EXPLORING NORTHERN ROCK
The Stone That Must Not Be Left Unturned

An article in The Quarterly Review, Vol 1, No 4, Winter 2007

"Banking turmoil hits the streets" - the *Financial Times'* front-page headline for weekend 15/16 September 2007. In the first serious run on a UK bank for 140 years its customers were queueing in the streets outside its branches in many cities, all anxious to get their money out before other customers took all that was left. Others brought the bank's telephone and online banking systems to a standstill.

The bank was Northern Rock. So far, by late October, the Bank of England has lent it more than £20bn to see it through negotiations with financial institutions which might take it over. Meanwhile government agencies and the media are asking a host of questions and collecting a mass of information: what went wrong? who should be held responsible? and what should be done to prevent similar disasters happening again? The enquiry by the House of Commons Select Committee on the Treasury is typical. Its list of points may remind many of us of impenetrable fog. But we should take a quick look at it. A money system unintelligible to intelligent people cannot meet the needs of a 21st-century democracy, and we cannot leave it to the professionals to bring it up to date.

Many Stones Being Turned

The Treasury Committee wants written evidence on the following points.

1) the reasons for the difficulties faced by Northern Rock, and the events that led up to the run on the bank;
2) the role of the Board of Northern Rock;
3) the functioning of the Tripartite system of regulation by the Treasury, Bank of England and Financial Services Authority according to the memorandum of understanding between them; and the actions undertaken by them during the crisis, both in relation to the overall market, and the situation regarding Northern Rock;
4) possible modifications to the insolvency regime for deposit taking institutions, including shareholder notification requirements, transparency requirements, the Takeover Code and the Market Abuse Directive;
5) changes that may be required to the regulatory requirements regarding liquidity;
6) lessons for Lender of Last Resort operations conducted by the Bank of England;
7) any other regulatory changes that may be required in the light of recent experience within the financial system;
8) the current position regarding Northern Rock's depositor guarantees, and the Government's balance sheet;
9) possible modifications to the Financial Services Compensation

Scheme, including, but not limited to, limits of deposit protection, funding of the scheme and payout times, in the light of the publication by the Tripartite Authorities on 11 October of a document entitled "Banking reform – protecting depositors: a discussion paper";

10) possible comparator (*sic*) schemes operated by other countries, assessing their suitability for the UK financial system;

11) lessons learnt from the effect of US sub-prime mortgage lending defaults on financial institutions and financial stability;

12) the effects of highly leveraged transactions, including those relating to private equity, on financial institutions and financial stability;

13) the effect of complex financial instruments on financial stability, and the need for greater transparency in regard to such instruments;

14) the role and regulation of ratings agencies;

15) the role of hedge funds in the recent financial disturbance.

The Bank of England's *Financial Stability Report* of 25 October deals with similar points. The people in charge of our money system as it is now supposed to work are clearly trying to leave no stone unturned. But they are ignoring what really matters. We should get them to examine a simpler, more basic point.

The "Credit Crunch" and the role of banks

A "credit crunch" is associated with the failure of Northern Rock. Also known as a "liquidity" crisis, it means that banks have stopped creating as much money to lend as people and businesses need to borrow. That means trouble if, like Northern Rock, you need to borrow money immediately to repay your previous borrowings or pay interest on them.

"Credit" means money that has been lent. Describing immediately available money as "liquid" distinguishes it from money which is not immediately available because, for example, you can't withdraw it from an investment without notice. These linguistic subtleties help to obscure the key point in the previous paragraph. Commercial banks do not just lend and borrow money as they encourage people to believe; they create it. In fact, in Britain today, they create almost the whole of the national money supply. They create it out of thin air by the simple act of writing it into their customers' accounts as interest-bearing, profit-making loans.

All they have to do is make new balancing entries in the bank’s accounts – the new assets being customers' new debts to the bank and the new liabilities being the new money credited to customers' accounts. Customers proceed to spend the money into circulation as additions to the money supply. When customers eventually repay loans to the bank, or the bank writes them off as bad debts, those sums of money go out of existence. But the banks continually create and lend more than is repaid. So the total supply of money in customers' bank accounts continually grows. Meanwhile, the banks receive interest on each loan until it is repaid or written off.

Trading the debts of other financial businesses - such as those belonging to the now notorious "sub-prime" mortgage lenders - has been a rapidly growing practice in the banking and financial sector. But the international merry-go-round of buying, repackaging and selling these existing debts can eventually reach a point where confidence evaporates that the debts will ever be repaid. Lending then dries up, bringing the merry-go-round to a grinding halt and leaving such a tangle of indebtedness between financial businesses that regulating authorities find it hard to judge if the collapse of one business could trigger the collapse of others.

