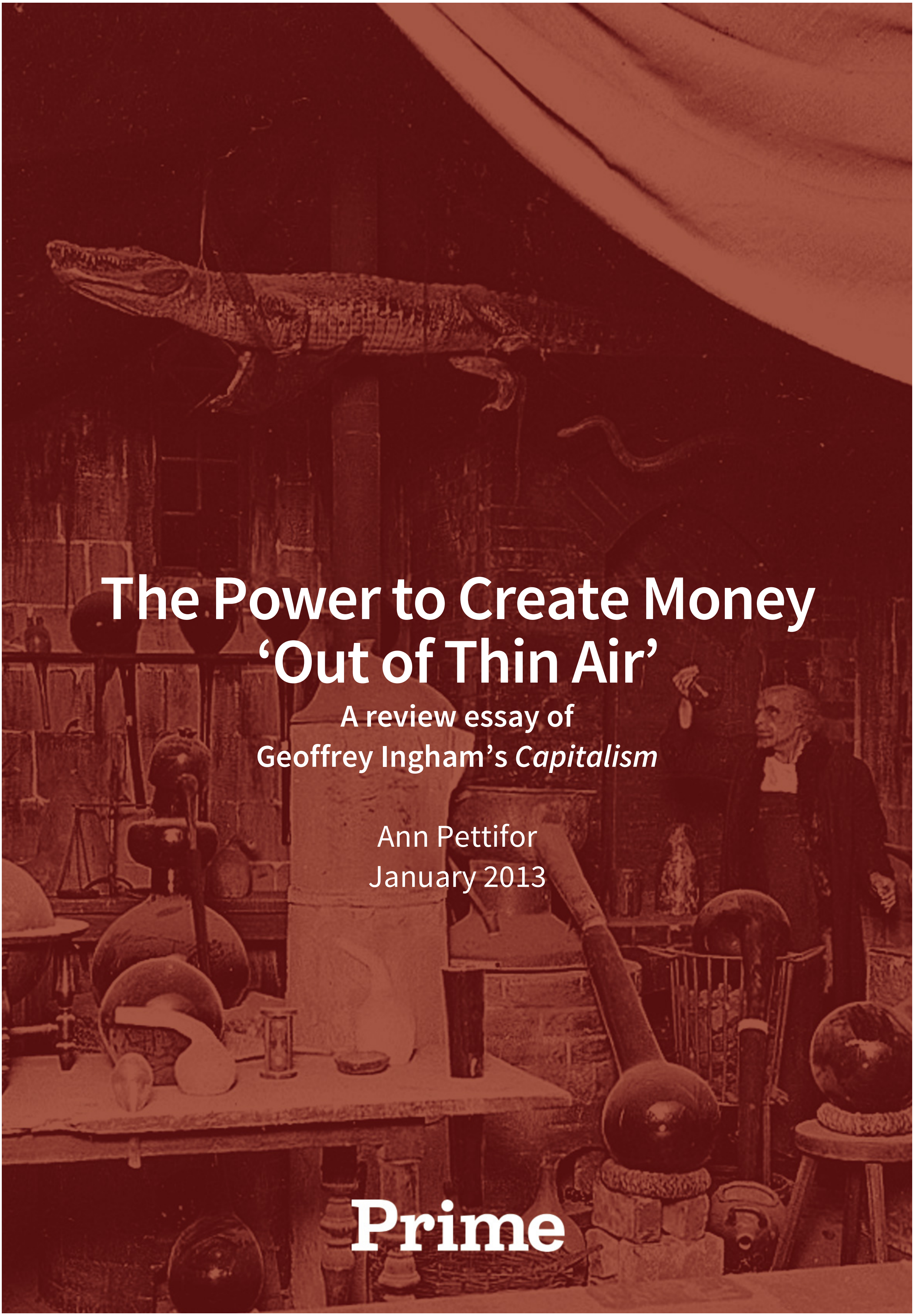

The Power to Create Money 'Out of Thin Air'

A review essay of Geoffrey Ingham's *Capitalism*

Ann Pettifor

January 2013

Prime

The Power to Create Money Out of Thin Air

A review essay of Geoffrey Ingham's Capitalism

By Ann Pettifor

In this review of Geoffrey Ingham's Capitalism, Ann Pettifor stresses the need to understand capitalism's elastic production of money and move beyond Adam Smith and 'fractional reserve banking.'

Introduction

> *Modern finance is generally incomprehensible to ordinary men and women... The level of comprehension of many bankers and regulators is not significantly higher. It was probably designed that way. Like the wolf in the fairy tale:*
>
> *"All the better to fleece you with."*
>
> Satyajit Das, in Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives. (2010, FT-Prentice Hall)

Last summer, I took up a book that had been on my reading list for some time: Cambridge sociologist Geoffrey Ingham's *Capitalism* (Polity, 2011).[1]

Geoffrey Ingham is one of a handful of academics not blinded by the smoke and mirrors of today's monetary 'alchemists'. His excellent *The Nature of Money* (Polity, 2004) reveals a sounder grasp of credit-money than many contemporary heterodox economists and almost all orthodox, monetarist economists.[2]

Just as with *The Nature of Money*, Ingham's *Capitalism* adds a great deal to our understanding of the *systemic* nature of capitalism. Like the distinguished sociologists on whose shoulders he stands, Ingham draws on those theorists whose work he "found to be most valuable". They are Adam Smith, Marx and Weber, but also Joseph Schumpeter and John Maynard Keynes – who are included he writes,

> "not only for their seminal heterodox contributions to the economic analysis of capitalism, but because this heterodoxy is implicitly 'sociological' " (ibid. p.2)

This book is therefore a must-read for both sociologists and economists; indeed for anyone wanting to deepen their understanding of the systemic nature of today's global financial crisis.

