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PositiveMoney

Support for Proposal No. 262 (Separating Money Creation from Bank Lending)

To whom it may concern,

I am writing on behalf of Positive Money in support of proposal No. 262. Positive Money is a not-for-profit research group focused on monetary system reform. Proposal No. 262 proposes the establishment of a committee to consider how in the current banking system the function of money creation can be separated from the function of lending. Such a separation would end the situation where most of Iceland's money supply is created and allocated by the same private banks that were implicated in the financial crisis.

Positive Money argues that this system of excessive creation of money by the private banking sector was at the root of the financial crisis. Our position was recently supported by the Chairman of the UK's Financial Services Authority, Lord (Adair) Turner, who stated that:

> "The financial crisis of 2007/08 occurred because we failed to constrain the private financial system's creation of private credit and money." (Speech on 2nd Nov 2012)[1]

We feel that it would be a serious oversight to ignore this issue in light of one of the worst financial crises in history, particularly given its effect on Iceland at the time of the crisis. However, the issue is not simply one of preventing future financial crises. The current system of privatized money creation also has impacts for debt, poverty, inequality, the business environment, and economic growth. Reforming money creation would have significant economic and social advantages.

Figures and data below refer to the UK situation. If the Committee is established we would be happy to prepare a comprehensive submission and proposal based on data specific to Iceland.

GROWING SUPPORT FOR THE NEED FOR REFORM

Historically there has been little understanding of the way that money is created in the modern economy, with most people assuming that only the government's central bank had the authority to create money. But in most countries today around 97-98% of the money supply is actually created by private sector banks, in the form of the deposits (electronic numbers representing accounting entries) in people's bank accounts. As the Governor of the Bank of England, Sir Mervyn King, described just over a month ago:

> "When banks extend loans to their customers, they create money by crediting their customers' accounts." (Speech on 23rd Oct 2012)[2]

The Bank of England's own papers explain the key importance of this money creation:

> "By far the largest role in creating broad money is played by the banking sector... When banks make loans they create additional deposits for those that have

[1] http://www.fsa.gov.uk/static/pubs/speeches/1102-at.pdf
[2] http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech613.pdf

> borrowed the money." (Bank of England Quarterly Bulletin 2007 Q3)[3]

The status quo has recently been heavily criticized by notable commentators, including Martin Wolf, who is the chief economics commentator of the Financial Times and was chosen to be one of the five Commissioners on the UK government's Independent Commission on Banking. Wolf has said that:

> "The essence of the contemporary monetary system is creation of money, out of nothing, by private banks' often foolish lending." (FT, 9th Nov 2010)[4]

He has argued that far from being the natural state of affairs, this is an unusual situation that should be questioned. Responding to the suggestion that the creation of money by the state or a public body should be opposed, he wrote that:

> "It is the normal monetary system, in which the "printing" of money is delegated to commercial banks, that needs defending. This delegates a core public function – the creation of money – to a private and often irresponsible commercial oligopoly…Why should one object, in principle, to the exercise of the state's power to create money by the central bank rather than by private interests? The power given to banks to create money is a privilege." (FT, 28th June 2012)[5]

Most recently, the IMF Working Paper "The Chicago Plan Revisited" has endorsed the approach of removing the ability of private banks to create money, and through the use of economic modeling has found that this would have significant beneficial impacts on public debt, private debt, and economic growth.[6]

ECONOMIC IMPLICATIONS

In our current monetary system we rely on private, profit-seeking banks to issue the nation with an adequate money supply. They create money through the accounting process used when they make loans, so almost every pound in a bank account represents money that has been borrowed by somebody else.

If banks are feeling confident they tend to lend too much, creating excessive amounts of money in the process. In the UK, this excessive money creation doubled the money supply in the 8 years running up to 2007.

This rapid increase in the money supply can cause very significant inflation in the areas of the economy where the money is spent. In the 10 years up to 2007 in the UK, around 40% of newly-created money went into property, with the result that houses have become unaffordable for the vast majority of people. Around 37% of newly-created money went into financial markets and financial intermediation, fuelling a buoyant stock market and financial speculation. However, just 13% of all lending went to the real economy – the sector of the economy that contributes to the figures for GDP and economic growth – with the remainder going into consumer finance. This meant that while house prices became more expensive,

[3] http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb0703.pdf
[4] http://www.ft.com/cms/s/0/93c4e11e-ec39-11df-9e11-00144feab49a.html#axzz1oXt9pYYV
[5] http://www.ft.com/cms/s/0/024b7a7a-bfa7-11e1-bb88-00144feabdc0.html
[6] http://www.imf.org/external/pubs/ft/wp/2012/wp12202.pdf

the real, job-creating economy was starved of the investment it needed to grow.

Rising prices in property and financial markets draw in speculators, who themselves borrow from the banks in order to fund their activities. Asset price bubbles, often in housing, arise as a result. As Adair Turner, chairman of the UK Financial Services Authority, notes:

> "We need also to recognise the role that credit can play in driving asset price cycles which in turn drive credit supply in a self-reinforcing and potentially destabilising process. Thus … increased credit extended to commercial real estate developers can drive up the price of buildings whose supply is inelastic, or of land whose supply is wholly fixed. Increased asset prices in turn drive expectations of further price increases which drive demand for credit: but they also improve bank profits, bank capital bases, and lending officer confidence, generating favourable assessments of credit risk and an increased supply of credit to meet the extra demand." [7]

The buildup of debt, when it became excessive, resulted in the sale of the assets which had previously been bought on credit. This lead to a fall in asset prices, and an increase in the number of assets brought to market, particularly amongst speculators who were gambling on prices increasing. This lead to further falls in asset prices, which leads to more sales etc, and the bursting of the bubble. The increase in nonperforming loans and the drop in the price of assets lead banks and businesses to revise their expectations of the future downwards. Banks responded by reducing lending, as well as by increasing the price of loans (the interest rate). Within the current monetary system, when banks restrict their lending, the money supply shrinks. This shrinkage of the money supply of the economy is equivalent to draining the oil from a car engine; very soon the economy starts to seize up, leading to job losses and insolvencies of businesses that would otherwise have been healthy.

