Chapter Four

Case Study: How Debt Came to Rule the World

> Human nature is ready and willing to heap up riches whenever it easily can, so eventually the powerful may get hold of everyone else's money and reduce them to slavery. This is tyranny indeed: true and absolute tyranny, as described by the philosophers and in ancient history.—*Nicole Oresme, 14th C, on abuse of the money supply.*

> The purpose of studying economics is not to acquire a set of readymade answers to economic questions, but to avoid being deceived by economists.—*Joan Robinson*, economist.

Of all betrayals of 'the people' made by elected representatives, allowing banks to create the money supply has been the greatest.[1] Case studies could be made of other areas in which representatives serve elites rather than ordinary people (e.g. culture, education, the arms trade, the environment, war, intellectual property, oil and energy, corporate rights); I

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[1] It would be more correct to call banks 'depository institutions'. Legal privileges first allowed to banks have now been extended to other types of institution. For instance in the U.S. the Depository Institutions Deregulation and Monetary Control Act (1980) extended banking privileges to federal credit unions. 'All depository institutions are subject to the reserve requirements set by the Federal Reserve. Thus all such institutions, not just commercial banks, have the potential for creating money.'—*Modern Money Mechanics,* Federal Reserve Bank of Chicago (online). It seems simpler, however, to adopt the common designation and refer to institutions possessing 'banker's privilege' as 'banks'.

have chosen bank-created money because control of the money supply is fundamental to all power.

The subject occupies a substantial chapter in itself because as well as telling the story of how the world has become so unequal, it exposes how powerful interests operate beyond public knowledge and democratic scrutiny. It also shows how privilege has become so much part of what 'just goes on', that the powerful themselves may live in denial, or even ignorance, of how they are privileged.

Legal accommodation of bank-created money began six years after representatives assumed supreme power in England (the dates are 1688 and 1694). Over the next three hundred years, bank-created money came to dominate the money supply of the world, as other countries followed in England's footsteps. It is impossible to understand how such a strange system came to be without a bit of history; but first it is intriguing to see how the system works today.

Beneath all the complex talk, the truth about bank-created money is not so complex. In the words of banker W.J. Thorne 'the banker's tricks of the trade are, when they are explained, hardly worthy of even a third-rate magician.'[2]

The magic trick of banking is to lend the same money again and again. Normally, if you lend something, it is gone and you no longer have it. But bankers are able to produce money they have already lent like a rabbit out of a hat, and lend it again. The trick depends on several special privileges given to banks in law.

The first and fundamental privilege of banks is to own deposits of money put with them for safe-keeping. This privilege was re-stated (rather impatiently and in no uncertain terms) by a judge, Lord Cottenham, in 1848:

> Money, when paid into a bank, ceases altogether to be the money of the customer; it is then the money of the banker, who is bound to return an equivalent by paying a similar sum to that

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2 W.J. Thorne (B.Com, Associate of the Institute of Bankers) in *Banking* (OUP) 1948. Mervyn King, ex-Chairman of the Bank of England, prefers the word 'alchemy': see his 'Speech to the Buttonwood Gathering, New York, 25 October 2010' available on the Bank of England website.

> deposited with him when he is asked for it. … [It] is to all intents and purposes the money of the banker, to do with it as he pleases. He is guilty of no breach of trust in employing it; he is not answerable to the customer if he puts it into jeopardy, if he engages in a hazardous speculation; he is not bound to keep it or deal with it as the property of the customer, but he is, of course, answerable for the amount, because he has contracted, having received that money, to repay to the customer, when demanded, a sum equivalent to that paid into his hands.[3]

In other words, as soon as you deposit your money in a bank it becomes the property of the bank. What you have in return is a claim on an equivalent amount of the bank's cash.

It is a strange, perhaps unique quality of money that *claims* on money can themselves be used as money. The economist Joseph Schumpeter pointed out the oddity of this.[4] If you need a horse to get to market, a claim on a horse is not enough: you need the actual horse. But if, when you get to market, your pockets are stuffed full of claims on money, you can use them to pay with by simply handing your claim to someone else. In other words, claims on money are themselves money. Almost all our payments today are made this way. Cheques, credit card payments, debit card payments merely transfer some of our claim on a bank's money to someone else.[5]

The fact that claims on money are themselves money allows the magic trick of banking to really take off. A bank creates money by creating claims. Here's how it works.

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[3] Foley v Hill, (1848). This was not the first statement of the fundamental banker's privilege. It has become famous because it is so direct and unequivocal.

[4] *A History of Economic Analysis,* p. 321. The scattered chapters on money, credit, banking etc. in this mighty book provided some of the material for these paragraphs.

[5] Knut Wicksell pointed out over a hundred years ago that modern economies are hybrids of two systems, cash and 'credit' (*Interest and Prices*, 1898: English translation 1936, page 70). Keynes, under a subheading 'Current Money is predominantly Bank-Money' (*Treatise on Money,* Chapter 2) estimated that 90% of money in use by the public at that date (1930) was bank-created claims. Now (2012) the percentage is consistently over 97%.

A bank extends a loan: the borrower now has a claim against the bank. When the borrower spends some of the loan, some of his claim passes to another person. The new person might bank at the same bank, in which case cash leaves and returns to the bank in a 'scintilla of time'; or the new person might bank at a different bank, in which case the bank loses some of its cash to the other bank. However, loans are created (and spent) every day at all banks, and at the end of each day's trading the banks tally up what they owe to each other (the process is known as 'clearing'). The various claims between them (usually) roughly even out.[6] Inequalities are met by short-term borrowing through the clearing banks.[7]

So a loan of cash is like a magic boomerang: cash leaves the banking system and returns again, creating on its journey a debt (from the borrower to the bank) and new claims on the bank's cash, owned by people the borrower has paid. The result is not all roses for the bank. If we take stock of where the bank is after making a loan, we can see that it has become vulnerable. There are new claims on its cash, but the cash is not there to back them up. When banks create bad debts, claims pile up on cash that isn't there: they are preparing for their own funeral (or for the modern luxury of a state bail-out).

So money is created by banks in the form of two debts: from banks to customers, and from borrowers to banks.

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6 Wicksell describes the process thus: 'The sum borrowed today in order to buy commodities is placed by the seller of the goods on his account at the same bank or some other bank, and can be lent the very next day to some other person with the same effect.' 'The Influence of the Rate of Interest on Prices', 1907.

7 'Clearing' means the banking system as a whole behaves as if it were one single bank, with a monopoly. Interestingly, the process depends upon all banks behaving in roughly the same way; otherwise, a 'multiple-lending' bank would quickly lose its money to other banks, as borrowers make payments. For a short summary of the process from a banker's point of view see 'The Theory Of Multiple Expansion Of Deposits: What It Is And Whence It Came' by Thomas M. Humphrey, *Economic Review* March/April 1987. Available online at the Federal Bank of Richmond website.

When a loan is 'retired'—that is, repaid—these debts, which are mirror-images of each other, get smaller by equal amounts. Money is literally destroyed, in the same way it was created but in reverse: the borrower accumulates claims then turns them over to the ownership of the bank, which uses them to claim cash from other banks. Cash shuffles between banks after which the claims are redundant: they no longer exist.

It is no coincidence that the word 'bubble' crops up so frequently in stories of bank-created money: bank-money is itself a bubble. It is made and it is destroyed, leaving nothing behind it but a transfer of assets to capitalists and banks.[8]

The loans have paid the banks interest.[9] Because they create many loans on the same cash, banks earn many times the interest they could hope for on the same cash if they were straightforward moneylenders. For this reason, they can lend at lower rates of interest than straightforward moneylenders (who have occupied a niche corner of the market for several centuries now—lending at high rates to the poor). Low interest rates, and a plentiful supply of created money, give bank-borrowers an advantage in the marketplace; and this advantage depends on the privilege of banks to create money for lending.

The result is that our money supply consists of two entirely separate systems: one of cash, almost all of it owned by governments and banks; [10] and the other of claims-on-cash, owned by the rest of us. These two systems are given a variety of different names by different agencies and different

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8 The words 'capital' and 'capitalist' suffer from long association with Marxist critique. Before Marx, there was sensible and constructive criticism of capitalism; now, criticism tends to conjure up visions of totalitarianism.

9 Banks also *pay* interest to some depositors; the difference between the interest they pay and the interest they receive is the primary income of banks.

10 Actual coins and notes make up a very small percentage of the money supply – usually around 3%. They are 'cash' and governments and banks like to discourage their use. If all citizens asked for the money due to them in cash tomorrow, governments and banks would collapse—or the system would have to undergo instant reform!

economists. 'Cash' is known as 'the monetary base' (acronym MB), 'state money' and 'high-powered money'. Claims are given an even wider variety of names: 'near-money', 'money substitute', 'representative money', 'fiduciary money', 'credit money', 'bank-money'. Following Keynes and Schumpeter (among others) I use 'cash' and 'claims', not only because are they familiar ideas, but because they describe accurately what is going on.[11]

Cash circulates between banks, central banks and treasury accounts, only leaking out a little to the general public in the form of government-issued notes and coins.[12] One of its names, 'high-powered money', is revealing. By creating new cash, and buying government debt from banks, governments feed cash into the system in the hope that it will stimulate banks to loan more claims (this is called quantitative easing). This does not always work, however. Banks like to lend when times are good and loans are productive. When times are bad, they call loans in: the process of money-creation goes into reverse and money is destroyed.[13] This is known by economists as the 'perverse elasticity' of bank-created money.[14]

The monetary system, which could be relatively simple if it consisted of cash, is made complicated by the huge variety of claims that can legally be used as money.[15] Claims are

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11 Even though it was written in the days of the gold standard when claims could be redeemed in actual silver-and-gold, C.A. Phillips, *Bank Credit* (1920) is by far the best explanation I have come across of what actually goes on in a banking system. Since modern banking is a virtual reproduction of the system he describes the book is still vital reading. It is downloadable at mises.org.

12 Notes and coins are sold to banks by the government and provided to customers of banks on demand. Once in circulation, they are however independent of the banking system.

13 See above (p. 50) for how it is destroyed.

14 E.g. Simons, (1948) p. 65; Lester (1939) p. 291.

15 Simons looked forward to 'an economy where all private property consisted in pure assets, pure money and nothing else. This, along with fiscal stabilization of the value of money, is the financial good society.' *Economics for a Free Society* p. 239. If sanity made a sudden appearance in human affairs, such a state would not be hard to achieve.

sub-categorised by type: claims that can be realised quickly, claims with a time delay, claims with special conditions attached (such as specific events occurring), claims on claims (derivatives) and so forth. The various official ways of measuring the money supply—M1-6, MZM, and so on—differ according to what kinds of claims are included in the measuring.[16] The tricks of financial acquisition by which speculators get rich are built on elaborately improvised claims, backed by state recognition of claims as legal tender, a recognition first made in the Promissory Notes Act of 1704.