However, while Ingham's review of heterodox analyses is illuminating, it is, by his own admission, not comprehensive and, I will argue, includes a number of flawed analyses which are the subject of current debate, and discussed in some detail in this review.

---

[1] First published in 2008, it was republished with a postscript on the financial crisis and its aftermath in 2011.
[2] There are important exceptions of course: Prof Victoria Chick's Macroeconomics After Keynes (Cambridge, Mass: MIT Press (1983); Geoff Tily's Keynes Betrayed (Palgrave Macmillan, reprint edition, 2010); and the finance team at the new economics foundation in London. See their 'Where does money come from?'

First while acknowledging that capitalism's hallmark is the "elastic production of money" he then retracts, and suggests that private credit-creation is constrained by the practice of 'fractional reserve banking' – a form of commercial banking probably not practised since the founding of the Bank of England in 1694. Again this is the subject of heated debate within the economics sphere, so more on the subject below.

Second Ingham, like many economists, blames the inflation of the 1970s on the 'the power of monopoly capital and their labour forces to mark up their respective prices'. (p.86) This analysis appears to discount the role played by the City of London in creating excessive credit - 'too much money chasing too few goods and services' - after Chancellor Anthony Barber's assault on banking regulation in 1971.[3]

Third, by his own admission, Ingham arbitrarily excludes from his list of heterodox theorists a number of 20th century thinkers who have greatly illuminated our understanding of both the systemic nature of capitalism but also its dutiful hand-maiden, neoliberal economic theory. While I respect his right to choose the most influential, the inclusion of progressive 20th century thinkers would have added considerable value to this study of capitalism.

These disagreements are not new, and I am not the first to raise them. However given the extent to which society, political parties and progressives have a 'blind spot' for the admittedly opaque role played by private bankers in the economic life of nations, I believe it important to raise further discussion about 'fractional reserve banking' and the causality of inflation.

My high regard for Ingham's work meant that these disagreements provoked a response in the form of this long review essay - to stimulate debate on the issues he has illuminated so clearly in his study of contemporary capitalism.

Ingham is a Reader in Sociology at Cambridge, and his books build on the work of other fine sociologists: Georg Simmel (*The Philosophy of Money*, 1907); Max Weber (*The Protestant Ethic and the Spirit of Capitalism*, 1905) and Charles Wright Mills (*The Power Elite*, 1956).

He defines capitalism in terms first used by Keynes: as a 'monetary production economy'. He explains that

> "bank credit-money and financial asset markets give the capitalist system its dynamism, flexibility and adaptability; on the other hand, they inevitably generate asset price

[3] I am grateful to Dr Geoff Tily for sharing his insights into the inflation of the 1970s. For more detail see his *Keynes Betrayed* (2006, 2010).

'bubbles' financed by debt and the inevitable defaults that sooner or later burst them." (p.230).

Ingham's understanding of capitalism as a monetary production economy makes a refreshing change from more typical characterisations of capitalism. While the creation of private or indeed public credit-money 'out of thin air' is fundamental to capitalism, it is not widely understood as such by the general public. Central bank monetary operations such as 'quantitative easing' (QE) or the ECB's proposed, but not as yet enacted, 'outright monetary transactions' (OMT) have been regular practice since the establishment of the Bank of England in1694. While there is nothing new in the creation of what a US Government Agency estimates at $16 trillion of new money, nevertheless QE came as something of a revelation to the general public.[4]

They were not alone. With notable exceptions, many economists failed to fully understand the processes behind the production of credit-money – not just by central bankers, but more importantly by private, commercial bankers. Not only is this fundamental aspect of capitalism both misunderstood and overlooked, it is seldom properly analysed or taught in universities. As Andy Haldane, Executive Director, Financial Stability at the Bank of England noted in a recent contribution to the website, Vox EU: [5]

> "Cycles in money and bank credit are familiar from centuries past. And yet, for perhaps a generation, the symptoms of this old virus were left untreated. That neglect allowed the infection to spread from the financial system to the real economy, with near-fatal consequences for both. Two developments – one academic, one policy-related – appear to have been responsible for this surprising memory loss. The first was the emergence of micro-founded dynamic stochastic general equilibrium (DGSE) models in economics. Because these models were built on real-business-cycle foundations, financial factors (asset prices, money and credit) played distinctly second fiddle, if they played a role at all.

[4] For more detail of the source of this number, see this post by Senator Bernie Sanders who commissioned a report on the cost of Federal Reserve bailouts from the US Government's Accountability Office, the GAO. http://www.sanders.senate.gov/newsroom/news/?id=9e2a4ea8-6e73-4be2-a753-62060dcbb3c3

[5] *What have economists ever done for us? By* Andy Haldane, Bank of England executive director, Financial Stability on 1st October, 2012. http://www.voxeu.org/article/what-have-economists-ever-done-us

> The second was neglect for aggregate money and credit conditions in the construction of public policy frameworks. Inflation targeting assumed primacy as a monetary policy framework, with little role for commercial banks' balance sheets as either an end or an intermediate objective. And regulation of financial firms was in many cases taken out of the hands of central banks and delegated to separate supervisory agencies with an institution-specific, non-monetary focus."

