POSITIVE MONEY: REINVENTING FINANCE

by Fran Boait
illustrations by Positive Money

Despite George Osborne's overly optimistic diagnosis that "the economy has left intensive care", people living in the real economy know the crisis isn't over yet. We still have 2.5 million people desperately seeking jobs, and almost 1 million of those are aged between 16 and 24. There are also about 500,000 people who rely on food banks. Yet there is no shortage of work that needs to be done: Britain faces a huge shortage of houses and a looming energy crisis. Dealing with these problems alone right now would create jobs and boost the economy.

So, we have jobs to do and we have people to do them — the problem seems to be money. Apparently there isn't enough of it. But where does money come from? How is it created and how come it doesn't seem to reach the places and people that need it the most?

Where does money come from?

Cash in the UK is created by the Bank of England, but it makes up only 3% of money in circulation. The remaining 97% is in electronic form, numbers in a computer system, created when banks make loans. When a new loan is made, the bank doesn't borrow money from savers — banks actually create new money with every loan they make. Those numbers in your account don't represent a pile of money in the bank; they're just numbers, accounting entries, in the computer system of your bank.

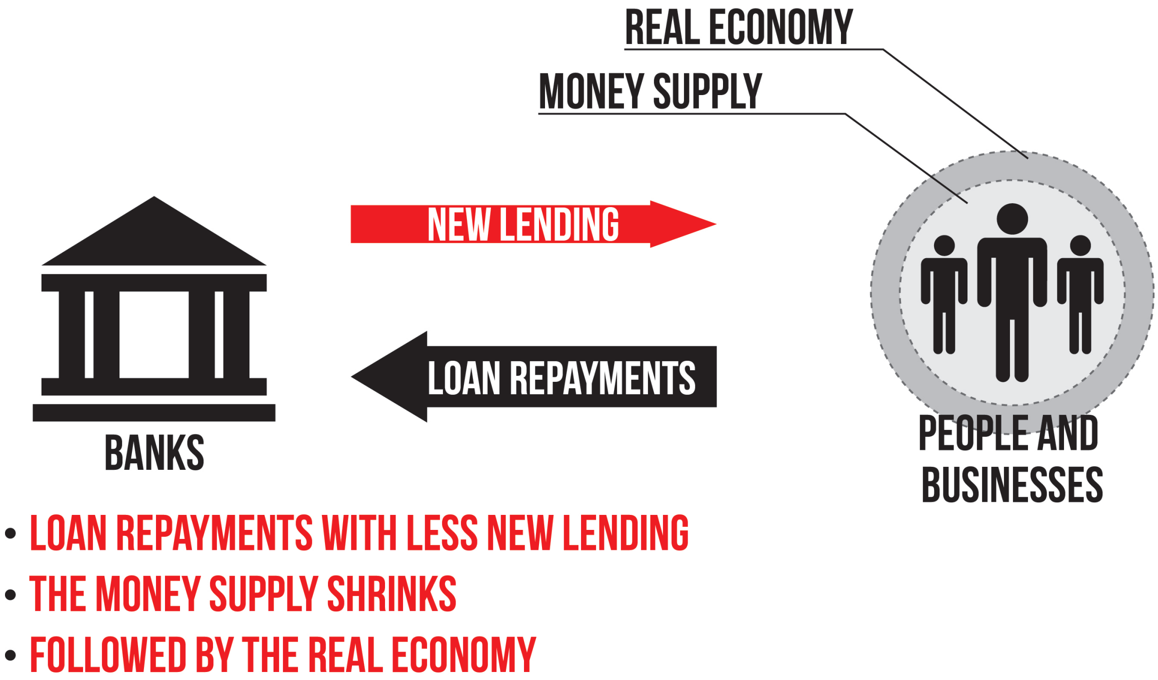
As all money is created when people take out loans, private debt increases at the same rate as the money supply. So if there's £100 in your bank account, someone somewhere else has to have £100 of debt. That £100 was created when someone else took out a loan from a bank. This build up of private debt lead to the 2008 financial crisis that has led to the high unemployment figures.

Earlier this year, former chairman of the Financial Services Authority Adair Turner said, "We got into this mess because of excessive creation of private credit and money: we should be concerned if our only escape route implies building up a future excess".

