquium in more detail. I am sure that the combination of Goethe and money will have many additional interesting insights in store for you this afternoon. Thank you for your attention, and I hope you will find the event both enjoyable and stimulating.