This neglect by economists but also policy-makers of commercial bank balance sheets, should not come as a surprise. As Satyajit Das argues in the quotation that opens this review: ignorance makes it easier for financiers to dupe and fleece both customers and tax-paying citizens.

While economists and many bank regulators turned a blind eye, what happened next, Haldane notes

> "was extraordinary. Commercial banks' balance sheets grew by the largest amount in human history. For example, having flatlined for a century, bank assets-to-GDP in the UK rose by an order of magnitude from 1970 onwards. A similar pattern was found in other advanced economies."

Was it a coincidence that the economics profession and media commentators were diverted by micro and macroeconomic blind alleys, while the private finance sector binged on credit-creation and more or less discreetly built up the largest balance sheets in history?

Is it still a coincidence that many mainstream economists consciously detach themselves from modern finance, disdaining any engagement with today's global economic failure? The Royal Economic Society – Britain's most prestigious economic club - lists the following as highlights from the 2012 *Economic Journal*:

- *Learning from the Crowd: Regression Discontinuity Estimates of the Effects of an Online Review Database* by Michael Anderson & Jeremy Magruder

- *The Effects of Promotions on Heart Disease: Evidence from Whitehall* by Michael Anderson & Sir Michael Marmot

- *Micro-costs: Inertia in Television Viewing* – by Constança Esteves-Sorenson & Fabrizio Perretti.

Of course micro-economic analysis serves useful, practical social and economic purposes. But the dominance of micro-economic analysis within the academic and commercial professions has served only to confuse and obscure. Stephen Cecchetti explains why. At a workshop organised by the Bank of International Settlements, in May 2012 [6] he highlighted a key flaw at the heart of most micro-economic modelling:

> "Let's say that we are trying to measure tide height at the beach. We know that the sea is filled with fish, and so we exhaustively model fish behaviour, developing complex models of their movements and interactions… The model is great. And the model is useless. The behaviour of the fish is irrelevant for the question we are interested in: how high will the seawater go up the beach?... By building microeconomic foundations we are focusing on the fish when we should be studying the moon."

It is no wonder that mainstream, orthodox academic micro-economists could not answer the Queen's famous question: why was the crisis not predicted? Their models had missed the macroeconomic forces, the surge and deluge that 'beached' many banks and other financial institutions in 2007-9.

As the financial crisis rolls on across the Eurozone, as unemployment rises across the world and economic failure intensifies, many economists remain detached from debates, and ignorant of financial factors (asset prices, money and credit). Their closer attention could help shape policy, stabilise the global economy, and alleviate human suffering. Instead many are caught like rabbits in headlamps: ignorant as to how the private banking system created/leveraged debts 'vast as space' [7] with which to crash the economy – and therefore of policies for de-leveraging and stabilising an unbalanced global economy.

Instead we are obliged to depend for insights into the crisis on the analyses of sociologists such as Geoffrey Ingham.

Regulatory capture and recourse to complexity

In his introduction to *Politics,* Ingham notes that nineteenth century sociological texts have very little to say about the monetary and financial aspects of capitalism.

[6] BIS Papers No 65. *Threat of fiscal dominance?* A BIS/OECD workshop on policy interactions between fiscal policy, monetary policy and government debt management after the financial crisis. Basel, 2 December, 2011.
[7] Attributed to M.Gustave de Puynode, and quoted in Dunning Macleod, H. *The theory and Practice of Banking*, in Chapter IV of *The Theory of Credit,* Longmans, London, 1879.

> “In this respect we get more guidance from the great economists such as Schumpeter and Keynes. But they and other economists concerned with the systemic structure of capitalism are, unfortunately, not likely to be encountered in an undergraduate sociology course.” (Ibid p.1)

Nor are they likely to be encountered in an under- or even post-graduate *economics* course. So, when the crisis broke politicians and policy-makers had few wise, academic economists to turn to. The world’s regulators had been drilled in economic orthodoxy, based on Adam Smith’s 18th century theory of money and credit, and so were at a loss as to what to do. Instead they turned for advice to the very people that had caused the crisis.

Robert Jenkins, an investment banker, has chaired an investment firm and also the trade association representing the UK investment industry. He is now a member of the Financial Policy Committee of the Bank of England. In a speech published by the Bank[8], he recently complained of regulatory capture by the banking system:

> “Driven by hubris, greed and stupidity bankers led the charge off the cliff. But where were the regulators? Why did they not see it coming? Why did they not prevent it? Why did they trust bankers to know what was best for banking? In short, how could regulators have been so dumb as to believe that bankers were so smart?
>
> As financial panic spread I watched in disbelief as bankers trooped through the doors of Downing Street to advise Government on how best to address a problem which bankers themselves had largely created. Far from being discredited, the guidance of these “experts” was eagerly sought – and with virtually no counterbalancing input from other stakeholder groups. Over the succeeding months officials went on to tap a more appropriate range of expertise. But at that key moment in time - capture was complete.”

[8] *Making Good Financial Regulation: Towards a Policy Response to Regulatory Capture*, Bank of England, 25 September 2012. http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech603.pdf

Politicians and central bankers, led by the widely admired Federal Reserve's Alan Greenspan, faithfully followed the economic orthodoxy of financial de-regulation that had created the conditions for the crash.