But what about Quantitative Easing?

Since the crisis started, the Bank of England has created £375 billion of new money, through Quantitative Easing (QE). But isn't that just the Bank of England going wild with the printing press? In fact, the reason behind this new money creation was that banks have been reluctant to make new loans. With people repaying old loans but not enough new loans being made to replace them, the amount of money in the economy started to shrink, pushing the UK into recession. This £375 billion was designed to replace the money that banks had been creating up until the start of the financial crisis. As Sir Mervyn King, Governor of the Bank of England, said in 2012,"[A] damaged banking system means that today banks aren't creating enough money. We have to do it for them".

But where did the QE money go? The money created through QE was used to buy government bonds from the financial markets. The new money therefore went to the financial markets, boosting bond and stock markets nearly to their highest level in history. The Bank of England itself estimates that QE boosted bond and share prices by around 20%. This effect is supposed to make people feel wealthier and spend more, but 40% of these financial assets are owned by just 5% of the population, so while most families saw no benefit from Quantitative Easing, the richest 10% of households would have each been up to £128,000 better off.



Quantitative Easing (as carried out in the UK) can be thought to be a bit like topping up all the casinos with chips to get players gambling again, but expecting businesses, shops, and factories to benefit. Very little of the money created through QE boosted the real economy where we live and work. The Bank of England estimates that the £375 billion of QE led to 1.5% to 2% growth in GDP — in other words, through QE it takes £375 billion of new money just to create £23-28 billion of extra spending in the real economy. It's incredibly ineffective.

So to recap: Up until the crisis, banks were creating a lot of new money that came into circulation when they made new loans, and at the same time creating the same amount of private debt. After the crisis banks stopped lending because their confidence was down, so the money supply also started to shrink. The Bank of England created £375 billion to try and get money to the real economy, but again, it was ineffective.

Why doesn't money reach the places that need it most?

The problem is that banks get to choose where new money is spent and banks will often choose where to lend based on their own profits rather than the needs of the economy. In the 10 years running up to the financial crisis in 2008, banks doubled the amount of mortgage lending. This resulted in house prices increasing by more than 300%. This increase in prices might be good for a very small proportion of people with multiple houses, but it has basically priced an entire generation out of being able to afford to buy a house.

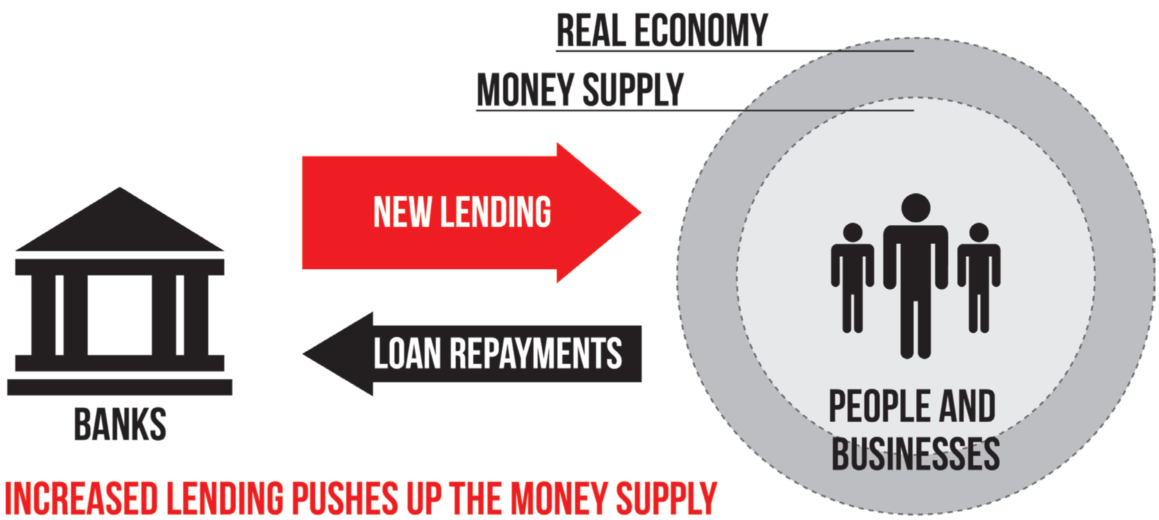
Because 97% of the money in the UK is created by banks, someone must pay interest on nearly every pound in the UK. Interest payments suck wealth out of the rest of the economy and into the banks. The bottom 90% of the UK population pays more interest to banks than they'll ever receive from them, resulting in a redistribution of income from the bottom 90% of the population to the top 10%. Collectively we pay £165 million every day in interest on personal loans alone (not including mortgages), and a total of £213 billion a year in interest on all our debts.