Our bizarre system is far from being the only way that money can be created (others will be looked at later in this chapter) and it is now manifestly a malignant one. How did such a bizarre system come to be?

The story of bank-created money is a story of governments accommodating dubious practices for their own advantage, and it reveals who are the winners and who are the losers of the system.

Banking is one of the oldest professions known to man (the oldest is said to be prostitution) and abuses of banking trust have been detected as far back as ancient Mesopotamia.[17] Systems of law from early times wrestled with two especially risky banking habits: the tendency of bankers to speculate with money they hold in safe-keeping, and the practice of issuing claims on more money than they have in

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16 M0 (or MB) measures cash only; when governments start creating more cash, they become reticent about publishing figures for these measurements, as have the U.S. and U.K. governments recently.

17 Michael Jones, *Creative Accounting, Fraud and International Accounting Scandals*, p. 117.

store.[18] Modern banking is the legal accommodation, development and management of these ancient habits.[19]

The modern story begins in the 17th century, at a time when money consisted of gold and silver coin (and cheaper metal alloy for small denominations). Being made of something valuable in itself, money consisted of wealth that already existed. Gold and silver bullion would be brought by its owners to the Mint and converted into coin, the monarch's stamp certifying it as currency.[20] Monarchs made a profit ('seigniorage') and owners of the bullion made a profit too: they would only bring in bullion when it would be worth more as coin. The profits were usually one-off of a few percent.[21] The system could be abused: for instance, monarchs could call in the currency, re-make it with cheaper metal and pocket the difference.[22] But in general, the process of money creation was roughly neutral, in that it did not make the rich much richer or the poor much poorer.

The men blamed (or praised) for kicking-off modern banking are the English 'goldsmith bankers' who began lending claims on gold they didn't have.[23] These men were

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18 The two habits result in the same outcome: claims on more cash than bankers have in store. Abbott Payson Usher examines banking practice in relation to various systems of law in *The Early History of Deposit Banking in Mediterranean Europe* (Harvard UP, 1943); see also Raymond de Roover, 'New Interpretations of the History of Banking' in *Business, Banks and Economic Thought* (1974).

19 Usher (op. cit.) stresses that multiple lending was practiced long before the goldsmith bankers: for instance, in the early 15th century Barcelona's Bank of Deposit 'was capable of extending credit in the ratio of 3.3 times the reserves on hand' (p.181). The significant development of English banking was managed cooperation between banks and elected representatives in government.

20 See *The Pound Sterling* by Albert Feaveryear (OUP 1963).

21 Feavearyear's *The Pound Sterling* Chapters 1 and 5.

22 Certain monarchs became notorious for this: Henry VIII, for instance, added it to his already long list of historical sins.

23 Innumerable textbooks and articles on economics and banking tell the tale: for instance, Baumol and Blinder *Economics: Principles & Policy* (2009, p. 632); Greg Mankiw *Principles of Economics* (2008, p. 650), Robert Laurent in *Federal Reserve Bank of Chicago Economic Perspectives* (March 1994, p. 4).

thorough-going members of the English establishment: among them Sir Jeremiah Snow, Sir Robert Vyner (Lord Mayor of London, 1653-4), and Alderman Edward Backwell, MP.[24] Goldsmiths began their banking careers during the insecurity of the English Civil War, when some of them found there was more profit in storing gold for other people than in making things out of gold themselves. When they took deposits of other people's gold they would issue paper receipts, and these receipts—claims on gold—began to circulate as methods of payment. In other words, claims began to circulate as money.[25]

People also came to these ex-goldsmiths to borrow gold: but instead of taking away actual gold, they too preferred to take away paper claims. These claims were the same as the ones given to depositors.[26] There was an obvious temptation in this for the new bankers—to lend claims on gold they didn't actually possess.[27] So long as claimants didn't all turn

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[24] From the Goldsmith's Company website (20/01/2012): 'Several leading goldsmiths who had for some time past been keeping 'running-cashes' in order to be able to lend money to their customers at short notice now all but abandoned the practice of making and selling plate in order to run full-time banking houses, and the promissory notes they issued formed the style of our first bank notes. Prominent members of the Goldsmiths' Company such as Sir Robert Vyner, Sir Jeremiah Snow, Alderman Edward Backwell, Valentine Duncomb and Robert Blanchard made vast fortunes in their new businesses.'

[25] '"The notes of goldsmiths (whether they be payable to order or to bearer) are always accounted among merchants as ready cash, and not as bills of exchange," Tassell and Lee v. Lewis (1696) 1 Ld. Raym. at p. 744.' Quoted in Holdsworth, *A History of English Law* (1926, p. 191 n.9).

[26] Good accounts of this are in Richards, *The Early History of Banking in England* and Horsefield, *British Monetary Experiments* 1650-1710.

[27] 'The last step in the evolution of the bank-note was the discovery by the goldsmith that, as his promises to pay on demand passed from hand to hand as the equivalent of coin supposed to be behind them, so he might, on the faith of his own credit, issue promises to pay on demand that had no foundation of the precious metals as their basis.' J.B. Martin, *The Grasshopper in Lombard Street*, p. 127. 'There is, also, documentary evidence which shows that the goldsmith's promissory note which was not actually backed by gold had made its appearance in the early years of the post-Restoration regime.' Richards, *The Early History of Banking in England*, p.230.

up at once to claim the actual gold, the scam would never be discovered. Meanwhile, the bankers charged real interest on pretend money. These men were already involved in many illegal practices (coin clipping, melting down overweight coins to sell as metal, lending at rates above legal limits) so it would have been strange if they had passed up on such an obvious opportunity.

There was a further incentive: having lent money that didn't exist, they found themselves being repaid in money that did exist. So long as the paper claims kept circulating as money, the gold they represented would stay unclaimed in the bankers' vaults. The borrower would pay back the loan in gold or in paper claims—either of which could be used as money. Those early bankers rapidly became extremely rich.[28] The practical consideration for these early English bankers was what it has remained for bankers ever since: how many claims be lent on the same money without inviting the disaster of a 'run on the bank'—that is, of everyone turning up at once to claim money, most of which isn't there?

There were obviously several types of fraud (or near-fraud) in the practice. It is lending a claim on something you don't have. It is taking money (interest payments and loan re-payments) under false pretences. It is diluting the value of currency held by others—a schoolboy's dream, taking a little from everyone so they won't notice. It is manufacturing money for your own benefit.

So far, the story is just another tale of dodgy bankers sailing close to the wind. Instead of outlawing their tricks, however, successive English governments first ignored them, then made use of them, and then passed laws to accommodate them. The system which emerged, of cooperation be-

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28 For instance: 'Duncomb, not long since a mean goldsmith, having made a purchase of the late Duke of Buckingham's estate at neere £90,000 and reputed to have neere as much in cash' (Evelyn's Diary, 11 June 1696).The stages in the evolution of the goldsmith 'into a banker in the modern sense' are summarised in Richards, *The Early History of Banking in England*, Chapter IX (iv).

tween government and banks, is the system of modern banking and finance—and of government borrowing.

The injustices arising from this cooperation were widely recognised at the time and there were vehement protests – of which, more later. They was also recognised in popular speech: the 'financial genius' of the seventeenth century, who introduced the bill of incorporation of the Bank of England to Parliament, was popularly known as 'Filcher' Montague (filching means 'surreptitiously misappropriating the assets of others').[29]

In retrospect, the government's accommodation of the new practice is not surprising, for a number of reasons. First of all, the rulers of England—the Stuart Kings, the dictator Oliver Cromwell, then (after 1688) parliament—were constantly in need of cash, and not averse to acting dishonestly themselves in financial matters: they found the bankers useful and convenient sources of lending.[30] Second, the frauds fitted no established criminal category (they differed from counterfeiting and theft in that money was only created in the act of lending). Third, people with ambition were generally happy because the bankers offered them easy money at better rates of interest. Fourth, it was not obvious at first who were victims of the fraud; later, when it became obvious, the victims were not strong enough to resist.[31] Fifth, there was at that time a great demand for credit and money for capitalist ventures, and bankers were thought to be contributing to the

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29 Charles Montague, Earl of Halifax. From the *Encyclopedia Britannica* of 1911: 'It may be affirmed that no other statesman has initiated schemes which have left a more permanent mark on the financial history of England.' Thomas Jefferson also referred to bankers as 'filchers' (letter to John Adams, 24 Jan 1814).

30 'By the time James II fled England in 1688, the later Stuarts had compiled a catalogue of arbitrary actions towards their creditors as lengthy and disreputable as that of the earlier Stuarts.' Nichols, 'English Government Borrowing 1660-1688' in *Journal of British Studies,* 10, 2 1971 p. 88.

31 Fraud against the poor was open-season. Political power was with the Whigs, who were a combination of great landowners and new-money men. 'The divine right of kings was replaced by the divine right of freeholders' (Acton quoting Defoe in 'The History of Freedom in Christianity').

greater good by supplying both.[32] Lastly, English law was at that time busy accommodating merchant law (the system of international law known as *lex mercatoria*) into its system of common law.[33] Merchant law concerned itself with regulating relations *between* merchants, and not with restraining merchants on behalf of the general public. This last point is significant for the legal status of bankers' privileges today.

The new form of banking was enormously profitable.[34] By judiciously sharing a little of the profit among customers, the new bankers attracted both depositors and borrowers. Who would put gold in a strong-room that charged you to store it, when close by someone else would pay you for the privilege? Who would borrow from moneylenders at twelve per cent, when you could borrow from bankers at six—or even less?[35]

The new bankers lent claims to the government to finance its wars.[36] Charles II needed just such finance, not only for wars but also for his court extravagances. A few years later, in the 'Glorious Revolution' of 1688, Charles' successor James II was ejected and a new King (William III) put in

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32 These factors are reviewed in their contemporary context in Horsefield, *British Monetary Experiments 1650-1710.*

33 See 'General Survey Of The History Of The Law Merchant' by Thomas Edward Scrutton in *Select Essays in Anglo-American Legal History vol. 3* [1909]. Available online at Liberty Fund.

34 Before the development of English banking, Holland was the centre of world commerce. Soon, Dutch investment was pouring into England, and over the next century England replaced Holland as the centre of world commerce. Among the many reasons for Holland's decline, Charles Wilson identifies the lack of a central bank restraining the creation of credit (see the relevant essays in his *Economic History and the Historian*; also *England's Apprenticeship* (2nd ed. 1985, p 220). During the period 1650-1750 the Bank of Amsterdam, as Adam Smith relates, made it an object of pride to not lend what it did not have; but other, less scrupulous financiers were rampant.