During the period of the inflating credit bubble policy makers had obliged the private banking sector by deliberately turning a blind eye to the way that credit inflated asset prices during the 90s and 00s. While policies for holding down the inflation of wages and prices were enforced, asset price inflation was allowed to let rip. Only after the 'credit crunch' on 'debtonation day' 9 August 2007 did some (not all) policy-makers turn their attention to the deflation of a massive, global asset price bubble, fuelled by expensive, unregulated credit - easy but dear money.

Blindness to the activities of the private finance sector allowed the rich – the owners of assets (e.g. property, stocks and shares, private equity, race horses, complex financial products (CDOs etc.), works of art) to quietly use easy credit to inflate the value of their assets. By this means were they obscenely enriched. Those without assets and therefore without access to 'easy credit', were correspondingly impoverished. Furthermore, as the incomes of those who worked by hand and brain fell, and the need to borrow rose, so did the cost of their risky borrowing.

Thus, the rich get richer and the poor poorer.

Despite blatant regulatory failure, few of the powerful have repented of the orthodoxy, or learned from the experience. Haldane, one of the more astute of the Bank of England's insiders, pointed out in a recent speech that regulators have reacted to the crisis in a typically human way: by masking their ignorance of the causes, not with a 'mea culpa' but with *more complexity*. Anxious to cover up their failure to predict the crisis, and their earlier mistaken de-regulation policies, banking supervisors rushed to build a highly complex, but still ineffectual regulatory skyscraper: a 'Tower of Basel' which, Haldane argues, is "at risk..of over-balancing."[9]

This confusion and muddle is not entirely accidental. Satyajit Das is right. Down the ages, both central and private bankers have been masterful in designing complex and opaque financial systems, clothing these in mystical and arcane language - all the better with which to disguise the speculative, exploitative and risky activities of capitalism's bankers. Orthodox economists in particular, have deliberately been blind (or blinded) to the private sector's financial operations.

So it is *not* surprising that, at the heart of this confusion and muddle that is the global financial crisis there lies a deliberate, profound and widespread ignorance of the very nature of credit and money.

[9] *The dog and the frisbee*. Paper by Andrew G Haldane, Executive Director, Financial Stability and member of the Financial Policy Committee and Vasileios Madouros, Economist, Bank of England. Given at the Jackson Hole Symposium, 31 August, 2012.

The great divide in economics

Ingham both understands and clearly explains the great divide in economics between those, from Adam Smith onwards, who regard money as "a neutral medium that facilitated exchange on the 'great wheel of circulation' " – and those like Keynes, Schumpeter and Minsky, who had a much sounder understanding of capitalism's ability to effortlessly create a vast and ever-expanding bubble of credit-money.

Ingham, as with Schumpeter, rightly regards the 'elastic production' of credit-money by bankers as a fundamental and systemic part of capitalism's success, but also as *causal* to its periodic, devastating crises.

He begins by reminding us that Adam Smith

> "relegated money to a secondary, passive role in his analytical system. …..This 'great wheel of circulation' was not to be confused with the real wealth of society that resided in the factors of production and goods that it circulated." (ibid. p. 10)
>
> "…In the era of precious-metal money, credit instruments – bills of exchange and promissory and bank notes – were to be distinguished from 'real' money. Thus, although credit was important in facilitating trade and production, it was not an autonomous force or factor of production…." (ibid. p. 41)

For the orthodox, the economy is based on barter, and money is just its 'neutral veil'. Paul Samuelson in his book, *Economics* (taught in every Economics 101 course in most of the world's universities, and now in its 17th edition) instructs students that:

> "Even in the most advanced industrial economies, if we strip exchange down to its barest essentials and peel off the obscuring layer of money, we find that trade between individuals or nations largely boils down to barter." [10]
> (My emphasis)

The Bank for International Settlements – the central bankers' bank – commented on the orthodox approach in a recent working paper by Claudio Borio: *The financial cycle and macroeconomics: What have we learnt?*

[10] P. Samuelson, 1973*, Economics*, 9th Ed., New York: McGraw-Hill, quoted in G. Ingham, *The Nature of Money,* Polity Press, 2004.

"Finance came to be seen effectively as a veil – a factor that, as a first approximation, could be ignored when seeking to understand business fluctuations. And when included at all, it would at most enhance the persistence of the impact of economic shocks that buffet the economy, delaying slightly its natural return to the steady state (e.g. Bernanke et al.)"[11]

Ingham draws parallels between Smith's relegation of money to a secondary role with Karl Marx's similar "underestimation of the role played by money in crises." (ibid. p 24)

"Marx correctly identified the capitalist mode of production's distinctive Money-Commodity-Money (M-C-M) circuit. But, in common with Adam Smith and most nineteenth century economic thinkers Marx was less clear about the way in which capitalism is uniquely characterized by a banking system that can create an unlimited amount of credit-money that fuels crises either through the financing of over-production and/or speculation." (ibid. p. 24)

It is remarkable three hundred years after the publication of *The Wealth of Nations*, Adam Smith's flawed analytical system still has a powerful hold on today's orthodox economists. Ingham rightly notes that

"… together with the work of later theorists such as Friedrich Hayek (1889-1992) and Milton Friedman (1912-2006), *The Wealth of Nations* forms the basis for the hegemony of today's economic 'neo-liberalism'."