Since banks create and allocate our money supply, banks have the power to shape the economy. They've used this power to push up house prices, inflate speculative financial bubbles, and starve small businesses of investment. They have no legal obligation to use this massive power in the interests of society as a whole, and we have no way of holding them accountable when they use it badly.

Just five banks hold (and create) 85% of the UK's money, and these five banks are controlled by just 78 board members. Some of these board members have much more decision-making power than others, which means that there may be as few as 20 people who take the key decisions about how much money is created, and what that money is used for. This is a huge amount of power concentrated in very few hands, with next to no transparency or accountability to society. It is a dangerous and undemocratic way of running the economy, and the financial crisis has shown how severe the consequences of this system can be.

An alternative

Although it is unnerving to think about, most economists and politicians do not fully understand why the financial crisis happened. This is reflected in the lack of media commentators on the subject of money. Martin Wolf, the chief economics commentator at the Financial Times, has been the most outspoken on the problems around money creation. On 20th June 2013 he wrote:



- INCREASED LENDING PUSHES UP THE MONEY SUPPLY
- THROWING MONEY AT FIXED ASSESTS DOESN'T RAISE WAGES
- AS DEBT GROWS, LOAN DEFAULTS BECOME INEVITABLE

> It is quite likely that the crisis will cost the UK a sixth of gross domestic product, in perpetuity. How is this disaster possible? The answer is that we have entrusted a private industry with the provision of three public or near public goods: the supply of money, the payments system, and the supply of credit.

Since most politicians do not have a full analysis of the crisis, they do not know how to get the economy started again. The big problems facing the UK today won't be solved by passively waiting for the economy to recover. We need to demand that the government do something new and different — something that will create jobs, deal with the shortage of housing and allow people to reduce their personal debts. Current government policies are failing and it is time for a change.

Positive Money advocates that the Bank of England create new money that can enter the economy via the government. This could be done in four ways: increase government spending, cut taxes, make direct payments to citizens, or pay down the national debt. Although each of the options have their own appeal, we think that because the UK is in such a desperate situation in terms of unemployment, the biggest benefit to society would be to increase government spending to create new jobs. Opportunities to create jobs and build a more sustainable economy lie in green energy infrastructure, building sustainable and affordable housing, and developing better public transport. It's not that we can't afford renewable energy, it's that we haven't got an economy that works.

In the long run we believe all new money should enter the economy free from debt, and through the government. Banks should only lend money they already have. This will put an end to the 'Too Big To Fail' subsidy that resulted in the big bailouts of the 2008 crisis. We do not think that changing the national money supply alone will be enough in the long term. In the long term we will need a much more decentralised banking system that can serve the needs of local economies. But it is a huge step in the right direction towards a sustainable economy that serves society and doesn't need continuing increases in consumption to function.

Recently, a former regulator told us that he only started thinking about the creation of money in 2010, three years after the crisis started. This admission is of great importance because it shows that there is simply a huge lack of understanding in both policy-making circles and the finance sector about how the current system works. The creation of money was not even considered as a possible culprit for the 2008 crisis. Very few mainstream economists are looking at who is creating the money and where it's going, even though money affects everything that happens in our economy. This is because the economics that is researched and taught widely across universities today essentially ignores money creation. This really is the biggest challenge we face. If you ask any economics student to explain the exact process of money creation, chances are they won't have much of an answer.

We have a lot of work to do to win the argument that there are better ways of creating money than either leaving it to banks or putting new money into financial markets, and we're keen to work with other organisations, charities, campaigns and individuals who want to get involved. The good news is that the idea hasn't been dismissed out of hand: the government's recent 'Review of Monetary Policy', which was released with the last budget in March 2013, explicitly permits the Bank of England to use what they call "unconventional policy instruments" in order to help the government to "achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries".