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Banks Create Money. It's a problem and here's what to do about it.

Summary

Today commercial banks create as their property almost all the money that our nation uses for its life and work.

It remains a debt repayable to the banks at interest. It enters circulation as a debt to them when they create money, electronically, out of nothing, in the act of lending to households, companies and the government.

This is money that the government could choose to create itself but instead it, illogically, asks the banks to create it and lend it to the nation at interest.

Money lent for mortgages isn't money banks got from anywhere. They just create it at the touch of a button and pay it out balanced (apparently this satisfies their auditors) by your repayment agreement which they consider their asset, ignoring the fact that a vast sum of money has just appeared from nowhere.

The power to create money gives banks a huge unwarranted, advantage in favour of themselves and against the rest of us.

It's wrong. It is not the right way to order our affairs. We won't recover as a nation until we put right this injustice.

Creating the circulating currency of our society is something that our society itself should do for the benefit of our nation's people and their life and work in the world with Parliament and the Bank of England acting as our servants.

Letting banks create and allocate our currency abdicates to them the right to shape our economy. Banks prefer to put new money into house purchase making house prices boom and fostering personal debt. The potentially productive parts of the economy wither since banks elect to put only 8% of their lending into the productive economy. The state should create our currency and allocate it in ways that nurture a thriving export economy.

The authority to create money should be taken from the banks and returned to the people to whom it rightly belongs.

"Monetary Reformers" assert that the creation of money by commercial banks is a major cause of our nation's economic and social problems.

They advocate taking the authority to create money from the banks and giving it to the Bank of England acting on the nation's behalf.

Their case is broadly as follows:

1. Bank money v state money. In 1963 21% of money in circulation was state-created money, that is notes and coin. Today, with the advent of electronic payment systems, only 3% is notes and coins and thus created by the state. All the rest is created by commercial banks as their property. Notes and coins circulate more slowly than electronic commercial-bank-created money so in terms of total transactions in a unit period of time almost all (over 99%) our circulation is conducted in money created by commercial banks.

2. Electronic money creation. Commercial banks create money in the act of issuing mortgages and other loans. They create it as a mere book keeping entry of new money written into the borrower's account at the moment of issuing the loan. This money didn't come from anywhere; it was just created at that moment in time as bank property. I imagine that some of the money came from savers deposits but most is created by sleight of hand "from nothing".

3. Privilege enjoyed by bankers. This right to create money is a special (I think - unwarranted) privilege enjoyed by commercial banks but not by ordinary citizens or non-financial corporations. It is rightly the prerogative of kings or - in a democracy – of the people. It lapsed into private hands at times down the ages and in European history was usurped by the Medicis of Florence who deceptively lent out more tradable gold receipts than the gold they actually had in their vaults. If the Medicis had been rulers ruling in the interests of the people, such an activity would have been legitimate but I think they did it for their own advantage. Bank money creation has rocketed away since the advent of commercial-bank-created electronic money and with the recent great reduction in the proportion of circulating money that is notes and coin and thus created by the state. I am not asking for a return to the large-scale use of cash but for use of electronic money created by agents of the society as a whole namely the Bank of England (BoE) under rules set by Parliament as opposed to money creation by – and in the private interests of - bankers.

4 Muddle and obfuscation. This apparently deceitful arrangement came to be accepted by governments in need of funds (especially for expensive war-making) who became debtors with befuddled understandings of what was really happening. They were therefore motivated to enshrine in law a system that they thought (wrongly) to be working to their benefit. More recently governments fear losing tax receipts from banks and so acquiesce with a system that unnecessarily makes governments poor, weak debtors and banks rich, powerful creditors. Note that almost all western governments are in debt and at the mercy of creditors. It suits bankers to give the impression that their practices are upright, trustworthy and reassuring but at the same time so complicated that the general public had better leave it to the experts. Society needs to grasp what is going on.