Similarly there are many progressive economists who have a blind spot for the role played by capitalism's elastic production of credit in inflating assets. No less a prominent and sound economist as CEPR's Dean Baker, argues that

"The basic story of the U.S. macro economy over the last 15 years is pretty straightforward. We have an economy that was driven by two bubbles, the stock bubble in the '90s and the housing bubble in the last decade."
- (Doctors Remove Bullet From Victim's Head, Seek to Determine Cause of Death, The Huffington Post, August 27, 2012.) [12]

[11] BIS Working Papers No 395 *The financial cycle and macroeconomics: What have we learnt?* by Claudio Borio. Monetary and Economic Department December 2012. http://www.bis.org/publ/work395.pdf

[12] See: http://www.cepr.net/index.php/op-eds-&-columns/op-eds-&-columns/doctors-remove-bullet-from-victims-head-seek-to-determine-cause-of-death

Bankers as ‘intermediaries’

Thanks to the dominance of Adam Smith’s flawed analytical system, the widespread assumption remains that credit plays a secondary role in the real economy (where e.g. stocks and shares are exchanged and houses bought and sold). From there the orthodox would have us believe that banks and bankers are mere ‘intermediaries’ between borrowers and savers: that savings *are* needed for investment; and loans *are* made from deposits.

Economists, sociologists, central bankers, commercial bankers, presidents and politicians have known since before the founding of the Bank of England in 1694 that the very opposite is true.

- Private bankers are *not* mere intermediaries.
- Savings are *not* needed for investment.
- Private bank loans issued by commercial bankers *create* deposits.
- There is no money in the bank when a borrower applies for a loan.

It is the loan application that, together with the promise of both collateral and repayment, creates deposits. Deposits in turn create economic activity (investment and employment) and income (wages, salaries, profits and tax revenues). These can be used to repay loans/debts.

If the system is to remain stable and work well, then it is essential that credit-creation is part of a virtuous *economic* circle. One in which carefully regulated credit drives sound investment in economic activity, which in turn generates income in the form of wages/salaries/profits and tax revenues, used in part to repay debt.

The system quickly becomes unstable if credit creation is not invested in income-generating activity that is ecologically, socially and politically sustainable. Debt inevitably becomes unpayable if credit is invested at high, unsustainable rates of interest that exceed profits and the ability to repay. And the system becomes unstable if credit is largely used for speculation.

The stories economists tell about money

Despite these fundamental aspects of capitalism being known for centuries, many persist in denial of capitalism’s greatest power – the elastic production of money - but also of its propensity to collapse if not managed and regulated.

This denial is most clearly manifest in the stories economists tell about money.

The orthodox story is that banks act simply as go-betweens 'twixt borrowers and savers. This narrative is so pervasive that, astonishingly, it informs the approach of Tim Geithner, who as US Treasury Secretary was probably one of the most powerful finance ministers in the world. In his written Testimony on Financial Regulatory Reform to the US's Congressional Financial Services Committee on 23 September, 2009, he said:

> "Stripped of its complexities, the purpose of a financial system is to let those who want to save - whether for vacation, retirement or a rainy day - save. It is to let those who want to borrow - whether to buy a house or build a business - borrow. And it is to use our banks and other financial institutions to bring savers' funds and borrowers' needs together and carefully manage the risks involved in transfers between them.
>
> The job of a financial system, in other words, is to efficiently allocate savings and risk."

The argument rages: Paul Krugman

And while the Nobel prize-winning Keynesian economist Paul Krugman towers over fellow economists by rebutting false neoliberal theory; by fully engaging in public debates about the financial crisis, and by proposing progressive remedies, he alas, also falls prey to the thesis that 'banks act as intermediaries' between savers and borrowers.

In a column for the New York Times (NYT) posted at 12.09 p.m. on 27 March, 2012 Krugman responded sharply to a pointed attack on him by Prof. Steve Keen in a blog titled: 'Primer on Minsky'. In his blog Keen explored:

> "the capacity for the banking sector to create spending power 'out of nothing'—to quote Schumpeter." (Steve Keen, EconoMonitor, 26th March, 2012.)

Krugman responded thus:

> "As I (and I think many other economists) see it, banks are a clever but somewhat dangerous form of financial intermediary, one that exploits the law of large numbers to offer a better trade-off between liquidity and returns, but

> does so at the cost of taking on very high leverage, with all the risks that entails.
>
> Banks don't create demand out of thin air any more than anyone does by choosing to spend more; and banks are just one channel linking lenders to borrowers.
>
> I know I'll get the usual barrage of claims that I don't understand banking; actually, I think I do, and it's the mystics who have it wrong."

Paul Krugman, Conscience of a Liberal, *Banking Mysticism*, New York Times, 27th March 2012

Later that day, in a NYT post titled *Minsky and Methodology (Wonkish)* Krugman made the astonishing point that he was

> "....all for including the banking sector in stories where it's relevant; but why is it so crucial to a story about debt and leverage?"

He returned to the subject on the 30th March in a post titled *Banking mysticism, continued* , with this:

> "There are vehement denials of the proposition that banks' lending is limited by their deposits.... This is all wrong...
>
> "First of all, any individual bank does, in fact, have to lend out the money it receives in deposits. Bank loan officers can't just issue checks out of thin air; like employees of any financial intermediary, they must buy assets with funds they have on hand. I hope this isn't controversial, although given what usually happens when we discuss banks, I assume that even this proposition will spur outrage."

His comments did spur outrage – because loan officers *can* "just issue checks out of thin air" as Martin Wolf noted in the Financial Times on 9th November, 2010:

> "The essence of the contemporary money system is creation of money, out of nothing, by banks often foolish lending."