The debt-fuelled boom running up to 2007, and the financial crisis and recession that has followed it, has been a direct consequence of leaving the power to create money in the hands of private banks. These private banks are incentivized by profits and bonuses and therefore created too much money for the wrong things which created a boom, which, when the burden of debt became too large, resulted in the bust.

SOCIAL AND ECONOMIC IMPLICATIONS

The current monetary system also has implications for debt and inequality. Since money is only created by banks when someone takes out a loan, there must be a pound of debt for every pound of money in the economy. If we want to reduce the level of household debt – for example, after a crisis caused by excessive debt – then the money supply will also have to shrink, as money is destroyed when loans are repaid.

However, in a recession we may want to increase the money supply to provide an economic stimulus, but the only way to do this is to encourage people to take on more debt, so that banks can lend more and create more money in the process. This dependency on the banking sector to create money through lending leads to the absurd situation where, when excessive debt causes an economic crisis, the policy response of central banks is to reduce

[7] Turner, A. (2010). What Do Banks Do? Why Do Credit Booms and Busts Occur and What Can Public Policy Do About It? In: The Future of Finance: The LSE Report. London: London School of Economics and Political Science. (pp. 3-63).

interest rates to encourage people to take on even more debt.

ALTERNATIVES TO THE IMF WORKING PAPER APPROACH

"The Chicago Plan Revisited" is a working paper from two IMF economists which reviews the 'Chicago Plan' of the 1930s and applies it to the modern financial system.[8] The paper finds that there would be significant beneficial impacts on public and private debt, and economic growth.

Positive Money advocate a slightly different approach to reform that does not require such significant changes to the banking system and which may be easier to implement than those documented in the IMF paper.[6] Our proposals do the following:

1. Remove the power of private banks to create money with a few changes to the account procedures used to make loans.
2. Transfer the power to create money to a transparent and accountable public body.
3. Ensure that new money is only created while inflation is low and stable, and that new money is used in the public interest (i.e. spent into the real economy, where it can support job and wealth-creation, rather than lent into the property or financial markets).

These proposals leave banks as true intermediaries between savers and borrowers, by removing their ability to create money. The proposals ensure that banks can be allowed to fail with no cost to the taxpayer. Furthermore, they result in a significant reduction in personal and household debt, without debt write-offs or debt forgiveness; in the UK household debt could be reduced from its current level of around £1,450 billion to around £400 billion over 10-15 years as a result of these reforms.

We would be happy to provide detailed reform proposals to the Committee when it has been established, including all the necessary step-by-step changes to manage the transition between the current monetary system and the reformed one.

It is important to note that these reforms can be implemented within one country without waiting for international agreement. Removing the power to create Iceland's money supply from the banking sector does not have any impact on Iceland's ability to trade international or the ability of Iceland to connect to the international banking system.

PRECEDENTS IN THE UK

The reforms advocated by Positive Money have a precedent in the UK. In 1844 the government of the day removed the ability of private banks to create paper bank notes, as these bank notes had started to function as money. With the effective power to create money, the banks naturally issued excessive amounts of paper money, causing financial instability and inflation. However, the 1844 act made no mention of deposits. Because of this oversight, banks could still create 'bank deposits' by making loans – and so they could still create money simply by opening accounts for people or companies and adding numbers to them. Today bank deposits make up 97% of the UK's money supply and are used for over 99% of payments (by value).

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[8] http://www.imf.org/external/pubs/ft/wp/2012/wp12202.pdf

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THE FIRST-MOVER ADVANTAGE

As a small nation Iceland may be concerned about the potential impact of unilateral reforms on its economy. However, rather than there being a disadvantage to reforming first, our analysis suggests the opposite. The first-mover advantage arises because the banking system would be far safer with the reforms advocated by Positive Money. With the risk of further financial crises removed, investment in Iceland could be expected to increase. Furthermore, the creation of new money would enter into the real economy rather than through the financial markets, reducing speculation and benefiting economic growth and financial stability. Finally, the resulting reduction in debt from switching away from a debt-based monetary system would mean that consumers would have more disposable income, which would have further benefits for the real economy and job creation.

THE TIMELINE

The timeline suggested for the Committee to report back is unrealistic. Around 12 months should be given for the members of the Committee to acquire a comprehensive understanding of the flaws and negative consequences of the current monetary system, and then to understand how potential reforms would work and the benefits (and potential risks) of each approach to reform.

CONCLUSION

The financial crisis and current debt-crisis facing households and governments internationally is a direct consequence of leaving the power to create money in the hands of the private banking sector. The idea that the money supply should be determined by the short-term profit-seeking behavior of the banks that were implicated in the crisis is absurd, yet this is exactly the system we have today. Iceland should take this opportunity to question whether the monetary system that caused this crisis is the right system to safeguard Iceland's prosperity in the short and long-term.

Positive Money would be happy to speak to any established Committee and also provide highly-detailed step-by-step reform proposals, an assessment of risks, and draft legislation (for the UK parliament) to show that alternatives are feasible.

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