A collapse comes when a bank like Northern Rock finds that, because of “bad debts” to it (i.e. debts or interest on debts that its borrowers can't repay), it doesn't have enough money to repay its debts. In the old days the bank would just go bust, and its customers would lose the money in their bank accounts. But central banks are now expected to act as “lenders of last resort” - to protect customers of reputable banks from losing their money, and to prevent the collapse of one bank (and the bad debts it and its depositors would consequently create for others) leading to a major melt-down in the banking and financial system. That is why the Bank of England has had to bail out Northern Rock.

The Money Supply and Who Should Create It

Official statistics show that in Britain over 95% of the money supply is money in bank accounts, and under 5% is coins and banknotes issued by the Royal Mint and the Bank of England on behalf of the state. The Bank of England estimates that the present proportions are 97% and 3%.

There is no mystery about who creates and issues the 3% consisting of coins and banknotes. But, when it comes to the question of who creates the 97% consisting of bank-account money, it's a different story. Officials of the Bank of England, the Treasury and Financial Services Agency; responsible elected Ministers, including Prime Minister, Chancellor of the Exchequer, and junior Treasury Ministers; lawyers, accountants and other professionals remotely connected with banking business; and academics and mainstream media commentators - all find ways of dodging the question. Virtually none are happy to admit that creating 97% of the national money supply is a lucrative side effect of the way commercial banks now conduct their lending business.

Some even claim that what the banks create is not really money; it's still only credit. But that's deliberately misleading. Almost everyone knows that, whatever its historical origins may have been, what we have in our bank accounts today is real money which we use for paying other people by transferring sums directly from our account to theirs. And, if what they say were true, who then does create that 97% of the money? How does it come into existence, if not created by the banks?

The history of banknotes provides an exact parallel. English banknotes still say "I promise to pay... ". That is because they originated as credit notes issued by goldsmiths, merchants and bankers. In the course of time they came to be used as a more convenient means of paying sizeable sums of money than metal coins. Eventually, in mid-19th century Britain, they were recognised to be money, and the right to issue them was transferred from other banks to the Bank of England. Today we should treat bank-account money in precisely the same way.

Monetary Reform - An Outline

Support for monetary reform is, in fact, growing in a number of countries. Among the many arguments for it - economic efficiency, social and political justice, and environmental sustainability - is that the process of adding to the public money supply by creating new money should be separated from the processes of lending and borrowing. That would clarify what is happening when financial businesses like Northern Rock trade money and financial assets as if there were no tomorrow.

The proposal which I, among others, support is outlined as follows. Full explanation and discussion is in the references in the concluding Note.

1) National monetary authorities like central banks should be made responsible for creating non-cash money (i.e. bank-account money) as well as banknotes and coins. At regular intervals they should create out of thin air the amounts of bank-account money they decide are needed to increase the money supply. They should give these to their governments as debt-free public revenue. Governments should decide how to spend them along with other public revenue and spend them into circulation.
2) It should become illegal for anyone else to create bank-account money denominated in the national currency, just as it is already illegal to forge coins or counterfeit banknotes.

This will involve the following changes:
1) The central bank will no longer regulate increases in the money supply by deciding the interest rates at which commercial banks lend into circulation money they create in order to lend it. The central bank will be directly responsible for deciding how much is needed and for

creating it and issuing it itself.
2) Commercial banks will be prohibited from creating money. They will have to borrow already existing money in order to lend it, as most people think they do now.

Concluding with some Significant Questions

Arising from the Northern Rock affair, we need to ask Ministers and MPs for answers to the following questions. We should also raise these questions in the media.

(1) The Bank of England has lent Northern Rock over £20bn (by the end of October)**.**
(a) Did that money come from tax revenue?
(b) If not from taxes, did the Bank of England create it out of nothing?
(c) In that case, did it add to the money supply?

(2) 96% or 97% of the money supply consists of bank deposits.
(a) In the normal way, who creates the continuing increases in that major part of the money supply?
(b) How closely is the process by which that part of the money supply is created linked with borrowing and lending?
(c) What part did that link play in the Northern Rock affair and the wider financial turbulence associated with it?

(3) If it is the case that banks are allowed to create new money to lend to their customers,
(a) what stops them creating it to pay off their own debts? and
(b) does anything stop them creating it to lend to one another to finance the trade in existing financial assets?

NOTE:
Further information on Monetary Reform and the many arguments for it can be found at:

www.jamesrobertson.com/books.htm#monetary

www.monetary.org (American Monetary Institute)

www.prosperityuk.com (UK monthly journal)

James Robertson 28 October 2007

www.jamesrobertson.com