5. Our money is created as an asset of the banks but it could be created as an asset of the nation. All our circulating currency except notes and coins is an interest-bearing debt to the banks on which society has to pay interest to the banks just to have it in circulation, since it enters circulation as a debt. If the Bank of England created our money and gave it to the government of the day to spend on something that does us all some good then it would be an asset of the nation rather than a debt owed by the nation to the banks or in other words an asset of the banks. We wouldn't have to pay any interest just to use it as a means of doing our business with each other. As it is, it's a lot of money to have to pay interest on that we needn't really have to pay interest on if we took to ourselves the power and authority to have our public servants create our nation's money for us on our own behalf.

6. We make a mistake to let banks be the allocators of new money, ie to decide what thrives and what fails. The elected government should do that. Banks having created this money also decide where this money is allocated in our economy. They allocate 92% of their lending to unproductive pre-existing assets that they can sell to raise cash if they need to. Mainly that means houses; and only 8% goes to the productive part of the economy such as export oriented industry and services. This isn't healthy. Banks don't like taking risks and they like a quick return BUT the country sometimes needs money to be spent on things that take a long time to bear fruit and may not succeed even then but are nevertheless important things to tackle …. Like how to generate electricity without wrecking the planet. None of that gets done as we have things organised today or if it does then it means we have to pay over the odds for generations to come if the project succeeds.

7. Why banks favour investment in housing mortgages over productive industry. Banks find it more attractive to lend to house buyers since, in case of default on the repayments, they can repossess and sell a house whereas the assets of a defaulting business are harder to sell, if the loan has been spent, for instance, on a specialised machine for which it is harder to find a buyer than for a house. If a business loan has been spent on staff skill acquisition there is even less that the bank can recoup if the business gets into difficulty before the benefit of the new skills can be felt in increased sales. So banks tend not to allocate money in ways that help us improve our economy but rather in ways that produce house price bubbles.

8. Bank of England to be the exclusive money creator. Monetary Reformers advocate that the power of money creation be reserved exclusively to the Bank of England acting altruistically as a public body on behalf of our nation as a whole and that commercial banks should be prohibited from creating money.

9. Historical precedent. It has been done before. Rulers have created money for circulation in their domains. Governments created money in the twentieth century in Britain (World War I Bradbury Notes) and in the United States (United States Notes or Legal Tender Notes). I believe the Chinese (now) and Japanese (prior to 1992) governments have created and allocated money in their respective economies promoting periods of vigorous growth, increasing employment and national wellbeing. Genghis Khan created paper money as his own FIAT act of creation. He declared that it alone was legal tender in his domain so there was a demand for it as people gathered wealth in that currency to pay their taxes with. Neither he nor any of his subjects borrowed it from bankers. Tally Sticks, see http://www.nationalarchives.gov.uk/museum/item.asp?item_id=6 were used as a debt free system of state issued money in England from 1293 until 1826.

10. The early Pennsylvania Settlers devised their own free-standing monetary system independent of the bankers of the Europe from which they had fled. The latter tried to persuade them to use as their circulating currency European bank money lent to them at interest. They saw that they would then be trapped into borrowing more and more just to pay the interest when it was due so they refused. A society can either devise its own currency system as a sovereign act or it can go to an outsider to borrow it at interest – which seems to me to be an unnecessarily servile option.

11. Baby sitting circle economics. Money is simply a system of account to keep track of activity and merit in a community. If a set of couples decide to organise themselves into a baby sitting circle they need some tally system to make sure they are helping others as much as the help they are receiving, otherwise people might sponge on the system. They wouldn't dream of borrowing the points from a banker: they just invent them and keep a record of how much baby sitting each couple has done - an autonomous, sovereign money system.

12. Not Gold. Some people think REAL money has to be gold or silver but it doesn't. Money isn't a commodity. It is a social relationship like doing your bit in a baby sitting circle. If more people join the circle you can just invent more points for the new people. If you depend on gold you're stuck because there's only a finite amount of gold in the world and if you have more people or more activity then there isn't enough gold to go round. Then you hear that there's gold in them there hills and you think it is a good idea to fight a war to gain ownership of the hills, but the gold is just an accounting token and has no intrinsic usefulness of itself unless you artificially give it such a value. So gold is not the answer.

