

Publicly Created Money and Monetary Reform

A New Finance Initiative

Summary

This paper explains why the publishers are supporting Early Day Motion¹ 854 tabled in the House of Commons on March 10, 2003 by David Chaytor MP (Bury North)² entitled "*Publicly created money and monetary reform*". Co-signatories are John McDonnell MP (Hayes & Harlington), Martin Caton MP (Gower), Dr. Rudi Vis MP (Finchley & Golders Green), Austin Mitchell MP (Grimsby), Harold Best MP (Leeds – North West) and Alan Simpson MP (Nottingham South). By March 12th seven more signatures had been added: <http://edm.ais.co.uk/weblink/html/motion.html/ref=854>

The EDM suggests the government investigate proposals made by the publishers that it is possible to fund public services without additional costs of borrowing being incurred by the government. Those proposals also suggest that this can be done whilst controlling inflationary lending by private banks.

The Early Day Motion

The full text of EDM 854 is as follows:

"That this House, concerned at the rising burden of private debt³, public borrowing⁴, student borrowing⁵ and public-private finance initiatives⁶;

- notes that the proportion of publicly created money⁷ in circulation has fallen from 20% of the money supply in 1964 to 3% today⁸;*
- believes that increasing the proportion of publicly created money in issue may provide a new means of financing public investment;*
- further notes that it is suggested that the use of publicly created money can cut the cost of public investment by at least one half of what it would otherwise be by eliminating the need to pay interest⁹;*
- accepts that such a policy can be adopted without any impact on inflation if suitable regulatory changes are made;*

and therefore urges the Treasury¹⁰ and Treasury Select Committee¹¹ to commission independent reviews on procedures for increasing the proportion of publicly created money in the economy and on the benefits of so doing and report them to this House."

The Third Way

The EDM suggests that there is a "third way" for the government to create more of the money used in the UK economy. It is commonly assumed that the government creates all money. This is not true. In fact the only money that is at present created by the government is notes and coin. According to the Bank of England there were £29.6 billion (i.e. thousand million) worth of notes and coin in issue in the UK in November 2002. But since most transactions involve payments from one bank or building society account to another these have also to be considered money for all practical purposes, and they are. In November 2002 the total value of such deposits exceeded £1,000 billion (or one trillion) for the first time, reaching £1,001 billion in that month.

It can be seen by comparing the figure for notes and coin and the figure for all cash available in bank accounts that the government creates 2.95% of all money. Commercial banks create the rest.

Do banks really create money?

The simple answer is “yes”, but most people do not believe that banks actually create money. They like to think that banks simply take in what is commonly thought of as money (i.e. notes and coin) from the public and then pay it out again. By doing so they want to agree with the eminent economist John Kenneth Galbraith, who said “the process by which banks create money is so simple that the mind is repelled. Where something so important is involved a deeper mystery seems only decent”¹².

How do banks create money?

In its simplest form the process does start with a person paying some notes and coin into a bank. For convenience let us assume they pay in £100. As a matter of fact banks know that most people do not draw out in cash most of the money they have in a bank account. They do instead write cheques, or pay by direct debit, charge card and so on. So, if the bank has received £100 of cash they know that there is very little chance that the person who paid it in will ask for it all back. In practice they need to keep in cash just that part that the person is likely to ask for again. This is called the “reserve ratio”.

If a bank estimates that its reserve ratio is 10% this means that they have to keep 10% of all deposits made in cash, as this is likely to be asked for by the person whose account it is in. The rest of the cash they can use themselves, and they do. In fact, they can safely loan £90 of the cash received to another customer. As a result the money supply increases by £90. The original depositor still has a deposit of £100, but the borrower now has £90 as well.

That is not the end of the story because the £90 that has been lent will itself almost certainly be deposited straight into a bank account. The lending process will then start again: the bank will hold back 10% of the £90 (or £9), and loan £81 to another customer, and so on. With each deposit and loan, more money is created and enters the money supply. It is, however, important to note that the process is not infinite as 10% of every deposit has to be kept if that is the reserve ratio.

