

Public Money for Public Investment

The need for a review of monetary policy

A third way to fund public investment in the UK

Briefing for EDM 854

"That this House, concerned at the rising burden of private debt¹, public borrowing², student borrowing and public-private finance initiatives³;

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

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

A Third Way for public investment

Public investment is traditionally funded by taxation or by borrowing. Public-private partnerships (PPP and PFI) are an alternative form of borrowing. Borrowed money comes from savings and credit created by banks. The "third way" for the government to fund public investment is to cut out the middle man and create more of the money used in the UK economy – as it used to do.

It is commonly assumed that the government creates all money. In fact, it only creates notes and coin. In November 2002, there were £29.6 billion worth of notes and coin in the UK. But the total value of money deposits in banks exceeded £1,000 billion (one trillion). Comparing the amount of notes and coin with all money in bank accounts shows that the government created just 2.95% of all money - down from 20% in 1964. Commercial banks created the rest.

Do banks really create money?

The simple answer is "yes". As the eminent economist John Kenneth Galbraith wrote, "the process by which banks create money is so simple that the mind is repelled. Where something so important is involved a deeper mystery seems only decent"⁴.

The process starts with a person paying notes and coin into a bank - let us say £100. Since most people pay by cheque, direct debit or charge card, the bank just needs to keep enough cash which the person is likely to ask for. This is called the "reserve ratio". If the bank estimates that its reserve ratio is 10%, it keeps 10% of all cash deposits. It can therefore safely loan £90 of the cash received to another customer. As a result the money supply increases by £90. The original depositor still has a deposit of £100, but the borrower has £90 as well.

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

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

“Banks can thus create new money” writes Philip Coggan, investment editor at the *Financial Times*. “This is because only a small proportion of the deposits they hold is needed to meet the claims of those who want to withdraw cash.”⁵

Is this credible?

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

This system has existed since before 1700 when the Bank of England was created. Concern at the practice was such that the Bank Charter Act of 1844 required any profit from creating currency had to be paid to the government. The Section was repealed by 1891. EDM 854 suggests it is time to restore the right of the public to profit from the creation of currency, as it was more than 150 years ago.

Won’t publicly created money mean inflation?

There is a widespread fear of inflation if governments “print money”. This risk exists if there is uncontrolled creation of money, but that is what we have now. There is currently no effective regulatory mechanism to stop banks creating new money. In practice, public control of money creation is likely to reduce this risk. This is, of course, the complete reverse of the commonly held view, but the evidence supports it.

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

It suits banks that growth (as measured by money) trails behind increases in money supply, as is shown by these statistics, because the more the money economy grows the more cash they have to create. And the more cash they create out of nothing, the more profit they make. The current system of cash creation by banks is therefore inherently inflationary. [COULD BE CUT: To counterbalance this trend, the government constrains its own activities.

This is also shown by published statistics. During the same 12 months, the amount of publicly issued cash and notes in the economy grew by just 1.9%, and, in fact fell throughout 2002. The government was much more prudent in the financial management of its part of the money supply than commercial banks. Even so, it might be unwise to wholly trust any government with such a powerful economic tool as publicly created money. This could be avoided by independent oversight of the issue of publicly created money, either by the Bank of England or a new independent authority. Any Commission set up to investigate these matters would need to study these options. END CUT]

How will publicly created money be used for government spending?

The process is as simple as that by which commercial banks now create money. The Bank of England or an independent authority would determine the amount of new money needed in the economy. This amount (and no more) would then be lent to the government and spent from a current account at the Bank of England. It would of course owe it back to the Bank of England. But the loan would not carry interest and might not require repayment. In that way the benefit of issuing new money would belong to the government, not private commercial banks. The government could use the new money to cut taxes or to invest in public services.

How do you stop banks issuing new money as well?

All it needs is a law that says that banks must recognise the money held by customers in current accounts belongs to those customers, not the bank. This means banks cannot use that cash to create new loans. It would no longer be part of a bank’s reserve ratio and as such banks will not be able to, literally, make money from them.

All money saved with banks can still be re-lent, without the creation of new money, to customers who want to borrow it. This is, of course, how most people think banks work now. As such the proposal is instinctively acceptable.

How much could this save the government?

Robertson and Huber⁶ suggest that this reform could save the government £48 billion a year. This is over 40% of income tax receipts of £110 billion⁷, and thirteen times the PFI spending of £3.7 billion,⁸ in 2001/02. Other opinions are no doubt available based on different bases of calculation. What is clear is that the amounts are substantial.

Eliminating the need to pay interest would also save the government at least half of what would otherwise spend. Many public investments are in long term assets such as schools and hospitals, funded by long term borrowing over 25 years (also a typical length of a PFI project). Interest at 4% over 25 years shows that 100% of the cost must be paid in interest, even before compounding. If no interest is paid, the cost of a project is halved. If interest is effectively paid at 16% (as is common on PFI projects), then paying for an asset using interest free publicly created money, would cut the cost by over 80% .

The economic benefits of investigating this proposal are compelling.

Why should I support EDM 854?

The evidence presented in this Briefing could open a whole new era of public investment and services. But you do not have to support these arguments to call on the government to commission independent studies to take a serious look at the potential benefits of using publicly created finance for public investment. Please sign EDM 854 now. Thank you.

Notes

- ¹ Private debt has grown at 13.5% over the year to October 2002, in a of growth in borrowing in excess of income growth, see: <http://www.bankofengland.co.uk/mfsd/li/030103/lending.pdf>
- ² Public sector net debt was £338bn in March 2002 (www.hm-treasury.gov.uk/media/9EB2B/consolloans02.pdf). It fell between 96/97 and 2001/02 by £38 billion, but is forecast to increase between 2001/02 and 2006/07 by £97 billion. [pubfinance_nov02.xls](#) published by the Office of National Statistics
- ³ PFI schemes were worth £3.7 bn in 2001/02 and are expect to rise tenfold in the near future.
- ⁴ "Money: Whence it came, where it went" J K Galbraith. 1975.
- ⁵ Philip Coggan, The Money Machine: How the City Works, Penguin, 2002
- ⁶ "Creating New Money" by James Robertson and Joseph Huber, New Economics Foundation 2000
- ⁷ Public Finances spreadsheet published November 2002, Treasury web site
- ⁸ data published by the Office of Government Commerce on PFI deals signed to 31 October 2002, at <http://pfi.ogc.gov.uk/statsView.asp?id=708> on 7 Feb 2003

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