13. So what is the basis of the value of money. So if the basis of the value of money isn't gold what is it? It's the inventiveness and activity of the people of the society concerned. If there's more activity and creativity it is appropriate to create more money and put it into circulation to facilitate the increased level of activity or there won't be enough money to go round and activity will grind to a halt for lack of money even if everything else needed for activity is available – as happened in the 1930s Depression. So money is a tool for the working of a society. And the creation of money and its allocation into circulation for its first use is a sovereign creative act and a means of shaping the economy of a nation. Money creation by a central bank is a tool for doing what we want to do as a nation. It should be done by the sovereign in the interests of his or her citizens and advised by her ministers and not by bankers in the interests of bankers, advised by bankers.

14. Seigniorage. When a king or government creates and issues money with a greater face value than it has cost to make, the difference or profit on such an operation is called seigniorage. Historically kings might mint coins with a greater face value than they had paid for the precious metal they contained and this was a source of revenue for the king. Today it costs the government a lot less than £20 to print and issue a £20 note and the differenc e is income for the government. However, when a bank creates, say, £200,000 and issues it into circulation as a debt (or mortgage) to a house buyer, it has cost almost nothing for the bank to create that money - just the pay of someone to type in those numbers on a computer keyboard. So a huge proportion of that newly created money is seigniorage and it goes to enrich the bank rather than to benefit society. It is not right that we tolerate this system.

15. Mechanism. The Bank of England's Monetary Policy Committee should meet regularly (as it already does) to decide, not the bank interest rate, but whether the healthy, optimal functioning of our economy (and not merely the containment of inflation) needs us to have more or less money in circulation and if so what quantity of new money is needed to let the economy run well but without inflation.

16. If more circulating money is needed, the BoE should create it and give it (not lend it) to the government. Conversely if money needs to be withdrawn, because too much money in circulation is causing inflation, then that can be done by taxation and by the government then paying that money to the BoE who would then remove it from circulation by destroying it electronically.

17. Our money system would be debt free. Under such a system our circulating national currency would be debt-free in the sense that we as a society would not have to pay interest to anybody just to have it as our circulating currency. If some citizen or corporation borrowed money from another then the lender might charge the borrower interest but there would be none to pay just for the money to be in circulation. We would still have an inherited debt to honour (unless we collectively decided on a national debt jubilee) but any new money would be an asset rather than a further debt.

18. There would still be a legitimate job for banks to do to attract savings (of state created money) by offering attractive rates to savers (probably better than current rates) and lending the money out at a higher rate to reliable people wanting, for instance, to buy a new machine for their factory. Banks would be conducting a legitimate trade in money but would not be creating it. It might be less exciting work but it would benefit society and it would be less fraught with danger and, in the end, more satisfying even for the banker who would have an honoured place in the renaissance of British national life.

19. The democratically elected government (instead of the banks) could allocate the newly created money to objects that benefit society as a whole and its mission in the world.

20. The Government could spend it on whatever the electorate wants them to, but wisdom dictates that it should spend it on things which nurture a thriving export economy, namely: infrastructure, higher education and higher technical training, scientific research, development of exportable products and services, research into environmentally wise electricity generation and then the actual generation of such energy, and on other essential public utilities. How is this process to be done in practice? Will it mean the government or the Bank of England having to do a huge amount of work to determine whether someone is credit-worthy. No. The allocation of new money could be done very much as bids are put in by government departments today to compete for money to be spent by the Treasury. In addition a fair geographical spread of the spending of new money for the common good can be achieved by elected regional government of each region of England as well as of Scotland, Wales and Northern Ireland. If such bodies were channels to disseminate newly created money for public works and the common good such bodies would have money to spend and would attract animated interest from the population of the region concerned. Once the money is in circulation it would operate and be handled as the money in our national circulation is handled today. Banks and the rest of us would compete for it but it would have entered circulation by paying for something of real public benefit and would then circulate from there as workers on the project in question spend their income.

21. I am advocating a general swing back towards government doing more of the activity of our economy. However, running the basic necessities of a lively economy well and enabling British industries and export services to thrive deserves the support of all.

