

Credit Asset Token (CAT) [Working title]

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Abstract

Inspired by recent events, for example, the collapse of Silicon Valley Bank due to a bank run, I want to analyse the current economic system and research improvements or alternatives based on the digital asset economy and technology with the following initial problem statement:

A 100% Reserve Banking system, to which digital assets (may) belong, can address many of the critical issues in our current fractional reserve banking system by separating bank deposits from credit (loans). The main concern is that such a system could hinder credit creation and economic growth, leading to a lack of research. The question to consider is: How can a digital asset-based system facilitate credit creation, economic growth, and monetary stability at a level comparable to our existing fractional reserve banking system?

A specific initial idea can be explored in the file brainstorming.md, but more research must be performed before the problem statement can be transformed into a specific idea.

0.1 Acronyms

Acronym	Definition
FRB	Fractional Reserve Banking
100RB	100% Reserve Banking

1 Background

This section will present the theory behind the current economic system based on Fractional Reserve Banking (FRB), proposed economic systems based on 100% Reserve Banking (100RB), and the decentralized economic system based on blockchain and cryptography. The section will then discuss their individual issues and compare them to each other.

1.1 The current system: Fractional Reserve Banking (FRB)

All economies in the world use different configurations of the Fractional Reserve Banking (FRB) system. FRB is a system in which commercial banks hold

only a fraction of their customers' deposits as reserves at any time. These reserves provide liquidity to satisfy short-term customer withdrawals, short-term obligations, and settle interbank transactions. Commercial banks want to earn profit on the deposit they hold, so they invest the rest of the deposit in financial investments such as loans, bonds, or stock. This system allows commercial banks to serve as financial intermediaries between savers and borrowers, where savers get interest on their deposits, borrowers get loans, and commercial banks earn interest and profit from the investments. Commercial banks serve an important function in the modern economy by facilitating this efficient capital allocation, promoting economic growth, and facilitating money transactions. However, this system also carries inherent risks, such as bank runs and financial instability, which necessitate the implementation of regulations and safeguards through monetary policy by central banks and fiscal policy from authorities to maintain financial stability.

The money multiplier theory is a simple way to illustrate how commercial banking works. The formula is given by $\frac{1}{\text{ReserveRatio}}$. A Reserve Ratio of 10% gives a money multiplier of $\frac{1}{0.1} = 10$. In this system banks could turn a \$1000 initial deposit into \$10000 by lending out \$900 of the initial deposit keeping \$100 in reserve. The borrower spends the \$900, and the recipient deposits it back into the bank. The bank then lends out \$810 of this deposit keeping \$90 in reserve, and the process continues. However this concept is criticized for being misleading as several countries do not set a legal reserve requirement [**chicagorevisited**], including the USA after the covid pandemic started in 2020 [**FRBinvestopedia**].

There are two schools of thought on money creation. Endogenous money theory posits that money supply is driven by the demand for loans and credit within the economy, with commercial banks creating money through lending. The central bank's role is to accommodate credit demand by adjusting interest rates. Exogenous money theory asserts that money supply is determined by central banks and governments through open market operations, quantitative easing, and printing physical cash. Commercial banks can create money within the limits set by the central bank.

mcleay2014money from the central bank of England argue that the former (endogenous) theory is much more prevalent. Commercial banks are the creators of money. The authors argue that for the money multiplier theory to hold, the amount of reserves must be a binding constraint on lending, and the central bank must directly determine the amount of reserves, however in modern economies (in most cases), central banks do not control the quantity of reserves, but rather implement monetary policy by setting the price of reserves by setting the interest rate. **chicagorevisited** argue that when commercial banks want to hold more reserves, the central bank will oblige by giving out a reserve loan to the commercial bank. In effect, this has the consequence that commercial banks can in theory create infinite money through infinite loans. In practice, this unique privilege is constrained by the profitability on loans and competition

in the market. For example, commercial banks have to pay interest on the reserve loans, this interest rate ripples into borrowers loan, where difference on interest rate of the central bank reserve loans and borrowers loans is the profit for commercial bank. Too high rate and borrowers do not want to take on new loans. The central banks interest rate is set by monetary policy. This web of incentives is much more complex and complicated than can be described here, however it illustrates the issue that commercial banks can missuse their power if they find it profitable. In theory, this power is also limited by regulation and oversight, however regulation usually lags behind the market, and oversight is often very limited by small government budgets, lobbying, and other factors. As an example of where banks missued their power, lets take a look at the great recession of 2008.