Of course bank clerks demand collateral for the credit, and insist on a contract for repayments over a term and at an agreed rate of interest. While there are physical limits to the number of assets that can be offered as collateral, nevertheless credit creation can be expanded by inflating asset prices – thereby increasing the value of collateral, and with it, the 'production' of new loans/debt set against the rising value of the asset.

Like Keynes, Joseph Schumpeter (1883-1950) challenged the dominant orthodoxy. He was scathing of the view that banks build

> "financial reservoirs ...collecting together little pools of savings for lending on. (He) and others saw that capitalist banks produced new money by the act of lending, in the sense that the deposits that were created when money was advanced to a borrower were not taken from existing savings or matched by incoming deposits. Money was produced simply by the debt contract between banks and borrowers. Schumpeter clearly grasped that the essential capitalist practice was the actual 'production' of bank credit-money out of nothing more than the promise of repayment." (ibid. p 39). [My emphasis]

Keynes and the doctrine of private credit-creation

Keynes – whose understanding of money and credit is central to *The General Theory of Employment, Interest and Money* – would have been dismayed by Prof Krugman's words. Because, as Schumpeter reminds us, he was concerned above all with monetary theory and policy, and made strenuous efforts to spread understanding of the nature of credit and bank money; of the importance of the interest rate to prosperity and economic justice; and of the ability of those engaged in private credit-creation to hinder economic stability and precipitate capitalist crises. 'Interest and Money' are fundamental to the General Theory.

In his magisterial *History of Economic Analysis* (written after Keynes's death and published posthumously in 1954 by his wife Elizabeth Boody) Schumpeter wrote:

> "it proved extraordinarily difficult for economists to recognise that bank loans and bank investments do create

> deposits…And even in 1930, when the large majority had been converted and accepted the doctrine as a matter of course, Keynes rightly felt it necessary to re-expound and to defend the doctrine at some length…and some of the most important aspects cannot be said to be fully understood even now." - Allen and Unwin History of Economic Analysis 1954. p 1114

More than fifty years after Schumpeter wrote these words, economists as powerful as Secretary Tim Geithner still appear unable to grasp that bank loans create deposits. And it is sobering to consider that Keynes's monetary theory, on which Schumpeter and Minsky subsequently built their theories, is totally absent from the curriculum of the faculty of Cambridge University's economics department. (For more on this theme see my post on the Real World Economics Review blog: *Cambridge excludes Keynesians from conference on Keynes*. 20 June, 2011*)*

Ingham, who clearly rates Schumpeter, fails to point out that his understanding of bank credit-money owes a great deal to Keynes's body of monetary theory. Indeed Ingham, while including Keynes in his list of heterodox analysts of capitalism, skates over Keynes's contribution to our understanding of the inner workings of capitalism. He is (to my mind) a little disdainful of the great economist, describing him as simply '*making capitalism work better'* (ibid. p. 43).

By so doing Ingham underestimates Keynes's attack on the 'hallmark' of capitalism's *systemic* failings – the 'elastic production' of credit.

Second, and vital for both reasons to do with economic stability and prosperity, but also public morality, Ingham pays scant attention to one aspect of economic policy: the role of the private de-regulated banking system in ratcheting up the 'price' of money - *interest rates* - to the detriment of both private and public sectors, society and the ecosystem.

Keynes wrote in 1933 that "the transformation of society… may require a reduction in the rate of interest towards vanishing point within the next thirty years."[13] He argued that a low rate of interest was fundamental to a) the repayment of debt, b) the health of firms and households, and c) to economic activity and stability. That rates have to be low across *the full spectrum* of both public and private lending: for safe and risky loans; real, short and long-term loans – and not just for central bank loans made to the banking sector at the 'base' or 'policy rate'.

Today we are well aware that low interest rates are vital for the health of the ecosystem too. When the burden of debt repayments rise, then the exploitation of both labour and the ecosystem is compounded too.

[13] John Maynard Keynes: *National Self-Sufficiency* The Yale Review, Vol. 22, no. 4 (June 1933), pp. 755-769.

For orthodox economists that argue money is commodity-related, variations in interest rates are believed to be beyond our control. Rates are determined instead, they argue, by the invisible hand of market forces.

For Keynes the rate of interest on 'fountain pen' or 'keystroke' credit was not, and could not be anything other than a social construct: agreed and fixed by committees (or cabals) of men.

So it is that central bankers determine base, or policy rates – once known as the 'bank rate'. Committees of men in central banks raise or lower rates in line with economic conditions as e.g. in recent crises: when after the bursting of the dot.com bubble in 2001 and after the 'credit crunch' of August, 2007 rates were quickly and dramatically lowered.

Second the LIBOR scandal that swirled around Barclays Bank in the spring of 2012 (and now swirls around other banks) brought to the attention of the general public (and the regulatory authorities!) the role played by back office 'submitters' in 'fixing' the inter-bank rate of interest. LIBOR - the London Inter- Bank Offer Rate - was fixed or manipulated so that bankers could profit from trades, or give the impression they were more creditworthy than they were.

The Economist is right to describe the LIBOR rate as the most important figure in finance [14] because, according to the UK's Financial Services Authority, LIBOR is the reference price for $300 trillion of loans and transactions around the world.[15] These range from interest rate swaps to direct lending and the pricing of mortgages to ordinary people, as well as commercial loans to businesses.

Third, commercial bankers, with one eye on their competitors, fix rates for each agreed loan, after an assessment of the risk posed by the project being financed and the borrower.

Unlike a commodity, therefore, the 'price' – or the rate of interest – for money and credit cannot be subject to market forces.