35 See Sidney Homer, *A History of Interest Rates* (1977) pp 139-141.

36 Adam Smith gives an account of financing the Seven Years' war with bank-money which is all the more interesting because he has to resort to outright speculation, the dealings between governments and banks being even more secretive then than they are today.

place—on the understanding that parliament was now the supreme power.

Parliament consisted of wealthy men elected by other wealthy men: their interests were commerce, capital and conquest. It seemed a good idea to the parliamentarians to incorporate bank-style money-manufacture for their own benefit and use. The Bank of England was established by Act of Parliament in 1694, initially to fund war-debt. From the very beginning, the Bank of England lent its capital at least twice over, to the government and to the public.[37]

The Bank of England and private banks created capital for borrowers and income for the government. The combination proved to be the engine-house of empire: wars could be waged, assets could be bought.[38] Capitalists could borrow almost any amount, provided bankers were convinced they could turn a profit. As for the government, it borrowed from bankers by promising future tax revenues to pay the interest. It could 'spend now, tax later'. Citizens and their children would have to foot the bill; or the debt would have to be financed from gains in foreign lands.

Military power and trade progressed hand-in-hand. Colonies were developed as profitable ventures: the slave trade burgeoned: Bristol and Liverpool became great cities on the back of it.[39] 'In the West Indies, the East Indies, and on the west coast of Africa, the age of exploration was everywhere giving way to the age of exploitation.'[40] The economy expanded fast, both at home and overseas, and despite the creation of large amounts of new money there was little inflation. The new banking system proved to be an excellent device for financing (and profiting from) empire.

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[37] For a discreetly-put banker's version see Thorne F.W. *Banking* (1948) pp. 6-7; for a more direct economist's version, see J.K. Galbraith *Money: Whence It Came, Where It Went* p. 41

[38] Dickson, The Financial Revolution in England (1993).

[39] The Treaty of Utrecht (1713) which ended the War of the Spanish Succession gave England a near-monopoly of the slave-trade for thirty years (until the next war between Spain and England). For the financial importance of this see Hugh Thomas, *The Slave Trade* (1977) p. 235.

[40] Charles Wilson, *Profit and Power* (1957) p.111.

What were the domestic effects of this new money? Borrowers were able to purchase assets and labour, and to put them to work for profit. The government increased tax demands to pay interest on its growing 'national' debt. A heavy tax on land was introduced, which hurt small-to-middling landowners. In communities where few transactions involve money, demands for tax can only be met by contracting debt, and debt is often the back door to possession.[41] Many landowners borrowed to pay their taxes and then found they had to sell up—as often as not, to the bankers who had lent them money. An opposition member complained bitterly in parliament that taxes paid by small landowners went to create profit for bankers:

> The Landed Gentlemen bore the greatest Share of the [*burden of the*] Late War; by that they had been loaded with many heavy taxes: by that were all the Funds [*government debts*] created out of which the Plumb Men of the City of London have made most of their estates, by which they are enabled to deck their Wives in velvet and rich Brocades, while poor Country Gentlemen are hardly able to afford their Wives a Gown of Lindsey Woolsey.[42]

As for the poor, they were being dispossessed by other means: private acts of parliament (the 'Enclosure Acts', eventually amounting to over 3,000 in number) were taking away their livelihoods and rights in land.[43] Import taxes hurt them, as food became more expensive. Then (as now), the financial and commercial community could avoid many taxes: they were, after all, the majority power in parliament and in a position to set up and manipulate laws.[44]

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41 This is a trick both ancient and modern. Medieval monarchs had money-lenders always on hand to lend to people who could not pay their taxes.

42 Joseph Bramber (1733) quoted in Dickson, *The Financial Revolution in England* (1993) p. 28. See also Charles Wilson, *England's Apprenticeship* (2nd ed. 1985) p 217.

43 See Chapter 3 for details of this process.

44 Whigs, who dominated the political scene, were 'associated with great interests in English society: with trade, and banking, and the city, with elements that were progressive, but exclusive, and devoted to private, not to national ends.' (Acton, 'The Rise of the Whigs' in *Lectures on Modern History*). When the legality and negotiability of banker's notes were

Landowners voiced their objections to the new bankers in terms that resonate today:

> A new interest has been created out of their fortunes, and a sort of property, which was not known twenty years ago, is now increased to be almost equal to the *terra firma* [land] of our island.[45]

Jonathan Swift, writing in 1713, observed the shift in power from land to finance.

> Artful men in Office and Credit [were able] to raise vast wealth for themselves in particular, who were to be the managers and directors in it… every new sum that was lent took away as much power from the landed men, as it added to theirs.[46]

Bolingbroke worried for the future:

> What will happen, when we have mortgaged and funded all we have to mortgage and fund… all the product of our land and even our land itself? Who can answer that the whole body of the people will suffer themselves to be treated as the poor Indians are in favour of the Spaniards, to be assigned to toil and starve… who can answer that such a scheme will always be endured?[47]

Such protests had little effect: the spirit and power of the times was against them. Then (as now) the virtues of 'progress' were loudly trumpeted by men with newly-created money: investment, management, productivity were the new virtues. The countryside and the cities filled with wandering and displaced poor, looking for employment or charity from those who had magicked away their assets.

The social consequences of bank-money, then as now, were most noticeable in the early days as banks, assisted by government demands for taxation, forced a transfer of assets

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challenged successfully in the courts, parliament passed the Promissory Notes Act of 1704 making promissory notes of many sorts legal tender.

45 Henry St John (Bolingbroke) quoted in H.T. Dickinson *Liberty and Property* (1979) p. 52.

46 History of the Last Four Years of the Queen (pub. 1758) pp 130-1.

47 The Gentleman's Magazine, or The Monthly Intelligencer, Vol. 4. (1734).

on a grand scale from independent small producers to capitalists. The pattern observed here in England has been repeated all over the world.

It became apparent very quickly that the power of creating money could be dangerous for capitalists too if it was overused. Within thirty years of the foundation of the Bank of England two financial 'bubbles' grew and burst leaving financial devastation in their wake: the 'South Sea Bubble' in England and the 'Mississippi Bubble' in France (both in 1720). These bubbles left behind them a lesson: managed with restraint, privileged money-creation could be a source of great profit: unrestrained, it would lead to catastrophe. The lesson was not always remembered, of course, and there would subsequently be many hyperinflations and other crises such as the one we are living through today (2013); but it was there to be referred to.

World-wide legal accommodation of bankers' privilege copied its accommodation in English law, so it makes sense to look at how it was accommodated in England. The fundamental privilege, of owning deposits, was established not by public debate or in statute. After being practiced for some years, it was merely assumed to be part of 'the law of merchants' and therefore supported also in common law.

Circular arguments and ambiguous language hide what a bank actually 'is' in law. A banker is 'someone authorized to take deposits for the purpose of carrying on another regulated activity in accordance with that permission.'[48] In other words, banks are businesses which are authorized to behave as banks.[49] Eminent judges have protested (with no reaction

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[48] *Commercial Law: Text, Cases and Materials.* Sealy and Hooley 2008, pp 610-11. Deposits taken by other businesses—for instance, by a shop from a customer who wants to reserve a TV set—remain the property of the customer and do not need to be regulated.

[49] Paget, *The Law of Banking* (1922, p.2): 'the custom of bankers, recognised in law, can only be formed and proved by legitimate bankers.' Abbott Payson Usher, on the other hand, declares straightforwardly that 'the essential function of a banking system is the creation of credit' (*op. cit.* p. 1). In European law, a bank is 'an undertaking whose business is to receive

from those who make laws). For instance, Lord Denning (1966):[50]

> Parliament has conferred many privileges on "banks" and "bankers", but it has never defined what is a "bank" or who is a "banker" It has said many times that a banker is someone who carries on the "business of banking", but it has never told us what is the business of banking.[51]

The 'democratic element' in this bizarre set-up seems to be: we authorize elected representatives, who authorize an authority to regulate banks, who operate a system set up by (and designed to favour) wealthy capitalists some three hundred years ago. Since the electorate and most representatives seem equally in the dark about what goes on, the democratic element is perhaps weak. Or is it non-existent?

If we want to know what banks are, we must look to the regulations to understand what they actually do. Banks are regulated in two ways vis-à-vis the creation of money. First, regulators limit the amount of loans banks are allowed to create relative to their cash: this is called the 'reserve ratio'. Second, regulators attempt to limit the extent to which banks expose themselves to the risk of bankruptcy: this it called the 'capital adequacy ratio'.[52]

So the privileges of banks insofar as they relate to the creation of money are: to treat other people's money as their own, and to lend the same money over and over again. These privileges exist 'by custom'. No popular debate surrounds their continued, almost hidden existence.

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deposits or other repayable funds from the public and to grant credits for its own account'. 'Receiving deposits' and 'grant credits for their own account' are shamefully imprecise; indeed, they are misdescriptions.

50 UDT v Kirkwood [1966] 2 QB 431 CA. The case can be read online at http://www.vanuatu.usp.ac.fj/courses/LA313_Commercial_Law/Cases/UDT_v_Kirkwood.html

51 Denning actually repeats this point fourteen times, as if berating Parliament for its sinful omission.

52 Although these two requirements overlap to a certain extent, both must be exercised in practice.

The courtroom scene referred to earlier gives a fascinating look into how the English judicial system accommodates banking in practice. Three judges in the English Court of Appeal are disagreeing over what makes a bank a bank. Two of the judges—Lords Diplock and Harman—are seemingly ignorant of what a bank actually does and are happy to recognise a bank as a business which 'accepts loans of money on deposit subject to withdrawal'. The third judge, Lord Denning, considers more widely the role of the law with regard to banks and commercial practice.

'When merchants have established a course of business which is running smoothly and well with no inconvenience or injustice,' he says, 'it is not for the judges to put a spoke in the wheel and bring it to a halt.' He quotes a long-standing legal principle 'from the time of Lord Coke'[53]: *communis error facit jus*—'common error makes law'. A legal dictionary explains the principle: 'What was at first illegal, being repeated many times, is presumed to have acquired the force of usage, and then it would be wrong to depart from it.'[54]

This principle, says Lord Denning

> applies with especial force to commercial practice. When it has grown up and become established, the courts will overlook suggested defects and support it rather than throw it down. Thus it will enforce commercial credits, rather than hold them bad for want of consideration.[55] It is a maxim of English law to give effect to everything which appears to have been established for a considerable course of time and to presume that what has been done was done of right, and not in wrong.

Lord Denning states that one of the characteristics of bankers is that are 'at liberty to make use of the money' they hold on deposit. However, he does not list this as a privilege, merely as a characteristic. He then goes on to list twelve

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53 Lord Coke, 1552-1634, called 'the greatest jurist of the Elizabethan and Jacobean eras' (Baker, 2002).

54 *A Law Dictionary, Adapted to the Constitution and Laws of the United States* by John Bouvier, 1856.