In XXXX commercial banks realized that they could pacakge many individual mortgages into a well diversified security. They could then earn a lot of money by selling this security, backed by mortgages, as a low-risk investement. Not a bad idea, but as time went on, commercial banks and the shadow banking system, continously wanted increased profits on this system, issuing increaslingy risky mortgages and manipulating rating agencies to classify the securities to give them the top rating. Then the shadow banking system made the problem much worse by placing massive and risky bets on these securites. The limitations set by regulation and oversight did not succeed in identifying or stopping this problem neither did the web of incentives and reserve requirements (that the USA had at the time). (source)

- Bailouts and why they incentivize increased risk...

1.2 Economic theory

Quantity Theory of Money (QTM) is an economic theory that suggests there is a direct relationship between the supply of money in an economy and the price level of goods and services. It argues that changes in the money supply will lead to proportional changes in the price level. The theory assumes that the velocity of money (the rate at which money is spent) and the level of real output are constant in the short run. **fisherQTM** defined the formula for the quantity theory of money as:

$$M \times V = P \times Y \quad (1)$$

Where M is the money supply, V is the velocity of money, P is the price level, and Y is real output. The equation states that the total amount of spending in an economy (MV) is equal to the total value of goods and services produced (PY).

Monetarism is an economic theory that emphasizes the importance of controlling the money supply to manage inflation and stabilize the economy. The theory is mostly associated with the nobel price winning economist Milton Friedman in his

work **friedman2008monetary**. Monetarists argue that central banks should focus on maintaining a steady growth rate of the money supply, rather than using discretionary fiscal policies. Thus, monetarism advocates for a rules-based approach to monetary policy, where central banks consistently and predictably adjust the money supply to achieve economic stability. The k-percent rule proposed by **friedman2008monetary** states that money supply (M) should grow at a constant annual rate tied to the growth of nominal gross domestic product.

Monetarists argue the money supply (M) drives the QTM equation. Essentially, alterations in M directly impact and dictate employment, inflation (P), and output (Y). **friedman2008monetary** assumed that velocity (V) remained constant, but monetarists today consider V to be readily predictable instead [**monetarismInvestopedia**].

1.3 Loans

Commercial banks issue mortgages to borrowers and can then sell these mortgages (at a discount??) to an investment company that packages and pools individual mortgages into Mortgage-Backed Securites (MBS). These securites have a fixed interest rate and monthly payouts based on the repayment of the underlying loans. Essentially banks act as a financial intermediary that lend investors money to homebuyers

1.4 100% Reserve Banking

In contrast, a 100% Reserve Banking (100RB) system requires banks to hold the entire amount of their customers' deposits as reserves. In general, this means that banks cannot create new money through lending and act more like safe deposit institutions. The 100% reserve banking system can reduce the risk of bank runs and financial crises but may also constrain credit creation and economic growth.

Several approaches towards a 100RB system exist:

- The Chicago Plan [**fisher1936**] developed by economists during the 1930s, proposes separating monetary and credit functions of the banking system by requiring 100
 1. Much better control of a major source of business cycle fluctuations, sudden increases and contractions of bank credit and of the supply of bank-created money.
 2. Complete elimination of bank runs.
 3. Dramatic reduction of the (net) public debt.
 4. Dramatic reduction of private debt, as money creation no longer requires simultaneous debt creation.

- The Chicago Plan Revisited [**chicagorevisited**] from 2012 revisits the idea within the modern economy of the US and finds support for all of Fisher's (RD-1) claims. Additionally, output gains approach 10
- 2018 Swiss citizens' (popular) initiative, 'For crisis-safe money: Money creation by the National Bank only! (Sovereign Money Initiative)' [**SwizzInitiative**]. The initiative was defeated with 442k yes votes and 1379k no votes. The Federal Council and Parliament were against the initiative due to no precedent in any country for this type of system, a radical departure from the current system, which they claim to work well and has taken effective measures to improve financial stability, and that the national bank would receive an undesirable level of power.
- In the aftermath of the 2008 financial crisis in Iceland, a study on monetary and banking reform [**IcelandReport**] was commissioned in 2015 by the prime minister. A Sovereign Money System was strongly considered, but no further action was taken.

1.5 Sovereign Money System (SMS)

1.5.1 The economy of cryptocurrencies and other Decentralized Digital Assets (DDA)