In practice, if the reserve ratio is 10%, for every £100 of cash deposited in a bank £1,000 can be lent by the bank. And if the reserve ratio is 2.95%, for every £100 deposited banks can create £3,390 of lending, even though they never had that much money to start with.

Is this credible?

A lot of people find this hard to accept but it is actually quite possible, because double entry bookkeeping allows it to happen. What happens is that when a bank lends money they open two accounts for that person. One is a loan account. The other is a current account. To lend them money all a bank has to do is make an entry of, say, £1,000 in the current account, to create cash the person can spend. This is what people think of as a “credit” balance. The other side of the accounting entry is in the loan account. This will be marked as being overdrawn by £1,000, and that will show that they owe the money back to the bank. This is usually thought of as a “debit” balance. The trick of using two accounts has meant that cash has been created out of nothing, and the bank’s books still balance.

This system has existed since before 1700 when the Bank of England was created. Concern at the practice was such that Section 9 of the Bank Charter Act of 1844 required that any profit arising to the Bank of England (then a private bank) from creating currency had to be paid to the government. The Section in question was repealed by 1891. The current EDM suggests it is time to restore the right of the public to profit from the creation of currency, as it was more than 150 years ago.

Won’t publicly created money mean inflation?

There is a widespread fear of governments “printing money”. It is believed that this causes inflation. This risk does exist if there is uncontrolled creation of money, but that is in effect what we have at the moment. There is currently no effective regulatory mechanism to stop banks creating new money. In practice, public control of money creation is likely to reduce substantially this risk. This is, of course, the complete reverse of the commonly held view, but statistics and facts support it.

Between September 2001 and September 2002, for example, the total money supply including all bank and building society deposits as measured by the Bank of England increased from £936.3 billion to £989.5 billion. That is an increase of £52.2 billion, or 5.7% in a year. Inflation in this period was 1.7% (as measured by the retail prices index) and the increase in Gross Domestic Product (based on HM Treasury data) was 5.2%. The money supply in this period grew by more than was needed to finance growth by either measure.

It suits banks that growth (as measured by money) trails in the wake of the increase in the money supply, as is shown to be happening by these statistics.

The reason for this is that the more the money economy grows the more cash they have to create. And the more cash they create out of nothing the more profit they make. The current system of cash creation by banks is, therefore, inherently inflationary. To counterbalance this trend, the government has to constrain its own activities.

This is again shown by publicly published statistics. During the same twelve-months period to September 2002 the amount of publicly issued cash and notes in the economy grew by just 1.9%, and, in fact fell throughout 2002. The government was much more prudent in the financial management of its element within the money supply than the commercial banks over this period. Even so, it might be unwise wholly to trust any one government with such a powerful economic tool as publicly created money. This could be avoided by independent oversight of the issue of publicly created money, either by the Bank of England or by a new independent authority. Any Commission set up to investigate these matters would need to study these options.

How will publicly created money cut the cost of financing government spending?

The process is as simple as that by which commercial banks now create money. What would happen is that the Bank of England would lend money to the government to the extent that it was agreed that new money was needed in the economy (and no more). That new money would be spent by the government from a current account it maintained with the Bank of England. It would of course owe it back to the Bank of England. The twist in this case is that the loan would not carry interest and might not require repayment. In that way the benefit of issuing new money would belong to the government, and not commercial banks, since the Bank of England is government owned.

How do you stop banks issuing new money as well?

This is quite simple. You make it illegal for them to do so! All it will require is a law that says that banks must recognise that the money held by their customers in current accounts belongs to those customers, and not the bank. That will mean that banks cannot then use that cash to create new loans as current accounts. That cash would no longer be part of a bank's reserve ratio. As such banks will not be able to, literally, make money from them. This will not affect any bank accounts now in existence, or the well being of any person or their entitlement to any asset they now have.

This will not, however, mean that cash for loans will not be available. Publicly created money saved with banks (and a great deal of cash is saved in this way) will be re-lent (without the creation of new money) by the banks to those customers who want to borrow it. This is, of course, how most people think banks work now. As such the proposal made is instinctively acceptable.