22. Evidence that banks do create money in this way:
a. that people within the system say they do. The Bank of England (BoE) senior staff have repeatedly said they do and the BoE 2007 Q3 Quarterly Bulletin p377 says, "When banks make loans they create additional (bank) deposits for those that have borrowed the money." Martin Wolf Chief Economics Editor of the Financial Times and member of the government's Independent Commission on Banking says, "The essence of the contemporary monetary system is the creation of money out of nothing by banks' often foolish lending."
b. that in the years around 2005, GDP was growing at only around 2% pa while M4 money supply was growing at around 14% pa. Someone was creating a lot of money that had no bearing on actual economic activity. Who was it? It wasn't the Bank of England. I think it was the banks.
c. that both governments since the 2007 crash have seemed almost desperate to get the banks lending again. I think this is because banks are our main source of new money rather than the Bank of England. Under the present system, without their lending our society is starved of money.
d. that there is confusion and obfuscation about this issue when it is raised and letters on this topic get dismissive replies.
e. that banks pay generous bonuses. It's not the bonuses themselves that are the problem. It is the activity that the bonuses encourage; namely persuading people and companies to borrow so that money can be created in the act of lending. It fits because if this money hasn't been hard to come by, it is easy for banks to create a bit more for their own employees' direct benefit in bonuses. Our jealousy over such bonuses suits the banks since it diverts attention away from the real problem which is that banks are creating money when other non-government actors, like you and me, can't and if we cottoned on we would be outraged!

23. More precise control of the economy. Direct control by public authority (the Bank of England) of the quantity of money in circulation would give much swifter and closer control of monetary affairs with less damaging side-effects than the present means of control of the money supply by manipulating the bank rate. People currently are encouraged to borrow and then, by later decision of the BoE, penalised for having responded to such encouragement. The new system would take effect quicker and have less unintended consequences.

24. My dialogue with banks, Treasury Committee MPs, government and opposition. It has been slow so far. However I am hopeful that banks will enter into clear and constructive discussion of these issues and will collaborate with the government whom I also plan to persuade. Banking auditors also should explain how they seem to miss billions of pounds being created! Financial journalists and banking - and economics academics ignore these insights but for how much longer? Soon the tipping point will come, beyond which it will be more comfortable to be seen to have examined this issue clearly and with integrity.

25. It all matters a great deal. I would say that it is really important to get clarity on this issue in the public interest. I want to play my part in getting the fog of confusion cleared away.

26. EU rules say you can't do it! Article 126 Treaty on the Functioning of the European Union ie the Lisbon document, prohibits central banks from creating money and giving it to their respective governments even outside the Eurozone. We must persuade the EU to change.

27. World solution needed? I don't think we have to wait for the whole world to make this change. In any case we should be advocating it vigorously in international fora.

28. Leading the way on this would be a tonic to our economy. The government would suddenly have money at its disposal to target on bold initiatives to grow our economy. In a livelier economy there would be more jobs, less youth unemployment, more useful openings for people of only moderate ability who need to be part of a supportive team, less crime done by idle hands, less of an underclass, less drugs, happier families, a more noble sense of national identity, better cohesion of the different ethnic elements of British society. There would be a better balance of payments and more money in the national kitty and more ability to fund the various aspects of a humane society that are under such strain at present, and no need to engage in casuistry to justify PFI because we would be able to pay for public works up front by conventional procurement methods without PFI.

29. We could waste this newly created money. That would be a terrible missed opportunity. So we do need vision and we need that vision to inspire us to work well together and to inspire our young people. Disastrously, we could squander it all on frivolities.

30. Current Accounts transit direct to a safe Bank of England account. Under the "new" system, money paid into such accounts would not become the property of commercial banks. It would transit immediately into a secure account of the Bank of England so that if the commercial bank fails, the money is safe and the government doesn't have to cover any lost deposits. Commercial banks acting as agents for the BoE thus, would not be able to lend out such deposits at interest as they do at present. At present banks lend such sums out even though depositors are entitled to come any day and withdraw their deposit on demand, so lending it out always risks a run on the bank by depositors demanding money that isn't there any longer. Having an entirely state run payments system like this would be secure. If commercial banks were to act purely as agents for deposits in transit to and from the Bank of England, there would be a cost to running such a system and without being able to lend such money at interest banks would want to cover their costs and so would probably charge. It would, however, be a simple risk free operation so such a bank would be easier to start and safer to run, so more companies could open up such services adding to competition in providing such a service, so minimising costs down by inter-bank competition. Alternatively the payments system and current accounts could be run entirely by the state and the Bank of England with commercial banks having no part.

