INQUIRY INTO THE BANKING CRISIS
Evidence Submitted to the House of Commons Select Committee on the Treasury, January 2009

http://www.parliament.uk/parliamentary_committees/treasury_committee/tc0708pn85.cfm

----

NATIONAL AND INTERNATIONAL FINANCIAL ARCHITECTURE: TWO PROPOSALS

Memorandum by Mr James Robertson, January 2009

Author's Background Note

1953-65 Whitehall official.
  1960 accompanied Prime Minister Harold Macmillan on his African tour (introduced 'wind of change' theme into PM's speeches).
  1960-63 Cabinet Office.

1968-73 set up and directed the UK Inter-Bank Research Organisation.
  1968-71 House of Commons Procedure Committee - part-time Adviser on parliamentary control of public spending and taxation.

1973- Independent writer, lecturer, consultant.
  1984 co-founded the New Economics Foundation, London.
  2000 co-authored *Creating New Money: A Monetary Reform for the Information Age*.

More at www.jamesrobertson.com

I. EXECUTIVE SUMMARY

1. This evidence is on the Committee's point 1.8, *amended as follows*:
"Possible improvements to the architecture of (*national and)* international financial regulation, and maintenance of (*national and)* global financial stability".
It affects other points too, as will be clear.

2. The money used by national and international monetary and financial systems provides the foundation for their architecture. Who creates and issues the money supply, and in what form, affects how those systems work and therefore how they should be regulated.

3. The ways money is now created, both for national and for international economies, combines conflicting functions. That is a cause of recurrent financial crises, and of other economically, socially and environmentally damaging outcomes. New, updated ways of creating national and international money supplies would separate the conflicting functions. Ideally, further emergency measures to deal with the current crisis would provide stepping stones towards those simpler, more basic changes.

4. The first proposal is for genuine nationalisation of the national money supply, making it unnecessary to nationalise commercial banks.

5. At present less than 5% of the estimated UK national money supply is created and issued as banknotes and coins by agencies of the state. Almost all the remaining 95% is created and put into circulation by commercial banks and building societies as profit-making loans in the form of bank-account money (often called "credit"). The Bank of England can only try to influence the amount the banks create by regulating interest rates. The proposal is that the Bank of England should itself create and issue bank-account money debt-free, and that - as already with banknotes and coins - nobody else should be allowed to create it.

6. The second proposal is for genuine internationalisation of the international money supply. In other words, the UK government should be asked to consider promoting the introduction of a genuinely international currency. It has now become unrealistic to hope that the US dollar or any small group of competing national or regional currencies like the dollar, euro, yen, yuan, rouble or pound can provide a firm foundation for a stable, efficient and fair international economy in a globalised world. Combining that underlying weakness with continuing to rely on money largely created as private sector debt, makes the international economy doubly vulnerable to instability (see para 35).

7. It is desirable (see para 33) for governments to discuss internationally the first, as well as the second, of these proposals. The Select Committee might therefore suggest that, as host to the G20 meeting in London on 2nd April 2009, the UK government might place the two proposals on the agenda for preliminary discussion. In the past two centuries distinguished leaders in the United States as well as in the UK have supported the first proposal, for a genuinely nationalised national money supply. The second proposal, to introduce a new genuinely international currency alongside national ones, shares the underlying principle of Keynes' proposal at the Bretton Woods Conference in 1944, and the principles put forward by the Independent UN International Commission on Global Governance in 1995. It has recent support from the BRICs Group of countries (see para 38).

8. Some experts in the complexities of existing financial architecture may dismiss these proposals as too radical and simple. But measures unthinkable a few months ago have now been taken in response to the present crisis. So I hope the Select Committee will ask the government to study these commonsense proposals and not dismiss them out of hand. They are in tune with the UK's historic record of financial evolution in response to changing needs. Treating them seriously could increase the Committee's credibility at a time when people are looking for new solutions to the problems of the new financial world of today and tomorrow.

