Open Letter to All Political Leaders

What the world now needs in response to the current crisis is

(1) the most efficient, cost−effective and socially just way of stabilising economies and employment, and

(2) a mechanism to terminate the frequent recurrence of banking crises and significant economic cycles, with all their costs, distortions and injustices.

Any proposal needs to be tested by whether it meets these two criteria. The proposals aired hitherto in the mainstream media fail this test. Here is an outline of a proposal that passes it.

How to End Banking Crises and Severe Economic Cycles

First, we need to understand what causes banking crises. Empirical research shows that the core of the problem is that 95% to 98% of the money supply is not created by central banks or governments, but by privately−owned commercial banks. It is a little−known fact that there is no such thing as a 'bank loan'. Banks do not lend money. 'Lending' refers to transferring control of the lent object to the borrower. If a car has been borrowed by someone, the owner can't drive in it any more. This is not what happens when banks issue a 'bank loan'. Instead, they are allowed by the current regulatory framework to create new money out of nothing. This is why this process is called 'credit creation'. The collective decisions of commercial bank staff thus determine how much money is created, who gets the newly created money and they also see what it is going to be used for. The only institution that has both the knowledge and the power to interfere in this process are the central banks.

Mainstream economics assumes that the decisions made by banks about how much money should be created and to whom it should be handed over for what purpose, will be the best possible outcome. But the current crisis has once again demonstrated that we can't expect banks' credit decisions to be in any way beneficial for the overall economy or social welfare. The incentive structure at banks is such that they tend to create too much credit, when not needed, and for unproductive use. Now we will see that this is followed by banks creating too little money, when more would be needed.

There are some simple rules for sound banking and sound economies: Whenever credit is created and used to increase the amount of goods and services provided, it will be non−inflationary: more money comes about, but also more goods and services. Whenever credit is created and used for unproductive purposes, inflation comes about: more money chases limited goods or assets. The unproductive credit creation can take two forms: when credit is extended for consumption, it will result in consumer price inflation. When credit is extended for non−GDP transactions (which means financial and real estate transactions), there will be asset inflation. Both cases are unsustainable and if sufficiently large, result in banking and economic crises.

To prevent banking crises, at the very least, it must be ensured that the bulk of credit creation is used for productive purposes. Specifically, aggregate bank credit for transactions that are not part of GDP (something that can be easily verified by loan officers) needs to be monitored, and suppressed when it rises in excess of overall bank credit growth. This simple measure would have prevented the credit bubbles in the US, the UK, Ireland, Spain and many emerging markets, which have now burst and caused the current banking and economic crisis. It would also have prevented the Japanese depression since 1990 or the US Depression of the 1930s. Central banks used to monitor this, but in the wake of excessive financial deregulation most chose to abolish their 'credit guidance' policies and instead let rip the unproductive bank credit expansion.

Thus one also needs to ask why those institutions that could have prevented the bubbles and thus the current bust, have singularly failed to do so, although they had expressly been given unusually strong powers with little accountability to democratic institutions: the central banks. This suggests that the very independence and lack of accountability of central banks has been a major factor in allowing the creation of credit bubbles and the propagation of the current crisis. Central banks have failed, not despite, but because of their independence, which has been revealed to have been excessive. Thus central banks should be made far more directly accountable to democratically elected assemblies and stripped of their independence. The highly respected central bank expert Milton Friedman already argued in 1982 that the US Federal Reserve be entirely abolished and replaced by one person at a desk inside the US Treasury. While this may sound extreme, it is technically possible and the burden of proof should be on central banks to demonstrate that their activities have been more successful than a simpler such set−up.

Few know that the Federal Reserve, which for most means and purposes is the Federal Reserve Bank of New York, is privately owned, by the Wall Street banks. It is doubtful that this corporate governance structure is socially optimal. Moreover, the current crisis should also be used to examine whether the archaic system of money creation by unaccountable privately−owned commercial banks makes sense. Today, technology allows far more efficient, transparent and less conflict−prone systems of money creation, for instance directly through the government. Such an alternative system of money creation would also reduce national debt significantly.

How to Fix the Banking System and Ensure Employment

These are some of the key long−term lessons. What are the immediate measures to end the current crisis and avoid large−scale unemployment? Just like the Japanese government in the early 1990s, governments have responded by increasing fiscal expenditure, funded by borrowing, and central banks have responded by lowering interest rates. However, both will not help: the privately−owned creators of the bulk of the money supply are battening down the hatches; in their increased risk aversion they will reduce credit creation. Just as their excessive credit creation affects us all, so does their reduction of credit: for economic growth, as traditionally measured, credit creation is necessary. This is why the current policies will not help. Fiscal policy on its own does not create credit in our current monetary systems. By borrowing more, national debt is increased, but the money for the fiscal stimulation is the same money that is removed from the economy through bond issuance. Thus fiscal policy, if not backed by credit creation, will crowd out private demand dollar by dollar. And lower interest rates will not help − even if they drop to zero − if the quantity of credit does not increase. This is why Japan will soon be in the twentieth year of recession after its own credit bubble burst in 1990.

The solution is simple: fiscal stimulation, in the form of purchases of non−performing assets from banks, and public purchases of bank equity, should be funded either by the issuance of government money (such as Kennedy's 1963 'United States Notes', to give a graphic example), or, failing that, undertaken directly by the central banks, for their own account. In both cases, national debt and interest liabilities will not increase, but credit creation will. Growth will hence not collapse. This also makes sense from a moral hazard perspective: not the tax payer is responsible for the current mess, but the central banks − so let them pay.

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