31. Fractional Reserve Banking. The following is an outdated model of bank practice but holds helpful lessons nevertheless. If you deposit £100 of state-created bank notes in a current account the bank will prefer to earn itself some money by lending most of that £100 out to somebody else at interest even though you are entitled to come back any time and demand it back. They keep a bit of it back (say 10%) to cover the unlikely eventuality that you will return for it but will lend out as much of it as they can get away with without the risk and embarrassment of a bank run. Say they lend out £90 of the original £100. The borrower spends it and the payee banks it and that bank lends out 90% of that sum which comes to £81. That sum is spent and the payee banks it and £72.90 of that is lent out. .. and so on and so forth until there is a huge interest-earning cloud of bank-created-money circulating on the basis of your original £100 of state created money which they hope you aren't going to demand back too soon or you might stop the party! This is model is out of date, however, since banks are no longer formally obliged to keep a specific reserve fraction but are trusted not to sail too close to the wind; also they don't have to wait to take in a deposit before lending out – they just lend it anyway if they think the borrower looks as if he will pay it back with interest and if so they just write the sum of the loan into the borrowers account without having to get it from anywhere! Preposterous!

32. An increase in bank reserves is irrelevant. An increase in agreed reserve percentages or assets to cover the risk of a run on the bank may help prevent a run but it is beside the point if money creation by banks continues. Even if the reserve fraction were increased substantially it would not stop banks creating money by fractional reserve lending. Anyway it will always be hard for regulators to ensure the value of anything pointed to by a bank as a reserve. Banks should not touch current account deposits at all.

33. Difference in treatment of current account deposits and savings deposits. There needs to be a distinction between the protected current accounts advocated in (30) on the one hand and savings accounts whereby savers willingly relinquish ownership of their money for an agreed period in exchange for a share of the interest paid by the borrower to whom the bank lends on their money. Such an account would not enjoy government protection, merely the protection offered by the reputation of the bank concerned.

34. A Bank of England (Creation of Currency) Bill. The group Positive Money has worked out in detail a draft Bill of the above name that could be presented to Parliament. It is designed to correct the inherent defect in the current monetary system that I have sought to describe here. http://www.positivemoney.org.uk/wp-content/uploads/2012/02/Bank-of-England-Creation-of-Currency-Bill-Smaller.pdf

35. Here's what I'd like you to do. The main thing is to take this analysis seriously and to see that tackling it is a big part of getting our "house in order" as a nation. Argue with it if necessary. Get it talked about amongst colleagues and friends even if talking about such things doesn't come easily to you. If you are an MP on the Treasury Select Committee of the House of Commons please seek to get the Committee to consider this issue properly leading to corrective action by HM Treasury. If you are a senior figure in government, opposition or another party please get it considered in such circles. If you are another MP or Peer please use the various channels open to you such as writing to the Chancellor of the Exchequer or his Shadow, asking a Parliamentary Question or tabling an Early Day Motion such as No.2075 of the previous session http://www.parliament.uk/edm/2010-12/2075 or if you have the stamina try to arrange an Adjournment Debate. Members of the public can write to- or meet their MP (see http://www.parliament.uk/mps-lords-and-offices/mps/ or collect a petition to him or her and can write to the press or online. There are polite ways of being persistent about these things. If you are a comedian crack jokes about it. Once you get going there are lots of ways to raise the profile of this crucial issue legally, courteously and tenaciously! It will make an enormously beneficial difference to our nation's welfare and its effectiveness in the world.

My sources include:
James Robertson: *Creating new money*. http://www.jamesrobertson.com/book/creatingnewmoney.pdf

Where does money come from? Josh Ryan-Collins et al. A New Economics Foundation book with a foreword by Professor Charles Goodhart.

http://www.positivemoney.org.uk/

Writings and conference speech of Professor Richard Werner http://www.southampton.ac.uk/management/about/staff/werner.page
Personal correspondence/discussion with a senior staff of the Bank of England and senior bank executives.

Thanks for reading this. I'd be glad to hear from you.

Yours sincerely

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