II. INTRODUCTION

9. The Committee has asked for evidence on thirty points in the key areas of (1) securing financial stability, (2) protecting the taxpayer, (3) protecting consumers, and (4) protecting shareholder interests. This evidence is on the Committee's point 1.8, *amended as follows*:

> Possible improvements to the architecture of (*national and)* international financial regulation, and maintenance of (*national and)* global financial stability.

It affects other points too, as will be clear.

10. Effective changes in organisational architecture have to have a stable foundation. On reforming the obsolete structures of British government in the early 20th century, an outstanding administrator of that time, Sir Robert Morant, warned against "seeking to build a substantial house by working spasmodically on odd portions of the structure on quite isolated plans, fashioning minute details of some upper parts, when he has not set up, nor indeed even planned out, the substructure which is their sole foundation and stay: his very best efforts being rendered abortive by the fact that, while he is hammering at this portion of it or that, he possesses no clearly thought out plan of the structure as a whole".

11. Money is the foundation of national and international monetary and financial systems. How the supply of money is created and issued, who by, and in what form (as debt or debt-free, in one currency or another), goes far to determine whether a money system is stable. If money continues to be supplied for national economies and the international economy as it is today, they will inevitably continue to suffer damaging crises of financial instability.

III. NATIONAL FINANCIAL ARCHTECTURE

12. The public money supply is at present created as follows. Less than 5% of the estimated UK national money supply is created and issued as banknotes and coins by agencies of the state. Most of the remaining 95% is created and put into circulation by commercial banks and building societies as loans to their customers in the form of bank-account money (still often called "credit", as if distinct from money). If that were not the status quo and we were starting from scratch, nobody would seriously suggest that the same businesses and procedures should combine the two conflicting functions - putting 95% of the public money supply into circulation efficiently and fairly on behalf of society as a whole, and competing for profit in the market for lending and borrowing. It would be obvious that to mix them up together would reduce the efficiency and reliability of both functions.

13. The facts show that, in practice, crises of financial stability do

inevitably result from combining them. This was famously expressed from the commercial bankers' point of view by the outgoing Chief Executive Officer of Citibank in 2007. Shortly before receiving his $multi-million 'golden parachute' to compensate for being 'chucked out' of his crisis-stricken bank, Chuck Prince explained that, "As long as the music is playing, you've got to get up and dance". As director of Inter-Bank Research during the secondary banking crisis of the 1970s, I saw and understood very well why, once the herd starts stampeding toward the abyss, bankers decide it's better to be wrong with the herd than right but alone outside it.

Separating The Two Functions

14. A basic monetary reform consisting of two complementary measures is needed to separate the two functions.

(1) It will transfer to nationalised central banks like the Bank of England the responsibility for creating, not just banknotes as now, but also the major component of the supply of public money that consists of bank-account money mainly held and transmitted electronically.

(2) It will prohibit anyone else, including commercial banks, from creating bank account money out of thin air - just as forging metal coins and counterfeiting paper banknotes are criminal offences.

15. These complementary measures will fully nationalise the national money supply but not the commercial banks. After the reform, when the present crisis is stabilised, the commercial banks that have been nationalised should be denationalised, and compete freely in the profit-making market for borrowing and lending already existing money.

16. The first of the two measures will make an agency of the public responsible for directly creating and maintaining the public money supply in the public interest. The second will lead to a more competitive market for facilitating loans between lenders and borrowers than today. Losing their present privilege of creating the money they lend will bring the commercial banks into line with ordinary private-sector businesses that are not given their main materials as a free gift. It will encourage them to provide more services to customers more efficiently than now, and also make it easier to attract new entrants into the payment services industry.