This was Keynes's point: because of the nature of credit-creation, the 'price' or cost of borrowing is unlike any other price. It cannot be determined by the forces of 'supply and demand'. It can only be *a social construct* – a 'policy rate' set by committees of men (sic) in central banks; LIBOR - fixed by an unregulated cabal of commercial bankers; or the rates set by individual commercial bankers.

---

[14] The rotten heart of finance. A scandal over key interest rates is about to go global
The Economist, Jul 7th 2012 | http://www.economist.com/node/21558281

[15] *Pushing the reset button on LIBOR*. 28 September, 2012. Speech by Martin Wheatley - Managing Director, FSA, and CEO Designate, FCA at the Wheatley Review of LIBOR.
http://www.fsa.gov.uk/library/communication/speeches/2012/0928-mw.shtml

It was because private bankers were opposed to managing rates in the interests of society as a whole; because they wanted to retain the power to fix interest rates out of sight of regulators, or society as a whole, that Keynes's ideas were so inimical to the finance sector. His monetary theory, his policies for a) managing/regulating capital mobility (essential if commercial interest rates are to be kept low); b) the regulation of credit creation, and c) his insistence on low, managed rates of interest – all these were policies deployed to great effect in the 1930s and during the 'golden age' of capitalism, from 1945-71. However, they presented a profound threat to finance capital, and to the interests of the City of London and Wall Street in particular.

So Keynes's theories and policies were quietly buried – with the acquiescence of both Keynesian 'friends' and the encouragement of Monetarist foes. Instead the ideas of Adam Smith were revived and used to inform the work of influential 'Keynesians' like Paul Samuelson and N. Gregory Mankiw of Harvard – to name but two – as well as the monetarist Chicago School.

Keynes's *fiscal* policies for full employment and for recovery from financial crisis were then presented as his sole outstanding legacy – isolated from *The General Theory of Employment, Interest and Money.*

The myth of 'fractional reserve banking'

In his analysis of the money market and the production of credit-money, Ingham, surprisingly, argues a straightforward orthodox case. On the one hand, he acknowledges that

> "capitalist banks produce money when they make loans, creating deposits which are drawn on, spent as money and, then, deposited back into the system by recipients." (Ibid p.75)

However he then goes on to argue that

> "conventional banking practice specifies a 'fractional reserve' – usually around 10 per cent of deposits – that banks should keep in order that depositors can withdraw savings. Thus for every £100 deposited (bank liabilities owed to depositors) a bank is able to advance loans (bank assets owed by borrowers) of £90." (Ibid p. 75)

Ingham is not alone in assuming that 'private banking practice' specifies that banks maintain a 'fractional reserve' of loans. Lord Adair Turner, of the UK's Financial

Services Authority (FSA) refers throughout a recent speech to the notion of 'fractional reserve banking', [16] and the new economics foundation (nef) in its otherwise excellent book on money and banking - *Where does money come from?* [17]- falls into the same trap.

In fact it is most unlikely that fractional reserve banking was 'conventional banking practice' in the days before the establishment of the Bank of England in 1694. Early goldsmiths quickly discovered that they could issue more paper loans than they had gold in their vaults. As the system evolved paper loans, based as they were on trust and a promise of repayment, quickly eclipsed the value of the gold supposedly underpinning the loans. Nevertheless the myth was sustained. Nef's Josh Ryan Collins et al. note in their book that by the 1840s "despite the Bank of England's notes being linked to gold, currency and banking crises remained frequent and inflation remained." [18] If bankers had kept a 'fractional reserve' of metal to back up paper loans, then 'Ponzi finance' banking panics and systemic banking crises would largely have been avoided.

Nevertheless the recurrent history of financial panics and crises has not stopped bankers and the economics profession from maintaining the defence, and the pretence that all lending is but a ratio (or multiplier) of deposits lodged with the bank, or reserves lodged with the central bank.

The opposite is the case. It is only when banks extend credit (loans) that deposits (liabilities) and central bank reserves (required for clearing or to be held against deposits) are created. As Claudio Borio of the Bank for International Settlements (BIS) argues in the above-mentioned paper:

> "the banking system does not simply transfer real resources, more or less efficiently, from one sector to another; it generates (nominal) purchasing power. Deposits are not endowments that precede loan formation; it is loans that create deposits." [19]

This disagreement with Geoffrey Ingham is important and fundamental because an adherence to the concept of fractional reserve banking implies a) that lending is constrained or disciplined by deposits; and b) that banks have made sufficient, if limited, provision for liabilities and losses by linking loans to deposits or reserves.

---

[16] Monetary and Financial Stability: Lessons from the Crisis and from classic economics texts. Adair Turner Speech at South African Reserve Bank, 2nd November 2012. http://www.fsa.gov.uk/static/pubs/speeches/1102-at.pdf

[17] *Where does money come from*? A guide to the UK monetary and banking system. Second edition. Written by Josh Ryan Collins, Tony Greenham, Richard Werner and Andrew Jackson. Published by nef 2012. http://www.neweconomics.org/publications/where-does-money-come-from

[18] Ibid. p.42.

[19] The financial cycle and macroeconomics: What have we learnt? Claudio Borio. BIS Working Paper No 395. December, 2012. http://www.bis.org/publ/work395.pdf

It also implies that central banks can stimulate commercial bank credit creation by increasing central bank reserves.