55 'Consideration' in this (legal) context means 'something had in return'.

privileges enshrined in statute.[56] They relate to secrecy, exemptions from liability, tax repayments, self-advertising and powers to expropriate. Privileges relating to money creation are not among the statutory privileges listed by Lord Denning: they are valid in law for the simple reason that they are customary practice. These practices are forbidden to others; therefore, it seems reasonable to call them 'unacknowledged privileges'.

The unacknowledged privileges of banks are supported in a similar manner in international law—as part of the customary practice of banks. Modern international commercial law has developed in international courts of arbitration.[57] Traders avoid using national legal systems, which tend to be slow, expensive, inexperienced in complex commercial transactions and in some countries corrupt. Traders tend to agree in their contracts that disputes arising should be resolved in one or other international court of arbitration (of which there are more than 150 with names such as ICC, LCIA, PRIME and SCC).[58] Courts of arbitration compete with each other (and with national law systems) for the lucrative business of providing satisfactory judgments for traders. National legal systems adapt to this new Merchant Law today just as English law adapted to the old Merchant Law in the 17th and 18th centuries.

The new Merchant Law conflicts in some respects with property law, just as did its medieval precedent. 'Many of

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56 Most of these are privileges of secrecy, allowing banks to hide the degree to which claims on their cash cannot possibly be met.

57 For a summary see 'The new Lex Mercatoria and Transnational Governance' by Alec Stone Sweet in *Journal of European Public Policy* 13:5 August 2006: 627–646. Normally referred to as 'transnational commercial law', whether it deserves to be recognized as a separate legal system is disputed by, for instance, Professor R. Goode.

58 'This legal system—replete with its own 'a-national' law of contract and a system of private 'courts'—is parasitic on state authority. It uses state authority where necessary, essentially for enforcement purposes, while otherwise working to reduce the reach of sovereign control over transnational business… National legal systems, for their part, have steadily adapted to the Lex Mercatoria, thereby altering, among other things, the relationship between public and private power in Europe.' *Ibid.*

the rules of the Law Merchant were directed to evade inconvenient rules of the common law,' says a student textbook from 1929:

> One of the first rules of the common law is that a man cannot give what he himself has not. Consequently, when you buy a thing, if you are to be sure that you have title to it, you must inquire into the title of that thing back to its remote possessors, to make sure that no one in the chain of title stole it or obtained it by fraud. Whereas, the merchant said that commercial business 'cannot be carried on if we have to inquire into the title of everybody who comes to us with documents of title.'[59]

Banks, of course, lend 'what they themselves have not'. The privilege to do this is established in most countries by simple adaptation to Merchant Law.[60]

During the early days, English banking gave a tremendous advantage to English traders in their dealings abroad. They borrowed money easily and cheaply, and provided they turned enough of a profit they prospered. Later, during the nineteenth century, London became 'the place par excellence where both small- and large-scale borrowers from abroad could come for loans to develop their commercial projects and their countries.'[61] These foreign countries experienced the same shift in property relations—the same change from land-based to money-based elites—as England had experienced a century before.

For English bankers, foreign loans became a major source of income. 'International banks exist mainly to transfer capital in one form or another from countries where it is cheap to countries where it is dear.'[62] Bankers were proud their role in

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59 *A Student's Course On Legal History* (1929) by Helen West Bradlee. Cf. Holdsworth. The argument of traders depended on the principle of 'Market Overt': if transactions took place in open market and broad daylight, a buyer in good faith should obtain good title even to stolen goods.

60 'The legal orchestration of the privilege is clumsy,' writes Huerta de Soto, 'and usually takes the form of a simple administrative provision authorizing only bankers to maintain a reduced reserve ratio.' *Money, Bank Credit and Economic Cycles* (1998), p. 154.

61 W.J. Thorne, *Banking* (1948) p. 30.

62 A.S.J. Baster, *The International Banks* (Arno Press, NYT 1977) p. 1.

the expansion of Western power: 'by 1914 the great loan-issuing houses could not unjustly claim that it was largely by their efforts that Britain held in fee not only the Gorgeous East but the greater part of the rest of the world as well.'[63] This kind of expansion resumed on a large scale in the late 20th century, when ex-Communist countries put their assets up for sale and Western capitalists took advantage.[64]

Banking practice has changed a great deal over the years, but it still depends on the banker's magic trick of lending the same money again and again, in the process creating claims. The nature of the claims has changed: once they were goldsmith's receipts, next they were bankers' notes and cheques, now they are digits in deposit accounts.

Boom-and-bust cycles also continue with dreary regularity. They are less extreme than in the early days of the South Sea and Mississippi Bubbles, and they play out in slower motion. This suggests a question: are such cycles inevitable when money is created by banks? Logic would suggest they are.

Certain 18th century economists—Malthus, Ricardo, Sismondi[65]—pointed out an obvious fact: if all money ends up in the ownership of a few capitalists, and most people have no money to buy goods, then production will become unprofitable and must dry up. (Of course capitalists also con-

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63 W.J. Thorne, *Banking* (1948) p. 31.

64 '[*In new member states of the EU*] nearly 70 per cent of banking assets are controlled by foreign banks, the percentage increases to over 80 per cent in the Czech Republic, Slovakia, Hungary, Estonia and Lithuania.' ECB report (2005) quoted in *Introduction to Banking* by Barbara Casu and Claudia Girardone, Philip Molyneux (2006).

65 For Malthus, see *Principles of Political Economy* (1836) Book Two, Chapter One, Section X. For Sismondi, see 'On the National Income, or the Income of the Community' (1835, tr. 1847). Ricardo points to ownership of the means of production as determining spending power: 'If machinery could do all the work that labour now does, there would be no demand for labour. Nobody would be entitled to consume anything who was not a capitalist, and who could not buy or hire a machine.' *Works* VIII, p 399. All are available free online at Liberty Fund.

sume and spend, but a single capitalist can only eat so many dinners, wear so many overcoats etc.).

As we have seen, bank-created money is a device invented for the purpose of transferring assets into the ownership of capitalists, a function it performs very well. As the proportion of bank-created money in the money supply increases, so this transfer of assets increases.

This transfer is evident in the day-to-day workings of banks. Claims—the money we use every day—disappear when a loan is repaid (see page 50). Meanwhile, interest payments continually transfer other claims (money) to bank ownership. Some of this bank income is used to pay running costs, and returns to circulation; some of it is invested, inflating asset (capital) prices; some of it returns to investors of capital, as profit. In other words, a proportion of interest payments transforms 'currency'—money used for spending—into 'capital'—money seeking investment. This augments the Malthus-Sismondi drift of currency to capital.[66]

So every bit of money created by banks as currency is created with two inbuilt mechanisms for its own destruction: either to disappear (when loans are repaid); or (via interest payments) to cease being currency and become capital. Both ways, it ceases to be money in circulation. This is the essential character of bank-created money, as distinct from money pure and simple.[67]

As the amount of currency diminishes, the system must go into crisis. There will simply not be enough money in circulation to pay for the goods and services that will make new loans profitable. Production cannot continue without a market: a market consists of customers both willing and able

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[66] A generalised statement such as this can be easily disregarded or attacked. Because an economic event is the outcome of many different factors, economists disagree with each other simply by emphasizing a selection of factors. Mathematics is of limited use (beyond confusing the opposition) because it can only deal with a limited number of variables.

[67] The loans-to-deposits ratio of banks is significant here: whereas 20% was normal before 1945, 100% is now more usual, meaning that if all loans were repaid, all money in circulation (except notes-and-coins) would simply disappear!

to buy. Banks' appetites for making new loans must simply dry up.[68] Only a massive drop in capital values, destruction of capital assets, and/or new investment possibilities can re-start the cycle. War is effective at the latter two of these.

The logic of this is both simple and congruent with what happens. But although economists generally accept that bank-created money exacerbates business cycles, there is strong resistance to the idea that it actually causes them.[69]

The process outlined above, combined with government taxation, borrowing and spending, causes a constant transfer of assets from independently productive people to corporate investors and government. It goes some way to explaining the wealth gap in our present world, the recurring booms-and-busts of the 'business cycle', and the need for relentless growth to create new loans and new deposits for currency.

The distinction between cash and claims-on-cash seems odd today when both are almost entirely digital numbers. Nevertheless, it is the system that banks and governments work to, a carefully-nurtured continuation of the old system based on gold and claims-on-gold which served them so well for so many years.

The system needs growth to feed it: to keep the money supply abundant. The rest of us may or may not care about growth: we might feel fine if the size of the pie was constant, or even a little smaller, but more equitably divided. We

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68 Economics has proved remarkably resistant to the language and concepts of cybernetics (the study of systems) which revolutionised most practical sciences in the 20th century. For instance John Hicks, preferring Newtonian descriptions based upon assumptions of equilibrium and perfect competition, objected (*Value and Capital* 1939 p.84) that abandoning these assumptions could lead 'to the wreckage of the greater part of economic theory'. Since economics is largely a study of systems, the wreckage might have been a prelude to better insight. Tyranny of theory puts any discipline in danger of becoming an art of *ignoratio elenchi* – elaborating the irrelevant.

69 Fisher, *100% Money* (1935); 'If some malevolent genius had sought to aggravate the affliction of business and employment cycles, he could hardly have done better than to establish a system of private deposit banks in the present form' (p. 47).

might prefer reform of the banking system to the devastating effects of relentless growth. But we are not asked; indeed, we are generally ignorant of how banks create money and our ignorance is carefully nurtured and preserved.

As mentioned earlier, banks can create an infinite amount of money unless they come up against some restraint. Until thirty or so years ago, these restraints were more effective than they are today.

Two kinds of restraint act on the amount of money that banks create. First is the self-interest of banks and bankers. If they create too many claims on the same cash word gets round: people panic and claim 'their' cash. The bank then goes bust (it happened recently in Britain with Northern Rock) or demands an expensive bail-out.

The second kind of restraint is government regulation, which banks must accept as a condition of their license.[70]

Both kinds of restraint became dramatically less effective around the 1980's. First, the self-interest of individual bankers shifted like a weather-vane to an opposite direction, simply as a result of a change in how they were rewarded. While bankers were on a fixed salary it was in their interests that their bank should do well: it would survive and continue to pay them. Once they began to earn gigantic rewards from bonuses, however, it was in their self-interest to turn business over as quickly as possible, making loans regardless of whether they were good or bad for the bank. Bankers looted their own banks and retired rich: banks were placed on life-support, at citizens' expense.

The other form of restraint – by government regulators – was relaxed as politicians and central bankers became excited about the huge quantities of money being generated by unrestrained banking.

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[70] This regulation is of two kinds. 'Reserve requirements' govern how many claims a bank may create on its cash: the ratio varies between 1 cash to 10 claims, and 1 cash to unlimited claims. 'Capital adequacy requirements' estimate the total worth of a bank and contrast it with how much the bank owes its depositors. The ratio has varied in recent years between 1 to 15 and 1 to 70.