Nationalising the Money Supply

17. Transferring responsibility for creating all new bank-account money to the central bank will catch up with what happened to banknotes under the Bank Charter Act of 1844. That Act finally recognised that, having originated as notes of credit from private banks and merchants, and having developed into means of payment over several centuries, banknotes had turned into money. Consequently, it transferred the right to issue them to the Bank of England. So, similarly today everyone knows

that the balances in our current bank accounts ("sight deposits") are no longer just "credit" but are money instantly available for spending just as banknotes are. Their total value is included in the "broad money" component of the money supply in the official statistics. (The actual total is not precisely known because of how it has been created by the commercial banks. That is one reason why, from beginning to end, nobody has known how many billions of money have been "lost" in the credit boom and bust, or where they came from and where they went.)

18. The proposal is that the operationally independent central bank should continue to implement monetary policy objectives published by the elected government. But it will no longer implement them indirectly by managing interest rates to influence the amount of new money created by banks as loans. It will itself decide at intervals how much new money needs to be added to the money supply, create it and transmit it as public revenue to the government. The government will then put it into circulation by spending it on public purposes along with other public revenue, as decided through normal parliamentary budgeting procedures. Only in exceptional monetary crises like the current one, which will then arise less often, will the central bank play a part in deciding how the money is to be spent that it creates to meet monetary policy objectives.

The Money Supply after Monetary Reform

19. After the start date for monetary reform has prohibited all but the central bank from creating new money, the money supply will change its character. As new debt-free money is created by the central bank, and as the repayment of existing bank loans extinguishes the money created by the commercial banks, the money supply will transform itself into a clearly defined and calculable fund of officially created and officially recognised money - which could perhaps be defined as "legal tender".

20. This will be money consisting of customers' "sight deposits" in current accounts with banks and other agencies licensed to manage them by the central bank, together with the money in those banks' current accounts with the central bank. That will constitute the clearly defined total supply of actual money in circulation which is immediately available for spending - a figure that will be precisely identifiable in the official statistics.

21. This fund of actual money will be quite distinct from other financial claims, such as savings accounts. Those will have been bought by their holders with money paid to their sellers. They will be recognised not to contain money themselves, but to be financial claims entitling their holders to be paid money at certain times under certain circumstances. That will be true of all other savings, investments, securities, insurance policies, etc, etc. Some will eventually pay out specified amounts of actual money. Others, like share certificates, will be exchangeable for money in the market at the going rate. In either case, a transfer of money will take place in exchange for the claim, just like the buying and selling of

anything else. This will apply to purchasing or investing in other currencies - purchasers and investors will pay for them with money from the national money supply.

Lending and Borrowing after Monetary Reform

22. As borrowers pay off bank loans borrowed before the reform came into force, any new money available for lending and borrowing will have been created by the central bank, and given to the government to spend into circulation. It will have circulated to, among others, people and organisations that want to lend it. Commercial banks will then channel it from them to borrowers, not creating new money but as intermediaries for transmitting already existing money from lenders to borrowers.

23. Prospective lenders, including customers of the lending bank with sight deposits in current accounts, will pay the money they lend to the bank as the purchase price of a claim to receive it back at a specified date with a specified rate of interest paid at specified intervals. The principle will, as always, be that money in the circulating fund of national money cannot be simultaneously available to more than one bank-account holder for immediate spending. The fund of national money in circulation will remain constant except for increases or withdrawals[1] made by the central bank to achieve monetary policy objectives.

24. A new problem of stock control will arise for the banks, which have hitherto been able to create money as soon as their customers ask to borrow it. This problem will be similar to, though very much simpler than, the problems of stock control faced by other businesses: how to make a range of supplies available to meet customer demand, while avoiding the cost of having too much on hand for too long. It will no doubt encourage money markets to develop ways of finding existing money quickly to lend to retail banks so that they can lend it quickly to their customers. But it will almost certainly lead to some loss of flexibility for banks and their customers, which will slow down the circulation of money, so that the central bank will have to increase the money supply to provide for that.

Could the Central Bank Create Enough Money for Borrowing?