How much could this save the government?

Robertson and Huber¹³ suggest that this reform might save the government £48 billion a year. Other opinions are no doubt available based on different bases of calculation. What is clear is that the amounts involved are substantial. To put the matter in context:

- total income tax received by the government in 2001/02 was £110 billion¹⁴
- PFI spending in 2001/02 was £3.7 billion a year¹⁵

It is clear that the amount of money created by banks, and which could be created for public benefit, is substantial when compared with this data.

Why do you say the cost of public investment could be halved using publicly created money?

This is the result of a simple calculation. Many public investments are in long term assets such as schools and hospitals. The borrowing that finances them is equally long term, often over 25 years (which is also a typical length of a PFI project). Even a very basic calculation of the interest paid at 4% on a loan over 25 years shows that 100% of the cost of the asset must be paid in interest – and this is before allowing for compounding. So, if no interest is paid, the cost of a project has to be halved. If interest is effectively paid at 16% (as has been suggested to be common on PFI projects), then paying for an asset on an interest free basis, using publicly created money, would mean that the public cost of the asset falls to no more than 20% of the cost of interest. Again, compounding would actually increase this ratio.

The economic benefits of investigating this proposal are compelling.

Notes

1. An Early Day Motion (or EDM) is the term used to describe notices of motions tabled by Members of Parliament to draw attention to an issue.
2. David Chaytor is Labour MP for Bury North.
3. Private debt has, according to the Bank of England, grown at the rate of 13.5% over the year to October 2002. This is part of a continuing trend of growth in borrowing being in excess of income growth in the UK. <http://www.bankofengland.co.uk/mfsd/li/030103/lendind.pdf>
4. Public sector net debt did, according to HM Treasury data published in November 2002 fall between 1996/97 and 2001/02 by £38 bn but is forecast to increase between 2001/02 and 2006/07 by £97 bn. <http://www.hm-treasury.gov.uk/media//54E68/040303PDB.XLS> published by the Office of National Statistics for HM Treasury.
5. Proposals made in January 2003 suggest the average student will see their student debt on graduation increase by at least £6,000 per annum as a result of increase tuition fees proposed for introduction if Labour are re-elected to a third term in office.
6. PFI schemes were supposedly worth £3.7 billion pounds in 2001/02 but are proposed to be worth ten times that sum in the foreseeable future (source: HM Treasury and data published at the time of the Labour Party conference 2002 and to coincide with the pre Budget statement November 2002)
7. It is commonly assumed that the government creates all money. This is not true.
8. Support calculations that show how such data is computed are in the main text.
9. Publicly created money does at present consist of notes and coin. No interest is paid to anyone who holds notes and coin, and as such the principle that publicly created money is interest free is well established.
10. The Treasury is the Government department responsible for economic management and is headed by the Chancellor of the Exchequer.
11. The Treasury Select Committee is a committee of backbench MPs in the House of Commons that scrutinises the work of the Treasury and undertakes critical analysis of it. It is entitled to commission its own research on matters that it believes will further its work.
12. "Money: Whence it came, where it went" J K Galbraith. 1975.
13. "Creating New Money" by James Robertson and Joseph Huber, New Economics Foundation 2000
14. HM Treasury Public Finances spreadsheet published November 2002 on HM Treasury web site
15. Information extracted from data published by the Office of Government Commerce on PFI deals signed to 31 October 2002 available at <http://pfi.ogc.gov.uk/statsView.asp?id=708> on 7 February 2003

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Published by **The New Economics Foundation** at Cinnamon House, 6-8 Cole St, London SE1 4YH and the **Forum for Stable Currencies** at 21a Goldhurst Terrace, London NW6 3HB.

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Thanks are due to Titus Alexander, Richard Murphy, Molly Conisbee, David Boyle, Pat Conaty, Rafiq Manji, James Robertson, Michael Rowbotham, Sabine McNeill, Donald Martin, Peter Challen, John Courtneidge and Andrew Simms.