Loss of restraint created a breeding ground for bizarre and outrageous financial instruments (derivatives and so forth, consisting essentially of claims-on-claims-on-claims etc., disguised by securitization). Mathematicians went to work to confuse and deceive innocent purchasers. Obscure legal principles were dug up to assist in fraudulent practice.[71] Outright corporate criminality also flourished and thefts of billions went unpunished.[72]

The scale and complexities of debt and temporary claims are now incomprehensible to the human mind. A 'shadow banking system', creating and trading complex financial instruments beyond regulation, feeds funds into the conventional banking system.[73] 'Quadrillion' is a fashionable new word for the amounts involved: if a pile of a million dollars comes up to a human knee, a quadrillion is high as a MILLION Empire State Buildings. Vast quantities of temporary 'money' expand and disappear like bubbles of gas, leaving behind real riches for some and real poverty for others.[74] Using the simple privileges of banks, the 'financial services industry' has become a gigantic predatory parasite draining the human and natural worlds of life.[75]

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71 For instance the 'holder in due course' doctrine which 'is part of the little-known, often-ignored backwater that is negotiable instruments law and, simultaneously, is at the heart of today's great crisis of the American financial system, predatory lending.' Kurt Eggert, 'Held Up In Due Course', *Creighton Law Review*, Vol. 35 (2002).

72 Citigroup, MF Global, Goldman Sachs are some of the more public examples.

73 'The size of the balance sheet is no longer limited by the scale of opportunities to lend to companies or individuals in the real economy. So-called 'financial engineering' allows banks to manufacture additional assets without limit. And in the run-up to the crisis, they were aided and abetted in this endeavour by a host of vehicles and funds in the so-called shadow banking system, which in the US grew in gross terms to be larger than the traditional banking sector.' Mervyn King, Speech to the Buttonwood Gathering, New York, 25 October 2010.

74 David Ricardo: 'There is but one way in which an increase of money no matter how it be introduced into the society, can augment riches, viz at the expense of the wages of labour.' *Works*, 3, 319.

75 Goldman Sachs was described as 'a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into

Where this scenario becomes extreme (in certain European states) ordinary citizens, bemused by the inertia and/or corruption of those who pretend to represent them, begin to imagine they would prefer the simplicity of one criminal, one organization, one set of rules however brutal, to a system in which they are helpless and uncomprehending victims. The spectre of totalitarianism rises once more.

The connivance of governments in perpetuating a system long past its sell-by date is at first sight puzzling. Is power so attractive, so intoxicating, that reason goes out of the window? Is ambition compatible only with shallow understanding? Is the prospect of reform too frightening? Do they believe that with a little tinkering we can carry on how we are?

Perhaps all of these: and there is more. Governments enjoy benefits from bank-created money which are available to them alone. They can borrow against the present and future work and wealth of their citizens without so much as a by-your-leave or a do-you-mind, to fund their expenditures.

Most debts are owed by or to a human person. The 'beneficial owner' of debt can be traced: if not an individual owner, perhaps a shareholder in a corporation. These owners can cash in or pay off their debts. Only the passive citizenry of governments are unable to opt in or out of the debts incurred in their names. The government holds them in an iron grip (unless they are rich enough to domicile elsewhere).

The bizarre element in this is that governments not only borrow in the names of their peoples, they simultaneously hold assets in the names of their peoples. An extreme example of this is the Chinese government which holds, in the name of its people, roughly 3 trillion in currency (earned from exports): it simultaneously owes its people getting on for three trillion in various types of debt.[76] Both these funds

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anything that smells like money'. Matt Taibbi, 'The Great American Bubble Machine, *Rolling Stone*, April 5, 2010.

[76] Debt owed at both national and provincial level. Official Chinese sources list the debt at 1.66 trillion: this excludes considerable assets held and

are available to it (and its favoured ones) for capital projects—and are most certainly not available to 'the people' in whose name they are held.[77] The people cannot withdraw from the contracts which bind them into lending and borrowing: the authority of the state in these matters is supreme. It is the same under all representative governments, whether one-party as in China or multi-party as in the West.

Such funds enable governments to undertake not just wars but immense financial and social projects. Arms production and sales worldwide are funded by money taken or withheld from citizens, fuelling the competitive needs of nations to bristle and sometimes fight.

What is perhaps even more important is that dependency on the state and its projects—military, employment, welfare—transforms a nation in its collective mentality. There will be more on this in chapter 6.

Meanwhile, the demands of debt grow until the prospect of bankruptcy looms. 'Until World War I, no government in history was able—even in wartime—to obtain from its people more than a very small fraction of its country's income—perhaps 5 or 6 per cent,' wrote Peter Drucker.[78] Now, governments take nearer 50%.

Where governments take 50%, citizens must be doubly productive to justify employment: their work must pay for everything else. Employees in such states become uncompetitive. Corporations relocate production to where workers are not so encumbered.[79] Unemployed workers become an additional expense for the state: another vicious circle.

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managed in the name of the people. *CIA World Handbook* (online) and other sources.

77 Outside of the corporate entities known as 'governments' and 'peoples', all debt and wealth can eventually be traced to some individual person's ownership, even if only via a long chain of corporate ownerships.

78 *A Functioning Society* (2003) p. 60.

79 This was noted by Montesquieu: See *De l'Esprit des Lois*, Part 4 Book 22 Chapter 16.

The bankruptcy of governments, businesses and individuals is now so vast, however, that change is inevitable.[80] The question is: will change be intelligently managed, or will it take some extreme form? Privilege is often a prelude to revolution: it is generally a good idea to avoid revolution.

But, from where can we expect reform? None can be expected from international commercial law: contracts are supported as a matter of course, so long as no illegality is involved. 'Illegality' is defined by national legal systems, which conform anxiously to international practice, partly from convenience, partly to avoid exclusion from markets. Where can reform begin? Legal reform of banking privilege would inevitably isolate a nation from the international community. It would however be possible (in theory) for a nation to challenge banking privilege in the International Court of Justice.[81]

Over the centuries, objections have come from many quarters to banking privilege. Remarks made by United States presidents after leaving office are prominent among them. John Adams, for instance, second president of the United States, noted that bank-created money depreciated the currency: it also 'represented nothing, and is therefore a cheat upon somebody'; Thomas Jefferson, third president of the

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80 'Zombies' is a new word for businesses, governments and individuals able to hang on to solvency only because interest rates are close to zero.

81 The days seem remote when financial devices were examined in court for their benefit to the community as a whole, as for instance in debates over the value to society of the 'floating charge' (see Lord Macnaghten's judgement in the House of Lords in the case of *Salomon v Salomon*, 1897). As early as 1800, the commentator Edward Christian complained that merchant law had 'very unfortunately led merchants to suppose that all their crude and new-fangled fashions and devices immediately become the law of the land: a notion which, perhaps, has been too much encouraged by the courts (…) Merchants ought to take their law from the courts, and not the courts from the merchants; and when the law is found inconvenient for the purpose of extended commerce, application should be made to parliament for redress.' Edward Christian, quoted in *Readings On The History And System Of The Common Law* p. 223 (Roscoe Pound & Theodore F.T. Plucknett eds., 3rd ed. 1927).

United States, wrote that creation of money by banks would 'deliver our citizens, their property and their labour, passively to the swindling tricks of bankers and mountebankers'.[82]

Adams' remark, that created money is a cheat upon somebody, is surely spot-on: nothing comes from nothing, and the value of created money is stolen from the value of everyone else's money. Jefferson's remark was also prescient. Over time, England, America, and other countries that adopted the English system, found themselves transformed from nations of (predominantly) independent and rightful occupiers into nations of (predominantly) dependent employees.

Vast cities of the poor and dispossessed bear testament to this process today, and provide a cheap and needy workforce for industries owned, either nominally or through debt, by investors, banks and financial corporations.

We are now perhaps in a position to see who are winners and who are losers in the game of money-creation.

The category of 'winners' is wide. Depositors and borrowers get better rates and charges. Managers take a lot in salaries and bonuses, etc. Employees get paid; services and buildings are paid for; governments receive taxes. Capitalists are able to own more. A few entrepreneurs get started with bank finance, although most have look to sources other than banks.[83] Shareholders benefit from income and capital gains, and not just shareholders: profits of ownership are reinvested, inflating the value of capital assets generally, mak-

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[82] 'Our medium is depreciated by the multitude of swindling banks, which have emitted bank bills to an immense amount beyond the deposits of gold and silver in their vaults, by which means the price of labor and land and merchandise and produce is doubled, tripled, and quadrupled in many instances. Every dollar of a bank bill that is issued beyond the quantity of gold and silver in the vaults, represents nothing, and is therefore a cheat upon somebody.' Adams to Vanderkemp, 16 February, 1809. Jefferson's remark is in a letter to John Adams, March 21 1819.

[83] Usually because they have no collateral, people starting out in business are not favoured by banks. They borrow from family, friends, associates.

ing everyone with assets a little richer.[84] Banks themselves inflate asset values by investing profits. They make available newly-created capital for speculation: this was responsible for the real estate bubble, as fund managers poured money into loans backed by homes.[85] By and large, winners are not primary producers, or if they are it is in some other area of their lives.

'Losers' include everyone who is out of the game or not successfully playing it. Some play incompetently; some do not want to play; some have no idea what the game is about. For most people, the game is something played far away in a place of which they have little or no knowledge. Their experience of the game is no fun at all: a slow loss of freedom and assets, punctuated with sudden traumas: homes and farms 'repossessed': a sinking into debt and a growing dependence on those who have filched their assets. By and large, losers are primary producers.

Most of all, however, the world loses what it could have been. Who can tell what kind of a world could have emerged, might still emerge, if capitalism was not privileged, but a level playing field: if it was fuelled by savings rather than by created credit. Who can even imagine a world in which governments are genuinely run by their peoples?

Electoral representation is now the dominant form of government across most of the world and it carries with it its characteristic system of banking. Late-coming nations find themselves robbed not only by powerful foreigners but also

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[84] 'High real profits seem but modest returns to shareholders who have come in later and paid high prices for their stock (simply because dividends were high), not to the company but to the previous owners.' *The Economic Organisation of England'* Sir William Ashley, (1914), 1957, pp179-80. Averaging holding periods for US and UK bank shares fell from around three years in 1998 to around three months by 2008.' Andrew Haldane in *London Review of Books*, 23 Feb 2012.

[85] 'NINA' loans were made to people with 'No Income No Assets'; some loans were made to dead people. This jamboree led to the financial collapse of 2008. Summary: http://www.thisamericanlife.org/radio-archives/episode/355/transcript

by their own elites.[86] Once the robbing is done, elites may relocate their assets to London or Miami or New York or to another centre of their choice, thereby further impoverishing their fellow-nationals and enriching their new home-country.