25. It has, in fact, been suggested that, if the central bank were responsible for creating the whole money supply, it would not create enough to meet the legitimate needs of borrowers. But central bankers will be able to judge how long, in the circumstances of the time, it will take the money they create to circulate to people and organisations wanting to lend it, and then to adjust the amount they create to take account of that. Central bankers surely will not do worse in this respect than commercial bankers who, in the recent credit boom and bust,

[1] On any occasion when the central bank decided that the money supply should be reduced, not increased, the government would pay the required reduction to the central bank out of public revenue, and the central bank would destroy it.

created far too much money in the boom and are now creating much too little in the bust. In fact, commentators are now recognising that, when we rely on commercial banks to create the money supply, the only lever available to the central bank to increase it - lowering interest rates - won't work when it is most needed and the central bank has already brought interest rates down towards zero. Currently the Bank of England is reported to be considering alternative ways to create new money and inject it directly into the economy.

26. It has also been suggested that, on the starting date for monetary reform when banks are prohibited from creating money as debt, new money created by the central bank will not have had time to circulate through public spending to people and organisations that want to lend it, and a temporary shortage of loan finance will result. But the central bank and the government should be able to resolve that problem, either by setting the central bank's starting date for the new arrangement a month in advance of that for the commercial banks, or by the central government advancing some of its public spending similarly. The details could be settled in the preparatory run up to the reform.

Supervision and Guarantees (Relevant to the Committee's point 1.4)

27. Responsibilities for supervision and guarantees will be clarified by the reform. They will reflect the split between the conflicting functions of public service provision of the national money supply and the private sector provision of competitive borrowing and lending facilities as a profit-making business; and the corresponding split between the circulating fund of money constituting the money supply and the range of financial claims which are bought and sold for money but are not money themselves.

28. The central bank should have supervisory responsibility for banks (and other organisations) licensed to provide payments services in the national currency. It should guarantee all deposits in current accounts, making up the total national money supply. It should also be responsible for guaranteeing the value of financial claims, like National Savings, sold by agencies of the government, and it should therefore be responsible for supervising their administration, as well as supervising the licensed providers of payments services.

29. The Financial Services Agency should be responsible for supervising businesses dealing in borrowing and lending and other ways of buying and selling financial claims - savings, investments, insurance policies, currency exchange, etc - primarily in order to protect their customers and preserve the integrity of the actual money supply. These businesses will be handling money as buyers and sellers of financial claims, as all businesses handle money to buy and sell things. But the claims they buy and sell will not themselves be money or contain it. So no guarantees from public funds need be given to their contractual or estimated values. Buyers should buy them at their own risk, subject to consumer protection

law. One important part of the supervisory task will be to ensure that existing consumer protection law is adequate. Another will be to ensure that businesses under supervision do not fraudulently try to create actual money. For that purpose both the FSA and the Bank of England will need to develop accounting and audit trails of actual money in circulation.

A Loss of Flexibility and Increased Cost of Payments Services?

30. Any resulting loss of flexibility for retail banks and their customers from changing the present method of creating new money will have to be weighed against the damaging effects and serious disadvantages of continuing to allow private sector creation of new money to lend. Those include recurrent credit booms and busts - that need not otherwise be inevitable - in addition to a range of other seriously damaging and costly economic distortions and injustices.

31. Initially, losing the subsidy they now enjoy from being allowed to create money to lend may lead existing commercial banks to charge more for managing the payments systems they offer to their customers. that is always likely to be the immediate response of any industry that stops being subsidised. In the longer run, their charges are likely to be under fiercer competition from new entrants into the payments services industry. Moreover their customers will no longer be bearing the costs imposed on every user of money when almost all the money in circulation has been created as interest-bearing debt.