Money need not be created by banks. In *Monetary Experiments* Richard A. Lester demonstrated how money created equitably also stimulates economic growth.[87] In these conditions, lending and borrowing does not disappear: some people accumulate, save and have money to lend, others have projects and need to borrow. Straightforward money-lending is very different to the activities of banks, which create money in the process of lending it.[88] One can only wonder how the world would look today if enterprises had been funded from genuine savings, not from 'credit' created by banks—money based on debt.

Debt is a kind of servitude. Other freedoms lose their meaning if, desperate and anxious from debt, citizens live constricted lives amid the ravages of 'economic growth' whose main purpose, concealed under veils of pretence, is to increase the wealth of remote owners. The more remote the owners, the less knowledge they may have of how their wealth is being used, for good or bad.

How can this situation be changed for the better?

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86 Western-style banking also greatly enhances opportunities for corruption. See, for instance, '$1bn fraud at Kabul Bank puts UK's Afghan pull-out in peril' *The Independent,* May 22, 2011 and 'Scandale étouffé à la Kabul Bank' in *Le Monde Diplomatique* 10/2011.

87 Richard A. Lester, *Monetary Experiments* (1939). Chapter V: 'Social Dividend in Maryland in 1733.'

88 In the 13th century Lombard bankers, by lending the same assets many times over, were able to charge low interest rates and thereby drove Jewish moneylenders out of the marketplace. This fact alone points out the devious psychopathology of writers such as J.A. Hobson, Ezra Pound, Henry Ford and my own grandfather Sir Oswald Mosley, who wrongly blamed banking on 'the Jews'. Banking was reinvented for the modern world by Lombards and established globally by nations following the English example. The Nazi banker Hjalmar Schacht was probably the most virtuosic banker of all time—in the service of the State (see below).

Every time the international and interconnected financial sector goes into crisis there is a flurry of discussion about reform. A battle of ideas takes place: on the one side are governments, banks and their dependents; on the other side are advocates of more sensible or fair ways of providing the money supply. So far, those against reform have always won. Eventually something has happened to kick off another boom—World War II, the collapse of communism, another revolution in production or technology—and thoughts of reform are (temporarily) forgotten.[89]

But after each crisis, a legacy of thought and writing is left behind by the defeated party for future consultation. The Great Depression—because it lasted so long—was particularly fertile for ideas, discussions, and suggested solutions.

Proposals for Reform

The object of this section is to outline a variety of proposals for reform that are currently being suggested.

To begin with, a suggestion for reform to be avoided: that is, nationalization of banking privilege. This suggestion is favoured by political extremists and is proving attractive to people in countries which have been bled dry by banks and investors. This could only lead in the direction of the totalitarian state.[90] The state would be able to pick up all the wealth and power which at present goes to banks and investors: suppression of freedom and democracy, mismanagement, and other monstrosities of twentieth-century totalitarianism would follow. The state, with its total power, would no doubt manage the trickle-down to consumers somewhat better, but at the cost of almost everything else.

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[89] Einstein is supposed to have said, "I don't know what weapons World War III will be fought with, but World War IV will be fought with sticks and stones."

[90] Nazi state-sponsored 'Mefo bills' created claims-to-equity in the ratio of 12,000:1, giving huge purchasing power to the state. A special company was created with a million in capital; twelve billion was lent against it; the government bank exchanged these bills for money on demand. Banks have never come near to such an outrageous ratio: 60:1 is regarded as pushing it. See Avraham Barkai, *Nazi Economics* (1990) p 165.

Reform 1: No-privilege Banking

The basic idea of 'no-privilege banking' is simple: banks should obey the law like the rest of us. They should not be allowed to treat other people's money as their own; they should not be allowed to lend multiple claims on the same money; they should not be allowed to create money. What would 'no-privilege' banking look like? At the till end, for the average customer, it would not look hugely different. Banks would do what many people think they do: they would be safe-holders of deposits and intermediaries of credit.[91] Their services would be more expensive, but a great deal more affordable (for most) than the hidden price of banking today.

Customers would be asked (in a similar way to today): 'Do you want to be able to take money out whenever you like? Or would you rather leave it with us, say for five years, and we'll pay you some of the interest we get from lending it?' The bank would then marry up deposits and borrowers in a fairly simple fashion—and not lend out money which customers want to be able to access at any time.

Bank balance sheets would look quite different, more like those of ordinary businesses. Deposits would belong to depositors and not appear in the balance sheets. Inspection and accounting would be conducted with the aim of suppressing fraudulent practices, including those which aim to create money. Detected occurrences of fraud would lead to the same penalties as forgery, counterfeit and theft. In addition, as Henry C. Simons points out in proposals outlined later in this chapter, the types of property recognized in law would have to be simplified, to restrain the creation of financial instruments whose sole function is to increase the wealth of traders.[92]

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[91] Most reformers suggest also a separation of these two functions between different institutions, though if bankers had no privilege I doubt that would be necessary.

[92] Simons, *Economics for a Free Society* p. 239. Chapter X: 'Debt Policy and Banking Policy'.

Amid the howls of outrage to be heard when such reforms are suggested is the protest: but there won't be enough credit for economies to flourish! Removing the privilege of banks to create money would indeed remove a certain kind of credit: the kind that is 'magicked' from the assets of others. Reformed banks, on the other hand, would be genuine intermediaries between would-be creditors and would-be debtors. Other ways of organising credit would become more competitive: true intermediaries such as friendly societies, credit rings, credit unions and mutuals, developed over the centuries, are with us still.[93] The market would presumably diversify: new sources of credit are now being developed, for instance by putting investors and entrepreneurs in touch with each other over the internet.[94]

There is also a fear that if banks in one country are not allowed to create money, that country will be vulnerable to banks which *can* create money—just as countries have been vulnerable in the past and are vulnerable today. That suggests an interesting question: what would become of a country that insisted upon its banks operating without privilege? Banks adopt the 'fractional reserve' system because it is more profitable: they would be fools not to.

An intriguing technical addendum: a bank compelled to maintain a 100% reserve ratio would (if integrated with the present banking system) swiftly gain cash from other banks via 'favourable clearing house balances'.[95] The presence of such a bank would (presumably) be intolerable to the system. At the moment, such an event is out of the question because banks act in tandem out of their own self-interest,

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93 An interesting case is the not-for-profit bank WIR, which, it is suggested, has contributed to Switzerland's relative economic stability during boom/bust crises. James Stodder, *Reciprocal Exchange Networks* (available online, March 2012).

94 For instance, the Angel Investment Network and other 'angel' investment groups.

95 See C.A. Phillips (1920) Chapters 3, 4 (particularly pp 77-8); also 'The Theory Of Multiple Expansion Of Deposits: What It Is And Whence It Came' by Thomas M. Humphrey, *Economic Review* March/April 1987 (available online at the Federal Bank of Richmond website).

expanding loans at the rate of what they can get away with, simply to maximize profit.

Reform 2: Governments and Currency Creation.

We are so familiar with money created as debt by banks that it is hard to imagine it being created any other way. Supposing money was created free-of-debt. Who would make it? How would it find its way into circulation?

When money circulated as coins—made of gold, silver and 'base metal' for the cheaper ones—the commonest complaint was that there was not enough of it. This didn't mean that people wanted to be given more money: it meant a shortage of coins in circulation was making it hard to exchange goods without resorting to barter.[96]

Coins entered circulation as payment. A merchant might take metal to the Mint because it would be worth more to him as coin than as metal: from that point on, coins drifted into circulation in payment for services, and circulated between people as a means of exchange. In other words, people were happy to 'buy' money in exchange for what they had to offer, because they knew they could use it to buy something else. The undisguised simplicity of this kind of economy, where money (valuable in itself) is swapped for something wanted by someone else, made it hard for individuals to amass vast quantities of money. Instead, power was gained and held by control of land and hereditary rights over others.

In the modern world, in so far as it is groping towards advances in democracy, neither type of power seems to be much of a good idea. There is no real democracy when most of the money (and therefore most of the power) is in the hands of privileged elites. 'No individual, no group, association or union can be entrusted with much power… it is mere foolishness to complain when absolute power is abused. It

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[96] In these conditions, money often became symbolic: an amount owing might be specified in currency but paid in another commodity, the amount being assessed by its known value in relation to coin. Again, see Usher: *The Early History of Deposit Banking in Mediterranean Europe.*

exists to be abused.'[97] It is also foolishness to believe that people with privilege will gladly give up their privilege—or support proposals to remove it. It is a rare person who, like Cincinnatus, voluntarily shuns privilege: elites have watched their worlds collapse around them rather than give up their privileges.[98]

Transitional periods are a concern: how would we move to a new banking order without the world collapsing around us? David Ricardo, suggesting reform of the Bank of England, proposed that money be created (by government) sufficient to make up the difference between the bank's cash and claims on its cash, and then given to the bank.[99] Variations on this idea have resurfaced (for instance on the Cobden Centre website).[100] Such a gift would not be inflationary, because the cash would stay put (be 'inert'). It would, however, shore up the property *status quo* and this might be undesirable, given the terrible poverty produced by years, decades and even centuries of filching.

Another possibility is to allow banks to go bankrupt, the government guaranteeing a certain minimum deposit (per individual, not per bank account!). Subsequently, banks would be authorised to reconstitute themselves, without debt, as true intermediaries of credit. Certain proposals already point in this direction, formulated by politicians in the event of catastrophic bank meltdown. When considering the consequences, an important consideration to bear in mind is that what most of us think of as 'money' is in fact debt, owed by banks to customers, which could not be repaid.

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[97] Oakeshott, 'The Political Economy of Freedom' in *Rationalism in Politics and Other Essays*.

[98] One has only to think of the French Revolution or the collapse of Communism.

[99] Ricardo was addressing the creation of money as bank notes. He denied that bank-credit creates money: see 'Evidence on the Resumption of Cash Payments' (1819, *Works*, Vol 5 p 437) and 'Plan For The Establishment Of A National Bank' (1823) Vol 4, pp 282, 283 (Liberty Fund Edition).

[100] http://www.cobdencentre.org/2010/05/the-emperors-new-clothes-how-to-pay-off-the-national-debt-give-a-28-5-tax-cut/

Governments cannot be relied upon, however, while they are busy with their own deceits. Niall Ferguson observed in his 2012 Reith Lectures:

> The present system is, to put it bluntly, fraudulent. There are no regularly published and accurate official balance sheets. Huge liabilities are simply hidden from view. Not even the current income and expenditure statements can be relied upon in some countries. No legitimate business could possible carry on in this fashion. The last corporation to publish financial statements this misleading was Enron.

Reform 3: Corrective (Restorative) Justice.