International Competition

32. Some say that the proposed monetary reform would be damaging to the UK economy: being deprived of their present subsidy would put UK banks at a competitive disadvantage against competitors from other countries, and "would lead to the migration from the City of London of the largest collection of banks in the world"[2]. Until the credit boom turned to bust, the financial sector energetically publicised its contribution to national GDP. Economic commentators now suggest that its dominance has been a disadvantage to our economy. <u>The government might usefully commission a comparative cost/benefit analysis of its contribution to and influence on the UK economy.</u>

33. The present monetary and financial crisis is recognised by the UK government as requiring internationally co-ordinated responses. A similar internal monetary reform to that proposed here has been prepared for introduction in the US Congress[3], and is relevant elsewhere too. <u>The UK government might perhaps float the possibility of simultaneously[4]</u>

---

[2] *Monetary Reform - Making it Happen*, p41 http://www.jamesrobertson.com/books.htm#monetary

[3] American Monetary Institute, http://www.monetary.org/

[4] International Simultaneous Policy Organisation, http://www.simpol.org/

introducing monetary reform in a group of economically important countries - for example at the April G20 meeting in London.

IV. INTERNATIONAL FINANCIAL ARCHITECTURE[5]

34. It is time to consider seriously whether the currency on which the international monetary system is founded should be more genuinely international - as Keynes proposed at Bretton Woods in 1944. This proposal is also one that could usefully be raised by the UK government in the April G 20 meeting in London.

35. By 1995 the Independent Commission on Global Governance was saying the international monetary system should be more genuinely international and less dependent on private capital markets: "the US has had the unique luxury of being able to borrow in its own currency abroad and then devalue its repayment obligations", and "the international monetary system's dependence on private capital markets exposes it to the risk of a collapse of confidence in the system as a whole".[6]

36. Since then the dollar's dominance has been increasingly criticised. By 2002 the world was estimated to be paying the US well over $400bn a year for using the dollar as the main global currency. A Pentagon spokesman justified this as a fee to the US global policeman for maintaining world order. Critics have seen it as the US making poorer countries pay for its over-consumption of global resources. World trade was being described as "a game in which only the US can produce dollars, while everyone else produces things for dollars to buy".

37. More recently practical threats to the dollar's international position have grown. Iran has threatened to switch its oil trading into euros. Russia's President, Dmitri Medvedev, announced in February 2008 that the rouble will become a regional reserve currency; and hoped that the new St Petersburg commodity exchange would reach 1.5 trillion roubles in 2008. It was suggested that, if China eventually replaced the US as the world's main superpower, the yuan would replace the dollar as the world's dominant international currency.

38. In 2007/8 the BRICs group of countries - Brazil, Russia, India and China - and other 'emerging' countries have been flexing their muscles. India and China caused the collapse of the recent seven-year world trade negotiations in Geneva, to protect their peasant populations. In May 2008, ministers from India and other BRICs countries demanded an international monetary system founded on the rule of law and multilateral diplomacy in "a more democratic, fair and stable world where emerging

---

[5] The need to develop international taxation and public spending is not discussed here.

[6] *Our Global Neighbourhood,* Oxford University Press, 1995, pp 181, 183.

markets have a greater role and the dominant powers are contained by the same rules as everybody else."

39. Failing a constructive response, international monetary chaos could follow further decline of the dollar's supremacy and the present global banking crisis. The world's people, and the world's businesses, could find ourselves in a disorganised global economy dependent on private sector investment in a variety of competing 'reserve' currencies including the dollar, the euro, the yen, yuan, rouble and pound.

40. The proposal is to promote the establishment of <u>a genuinely international debt-free currency, used in parallel to national and regional currencies</u>, to provide a more efficient and more stable basis for international exchanges in the global economy.

41. The new currency would be issued by a world monetary authority, with operational independence to implement the monetary objectives published by the United Nations and accountable to it. It would issue the new currency as a new source of public revenue for UN expenditure on global public purposes - peace-keeping, for example, and climate change - and possibly also for *per capita* distribution to UN member nations.

V. CONCLUSION

42. If the principles of the proposals offered here to the Select Committee are thought worthy of serious consideration, the practical details will have to be explored by the authorities. But I believe they identify essential lessons to be learned from the current banking and economic crisis and the measures being taken to deal with it; and that, if they are not learned, such crises will inevitably recur.

James Robertson
2nd January 2009

www.jamesrobertson.com