From the time of Aristotle, an important part of justice has been 'corrective' or 'restorative' justice. The basic idea is pretty simple: when something has been stolen, it should be restored to its owner.[101] This has been known more recently as 'restitution' and a proper application of the laws of Unjust Enrichment would qualify a huge number of people for restitution.[102] This seems, however, a most unlikely outcome.[103]

However, it is still worth considering whether, given that much of the world's wealth has been transferred from independent owner-producers to creators of capital as a result of banking practice, some restorative justice is appropriate. Should the new property *status quo* just be accepted, or should there be an attempt to redress injustice? The situation is complicated by the fact that privileged money-creation, by and of its nature, has selected certain human qualities to prosper above others, and the qualities of our new elites are perhaps not of the best. Repudiations and negotiated reduc-

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[101] 'The judge tries to restore equality by penalty, thereby taking from the gain.' Aristotle, *Nicomachean Ethics*, V, 4, paragraph 2. This has nothing to do with modern 'restorative justice' which involves trying to reconcile perpetrators and victims, and would be better called 'reconciliation'.

[102] *Unjust Enrichment* by Peter Birks (OUP, 2005). Chapter 1.

[103] St Augustine tells how Alexander the Great captured a pirate and took him to task for terrorizing the seas. The pirate replied 'because I do it with a little ship I am called a robber, while you, who do it with a great fleet, are styled emperor.'

tions of debt contain an element of restorative justice. At the moment, these happen only when they can no longer be avoided. Why should not banks go bust, and governments give set amounts of newly-created money to everyone? As for those now destitute, who were once just poor—should they be given assets to (for instance) re-purchase land or set up in business—or, for that matter, just to 'spend, spend, spend'?

In 1919 the economist John Maynard Keynes wrote of a world complicated by great debts, both internal and between nations, arising out of the First World War. Keynes recommended a carefully-conducted 'general bonfire' of debt. His advice was not taken. Twenty years later, war broke out in Europe once again. The debt situation today is not (so much) the result of war, but sentences from what he wrote ring bells for today: the passages that follow could hardly seem more apposite (the original is available online at Project Gutenberg, www.gutenberg.org):

> The policy of degrading the lives of millions of human beings, and of depriving whole nations of happiness should be abhorrent and detestable even if it were possible, even if it enriched ourselves, even if it did not sow the decay of the whole civilized life of Europe. A debtor nation does not love its creditor, and it is fruitless to expect feelings of goodwill if future development is stifled for many years to come. If, on the other hand, these great debts are forgiven, a stimulus will be given to the solidarity and true friendliness of nations.

> The existence of the debts is a menace to financial stability everywhere. There is no European country in which repudiation may not soon become an important political issue. In the case of internal debt there are interested parties on both sides, and the question is one of the internal distribution of wealth. With external debts this is not so, and the creditor nations may soon find their interest inconveniently bound up with the maintenance of a particular type of government or economic organization in the debtor countries. Entangling alliances or entangling leagues are nothing to the entanglements of cash owing.

> The final consideration influencing the reader's attitude must depend on his view as to the future place in the world's progress of the vast paper entanglements which are our legacy both

> at home and abroad. We shall never be able to move again unless we can free our limbs from these paper shackles. A general bonfire is so great a necessity that unless we can make of it an orderly and good-tempered affair in which no serious injustice is done it will, when it comes at last, grow into a conflagration that may destroy much else as well.
>
> As regards internal debt, I am one of those who believe that a capital levy for the extinction of debt is an absolute prerequisite of sound finance. But the continuance on a huge scale of indebtedness between Governments has special dangers of its own. Bankers are disposed to believe that a system between Governments, on a vast and definitely oppressive scale, represented by no real assets is natural and reasonable and in conformity with human nature.
>
> I doubt this view of the world. Will the discontented peoples be willing so to order their lives that an appreciable part of their daily produce may be available to meet a foreign payment, the reason of which does not spring compellingly from their sense of justice or duty?'[104]

Reform 4: Money, Freedom and Democracy.

In relation to economics, the three qualities that we believe to be the foundation of modern civilization—democracy, freedom and equality—seem to genuinely share common ground. As mentioned before, debt is a kind of servitude. Destitution is worse: there is a pretty desperate kind of freedom in being broke, whatever the popular song may say.[105] Money only gives one kind of freedom, and perhaps corrupts others, but in the modern world it is a rare person who can live happily or well without it.

(i) Equitable distribution

Equitable distribution of new money—very different from equitable distribution of assets, because money quickly leaves some of us and just as surely is attracted to others—

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[104] From 'The Economic Consequences of the Peace' by John Maynard Keynes (1919). Project Gutenberg, online.

[105] 'Freedom's just another word for nothing left to lose.' *Me & Bobby McGee*, Kristofferson & Foster.

would allow everyone at least a stab at equality of opportunity and it is certainly more democratic (by any definition of 'democracy') than current arrangements. Our modern affluence is mostly produced by machines. Sharing it would be more grown-up than fighting over it.

There exist historical examples of equitable distribution. For instance in Maryland, as told in *Monetary Experiments* by Richard Lester:

'When Maryland first issued paper money in 1733, most of it was given away—a certain sum to each inhabitant over 15 years of age.' This appears to have been 'the most successful paper money issued by any of the colonies... Hitherto, nearly all the people in the province had been engaged in the raising of tobacco… But now, wheat was raised, roads were cleared, bridges were built, towns sprang up, and facilities of social and commercial intercourse were thereby greatly increased.'[106]

A more modern story of equal distribution is told by R.A. Radford, of money emerging spontaneously in a specific currency in the confines of a prisoner-of-war camp during the Second World War.[107] Cigarettes were issued along with other goods in equal rations by the Red Cross. Cigarettes became the agreed currency, used by all inmates to value and pay for goods. As might be expected, some inmates became wealthy in cigarette-currency and others merely got by: wheeler-dealing, innovative business practices and smoking the currency all played their part in the redistribution of wealth. Debt in this situation is obviously unrelated to the issue of currency. From Radford's account, it would seem that debts were short-term and minor, contracted on the spot and soon redeemed.

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[106] Richard A. Lester, *Monetary Experiments,* Princeton University Press (Reprinted David & Charles 1979) pp 142-151: he quotes from Gould, *Money and Transportation in Maryland, 1720-1765* (1915) and Mereness, *Maryland as a Proprietary Province* (1901).

[107] R.A. Radford, 'The Economic Organisation of a P.O.W. Camp' in *Economica* Nov. 1945.

Various suggestions that currency be distributed to all citizens, without either means test or work requirement, have come under the rubric 'basic income'. These payments would replace standard welfare payments and they would be paid to everyone whether or not they were in work. A 'basic income' is obviously a more equitable, and perhaps less toxic, way of distributing new money than present practice. It would also mean that wages would add to, rather than replace, state-supplied income, thereby eliminating the 'poverty trap'. A surprising variety of people have supported this idea under the name Guaranteed Annual Income (for instance US Presidents Nixon and Carter).[108] Whether new money would be distributed as and when monetary stability requires, or whether some steady and guaranteed amount would be supplied, would be the key consideration here.

These kinds of innovation have been relentlessly (and so far victoriously) opposed, not just by self-interested beneficiaries of government and business, but also by a strong puritanical element in Western civilization which views the poor as unruly, undeserving, improvident and a variety of other epithets used to justify what historian Preserved Smith has called the 'ceaseless war on the poor'.[109] Even when governments create money, there seems to be a reluctance to let it enter circulation outside the control of banks.[110] Is there a fear of the poor regaining their independence? Do the affluent believe that affluence is theirs by moral right? To this,

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108 See Brian Steensland, *The Failed Welfare Revolution: America's Struggle Over Guaranteed Income Policy*. Princetown University Press, 2008.

109 Preserved Smith, *The Reformation.* The chapter on 'The Rise of the Money Power' is as interesting as Weber's famous book on the same theme, *The Protestant Ethic and the Spirit of Capitalism* (1905).

110 Keynes apparently thought that new money should be hidden buried in milk-bottles so that only needy people, who would actually spend it, would bother looking for it. 'Quantitative Easing' is the opposite of this practice: feeding cash in at the top end in the hope that it will be multiply lent.

Acton remarked, 'there is not a more perilous or immoral habit of mind than the sanctifying of success.'[111]

(ii) A Return to Commodity Money

The origins of money are lost in pre-history. Archaeologists tell us that commodities such as gold, cowry shells, salt, rice and cattle were in use as currencies long before written records. These commodities were valuable in themselves: gold and shells were valued as jewellery and ornaments; copper for its use in making vessels; salt, rice and cattle for food. For thousands of years, money continued to be made of something valued in its own right—most usually of metals, because they can be easily shaped into different sizes and weights. This kind of money is now referred to as 'commodity money'. It cannot be created out of nothing and its value as money tends to stay pretty close to the value of what it is made of.

Many of these commodities were used as money with no alteration. Metals were of course transformed when made into coin, but we have seen how there were not usually huge profits in the process. The relative stability of money continued with paper money, for as long as each piece of paper represented a piece of gold or silver in storage.[112] As we saw earlier with the 'goldsmith bankers', it was only when paper claims began to be issued in excess of stored bullion that rampant money-creation began, resulting in great riches for some and gradually increasing poverty for others.

Seeking a return to stability, many suggestions for reform centre on a return to a gold standard, or to currencies fully

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111 Acton, *Lectures in Modern History: The Puritan Revolution*. The connections between Protestantism and capitalism are explored in a number of classics (Weber, Tawney). Puritans tell us that God sanctified capitalism in the Parable of the Talents (Matthew, Ch. 25) but it contains no mention of multiple lending. Christians might also note the Parable of the Unjust Steward, where a servant is praised for currying favour with his master's debtors by letting them off (Luke, Ch. 16).

112 This was the system recommended by David Ricardo; it would now be called 100% reserve.

backed by stored precious metals.[113] A related suggestion is that everyone should have the freedom to create currency, so long as it is backed by stored precious metal.[114] There are, however, great inequities and complications in systems based on precious metal which in any case now seem redundant, as if we were all to go back to travelling on horses or to dispense altogether with reading and writing.[115]

(iii) Fiat Money

Most of what the law recognizes as 'money' today is mere information stored in computer systems. Only a small proportion (3% is the figure usually quoted) of pounds, dollars, etcetera, is made of paper or metal coin, and that too is cheaply produced.[116] When the purchasing power of money bears no relation to what it is made of, it is called 'fiat money' (*fiat* is Latin for 'Let it be done!'). It is acceptable as money by state decree. [117]

The challenge is surely to manage 'fiat' money in a way which is transparent, equitable, and comprehensible to anyone who cares to take an interest. In other words, in a way exactly opposite to the way it is done at present (opaque, inequitable, and incomprehensible finally even to those who are managing it). The design would be capitalistic in that

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113 These suggestions are thoroughly explored on The Cobden Centre website. Ricardo's preferred option was 100% gold reserve. Ron Paul stands repeatedly for Republican presidential nominee on this ticket.

114 The idea is discussed critically by James Tobin: 'Financial Innovation and Deregulation in Perspective', in *Monetary and Economic Studies* (Bank of Japan) Vol 3, Issue 2, Sept 1985.

115 The worst being, perhaps, the wars that were fought over gold, just as they are fought over oil today.

116 Paper and coin are manufactured by governments and sold by them to banks. 'The cash is exchanged at face value for an equal amount of electronic central bank money taken from the BoE reserve account of the requesting bank, or sometimes for gilt stock owned by the bank. The commercial bank exchanges one asset for another.' www.positivemoney.org.uk

117 When 'real' money was gold or silver coin, notes were merely claims on real money. Now, however, they are valued for their regulated scarcity and legally-sanctioned acceptability as a means of payment, not as claims on coin. They are cash.

saving and lending would play their part; but the playing field would be level, not tilted towards capital, thereby restoring some meaning to the phrase 'free-market economy'. Savings, rather than 'created credit', would be lent. Deposits would consist of real money, not claims created in the act of lending.

The great advantages of fiat money—easy and almost cost-free production, and independence of a particular commodity such as gold—also give rise to its main drawback, which is that vast amounts can be created merely by printing, or pressing computer keys. When governments do this, hyperinflation is the result. When bankers' privilege does it, the result is legalised misappropriation. When both do it together, the human and natural worlds are ravaged to and beyond the limits of their endurance.

Fiat money works, no doubt about that: most currencies in the world today consist of it. Problems arise from abuse of the system, not from the system itself. Given that it is so easy to abuse, is it foolish to imagine it ever might not be abused?

One suggestion is that no new money should be created beyond what is already in circulation.[118] This would mean money varying in value as quantities of goods, expectations, appetites, etcetera, grow or shrink. If the smallest unit of currency became almost worthless, it could be abandoned; if it became too valuable, a new smaller unit could be introduced. If this policy were adopted, then money creation by financial institutions would be made a distinct crime and money creation by governments constitutionally abandoned. The problem with this is that money would be always changing in value. Inflation and deflation, with their many attendant problems, would become the order of the day.[119]

If, on the other hand, stability in purchasing power (money keeping a steady value) is to be aimed at, money has

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118 '…changes in money demand can always be met by changes in money's purchasing power'. Detlev Schlichter, *Paper Money Collapse* (2011), p.33.

119 For the advantages of monetary stability see *Lectures On Economic Principles* by Dennis Robertson, Vol III pp31ff.

to be sometimes created and sometimes destroyed. If banks were no longer allowed to do this, who would do it?

Government (through their treasury departments and central banks) attempt to manipulate how much money is created by banks. If banks were no longer allowed to create money, this role would be redundant. If the task of money creation was to be associated with 'government' how should it be instituted, controlled, and made accountable?

Two of the best-known economists who have advocated government control of the money supply—Ricardo and Simons—were well aware of how badly governments like to behave. They both advocated the formation of a separate agency for providing a stable currency, effectively a fourth power adding to the existing three of executive, legislative and judiciary.[120]

It is surely true that control of the money supply, like the justice system, should be a power separate from the legislature and the executive. Entrusting it to legislatures and banks has been a disaster. Like the justice system, it should be both open to scrutiny and contain a true democratic presence: juries selected by lot, considering at length and actually making decisions.

When governments create money for their own use, it amounts to another form of taxation: the currency loses value and everyone gets poorer.[121] Governments commandeer resources for a vast array of activity: wars, welfare, health, roads, social services, diplomacy, education, police, standing armies, and so on and so on. Some government expenditure is undertaken for agreed common benefits, some to buy votes in the next election, some to attempt to engineer us into more compliant citizens. Each of these activities is (and should be) subject to argument as to whether

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[120] For Ricardo see 'Plan For The Establishment Of A National Bank' (1823) in *Works* Vol 4 (Liberty Fund Edition). For Simons, see later in this chapter.

[121] Because it takes a little from everyone in proportion to how much they have, it could be a genuinely progressive tax—except that money can be moved between currencies, so it would also be an easy tax to avoid.

it is appropriate, efficiently conducted, better left to others or better not done at all: but money for these projects should not be raised surreptitiously. We should always bear in mind the economist Bastiat's humorous epigram: 'The state is the great fictitious entity by which everyone seeks to live at the expense of everyone else.'[122]

Questions of how government should spend our money are different to the simple question: How much money should be created or destroyed, purely to aim at a steady value for money? A separate power would protect that difference.

How would people be chosen to make up this separate power? Not from political parties, who are partisan by nature and inclined to offer other people's money to their constituents. Nor should they be selected from the establishment, which tends to favour itself. Only a totality of the people can be expected to guard against privilege for one part of it. A jury selected from *all* the people is the obvious answer, tried and tested over centuries in courts of law (see Chapter 7, below). Just as in trials by jury, presentations could be made by experts and interested parties, and summings-up given by a competent adjudicator before decision by vote from the jury. For such an important duty the jury could consist of many hundreds of people.

There is, however, an addendum to the rule that the totality of a people can be relied on to outlaw privilege, which is that an entire people may (and often does) enjoy privilege over another people. Just as electoral representation may produce oppression by one class over another, so (true) democracy may produce oppression by one nation over another.[123] The Athenians and the Swiss, both notably and

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122 *L'État* (1848).

123 Acton: 'the tyranny of the majority, or rather of that party, not always the majority, that succeeds, by force or fraud, in carrying elections' ('The History of Freedom in Antiquity', 1877.) For examples, see Chapter 5.

truly democratic at home, were notoriously oppressive abroad.[124]

This is a good reason why banking should be (as it is to some extent already) governed by global agreements. The change needed is for legislation and regulation to be made with popular knowledge and consent, rather than administered by those who stand to benefit.

During the Great Depression (roughly 1929-39) Henry C. Simons recommended a careful strategy for moving towards a healthy banking and monetary system. Government policy, then as now, was struggling to stimulate economic recovery without reforming the privileges of banks. Goods were being manufactured in huge amounts, but ordinary people did not have money to buy them. Then as now, banks were popularly blamed, but supported by anxious governments. Then as now, the idea of creating money equitably was anathema to the powerful.

Being realistic about the corrupt tendencies of governments, Simons suggested that money creation should involve scrutiny and deliberation by the people.[125]

The authority responsible, Simons wrote, should have 'a direct and inescapable responsibility for controlling (not with broad discretionary powers but under simple, definite rules laid down in legislation) the quantity (or through quantity, the value) of effective money.'[126] The rules should be not just simple but 'expressive of strong, abiding, pervasive and reasonable popular sentiments'[127] so that the public would take an interest in what was going on and exert moral pressure against 'administrative and executive tinkering.' The authority would be a separate power within the state. It

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[124] See Benjamin Barber, *The Death of Communal Liberty: A History of Freedom in a Swiss Mountain Canton*. Princeton University Press, 1974. Pp. 148-156. The Swiss episode was the Graubunden domination of the Valtellina in the 16th—18th Centuries. The most famous act of imperial barbarity by democratic Athens was its extermination of the Melians (416 BC).

[125] Henry C. Simons, *Economic Policy for a Free Society.* University of Chicago Press, 1948, pp. 181-2.

[126] Simons, *Economic Policy for a Free Society*, pp. 57, 181-3.

[127] Simons, *Economic Policy for a Free Society*, p.181.

would operate with the sole objective of pursuing stability in prices by adding to, or subtracting from, the money supply.

The process would not be complicated. If there is too much money in the system, Simons said, the authority would instruct the government to increase taxes and put money into cold storage; if there is not enough money, the government would be authorized to create money and spend it.[128] Since today (2013) governments habitually spend between thirty and fifty per cent of GDP, there would be plenty of room for manoeuvre. Approval of what the government spends its money on would be a separate issue governed by political mechanisms already in place.

Simons thought that suppression of private money creation would unavoidably be subject to some disappointments because the ingenuity of tricksters would keep them one step ahead of the law.[129] However, with genuinely democratic supervision there would be a strong chance that new abuses would be detected and stopped.

To further pre-empt the ingenuity of tricksters, Simons recommended reform of property law, so that layers-upon-layers of claims could not be used to generate money and hide other types of fraud.[130] This would also do away with unauthorised contracts between financial operators based on money and claims owned by others (thereby conflicting with basic principles of property law, even while conforming to commercial practice).[131]

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[128] Or as Simons puts it, in the language of economese: 'The powers of the government to inject purchasing power through expenditure and to withdraw it through taxation—the powers of expanding and contracting issues of actual currency and other obligations more or less serviceable as money—are surely adequate to price-level control.' *Economics for a Free Society*, p. 175. The fact that most money now consists of electronically recorded numbers (as opposed to metal or paper) makes little difference; it is still money.

[129] 'the reappearance of prohibited practices in new and unprohibited forms'. p. 172.

[130] Simons, *Economic Policy for a Free Society*, p. 38.

[131] Buying-and-selling contracts are not valid if they involve property rights unrecognized in law: I, for instance, cannot sell the British Navy.

The two traditional roles of high street banks should be separated, Simons said. Banks should be of two types: one which accepts, stores, and transfers actual currency; another which provides long-term lending of actual assets.[132] This would make fraudulent money-creation harder to conceal.

To restrain financial corporations from inventing new methods of 'money-bootlegging', he suggested simple reforms of the borrowing powers of corporations 'to prevent their effectively taking over the prerogatives of which banking corporations as such had been deprived.'

'If such reforms seem fantastic, it may be pointed out that, in practice, they would require merely drastic limitation on the powers of corporations (which is eminently desirable on other, and equally important, grounds as well).[133]

Simons wrote for the benefit of other economists, believing he could influence them through argument and that they in turn would influence the course of political events. One by one, however, his colleagues accepted salaries from business or government and fell silent on the subject of privileged banking. Simons committed suicide in 1946. Meanwhile the Great Depression fizzled out in the vast capital destructions of World War Two.

Can we improve on the kind of program suggested by Henry C. Simons? Are his proposals as 'fantastic' as he thought? The separation of retail and investment banking has once again become the focus of government policy on both sides of the Atlantic. For the U.K. the creation of the non-political Monetary Policy Committee (1997) might one day seem, in retrospect, the first step towards the kind of independent authority Simons proposed. The vital ingredients are still missing, however: acknowledgement of, and public familiarity with what is going on, and a truly democratic procedure capable of eradicating privilege.

It is hard to imagine that a jury of ordinary people, after careful deliberation, would allow banks to create 97% plus of new money as debts to and from themselves.

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[132] Simons, *Economic Policy for a Free Society*, p.171.
[133] Simons, *Economic Policy for a Free Society*, p. 171.