Professor Steve Keen in his book '*Debunking Economics'* [20] has demolished the argument by the governor of the Federal Reserve, Ben Bernanke, that a massive injection of 'base money' by the central bank into the reserve accounts of private banks would result in a far larger sum of bank-created credit being added to the economy – as much as $10 trillion (for the by then $2.15 trillion injected by Governor Bernanke's Federal Reserve.) So while the injection of central bank 'quantitative easing' did help prevent a deflationary spiral, the impact was small, as Keen notes:

> "There is little doubt that this massive, unprecedented injection of base money did help reverse the deflation that commenced very suddenly in 2008, when inflation fell from plus 5.6% in mid-2008 to minus 2.1% a year later – the sharpest fall in inflation in post-World War II history. But I expect Bernanke was underwhelmed by the magnitude of the change: inflation rose from minus 2.1 per cent to a peak of 2.7 per cent, and it rapidly fell back to a rate of just 1 per cent. That is very little inflationary bang for a large amount of bucks." [21]

The build-up of a vast bubble of unsecured credit by private financial interests before the crisis of 2007-9, the subsequent contraction of private credit creation, and the ongoing global financial crisis make plain that central bank reserves played virtually no role in first constraining credit creation pre-crisis or expanding private credit creation, post-crisis.

The fact is that private credit creation is not limited by either deposits, or central bank reserves, or 'fractional reserve banking practice'. *Central bank reserves and private bank deposits are a consequence* of de-regulated commercial credit creation. And as Marshall Auerback argues: "Bank loans create deposits and are made without reference to the reserve positions of the banks."[22]

If private commercial banks are today constrained in their lending, that is because of a) their vast and often incalculable liabilities, losses and effective insolvency, b) the decline of economic activity and associated income caused in part by the Great Recession, c) a consequential lack of confidence amongst bankers that borrowers can generate the income needed to repay loans, and d) a reluctance by indebted borrowers to borrow more, for fear that continuing crises and austerity will constrain profits and income, and their ability to finance debt repayments.

---

[20] *Debunking Economics* by Professor Steve Keen, published by Zed Books, 2011. Pg.305.
[21] Ibid. Pg.305.
[22] *The Chicago Plan does not deserve to be revisited*. 23 October 2012. Macrobits. http://macrobits.pinetreecapital.com/the-chicago-plan-does-not-deserve-to-be-revisited/

The Chicago School and 'fractional reserve banking' [23]

'Fractional reserve banking' is based on Chicago School monetarist theory, long discredited. Professor Steve Keen discusses at length the 'neat, plausible and wrong' monetarist model of how money is created in *Debunking Economics*.[24]. He argues that Milton Friedman's 'money multiplier' model

> "assumes that banks need excess reserves before they can make loans, and then these excess reserves allow loans to be made, which create more deposits. Each new loan reduces the level of excess reserves, and the process stops when this excess has fallen to zero."

The direction of causation is the very reverse of that modelled by monetarists. If after lending, banks have insufficient reserves, they turn to the central bank. And the central bank is obliged to provide reserves, *on demand*. As Keen notes:

> "the direction of causation flowed, not from reserves to loans, but from loans to reserves."

Keen cites a senior vice-president of the New York Federal Reserve, Alan Holmes who wrote of the 'naïve assumption' behind the monetarist 'fractional reserve banking' model, and argued that:

> "In the real world, banks extend credit, creating deposits in the process, and look for the reserves later."[25]

While neat, plausible and wrong, the monetarist model had one advantage. When applied in Britain in the 1980s, the theory was aimed at the central bank money supply, ignoring credit generated by the liberalised commercial banking system. To control private credit creation, the Bank of England was encouraged to raise interest rates.

This was a little like trying to discourage tomato-growers from growing too many tomatoes by increasing the price of tomatoes. (With the proviso that tomatoes are not comparable to credit at all.)

---

[23] For a more detailed rebuttal of 'fractional reserve banking' see Bill Mitchell's Blog of 21 April, 2009. http://bilbo.economicoutlook.net/blog/?p=1623
[24] Ibid. 'The mythical Money Multiplier' Pg. 306-312.
[25] Ibid. p. 309

Orthodox economist David Smith explains in *The Rise and Fall of Monetarism* (Penguin, 1987) how monetarist theory failed:

> "Controlling (commercial) bank lending was rather more difficult... With the abandonment of exchange controls in 1979 and the corset in 1980, the task fell to (central bank) interest rates to control bank lending, and they did not do so. In the recessionary condition of 1980, higher interest rates actually boosted bank lending… In 1985 and 1986 real interest rates were at historically very high levels of, on average, 6 or 7 per cent. Even so, by the summer of 1986 bank lending was rising fast enough to push up sterling M3, on its own, by 2 per cent a month." –(ibid. p 152)

And so, as William Keegan argues in his book *Mrs Thatcher's Economic Experiment (*Penguin 1984*)*:

> "when the (monetarist) evangelicals found the links between the money supply and the economy were not quite what they believed, and not quite so easy to control, they redoubled their efforts to control one particular component of the money supply, namely the public sector borrowing requirement."

By excluding the liberalised private banking system from the application of their theory, the Chicago School won the support of bankers, and of politicians like Margaret Thatcher and Ronald Reagan. They failed however to control the ever-expanding supply and then drastic contraction of private credit. Above all their apparent blind spot for the private banking sector meant that credit creation before the 2007/9 crisis was increasingly aimed at the massive capital gains that can be made (in advance of a crash) from speculation.

The excision of private banking from their theory and model no doubt delighted the finance sector, but it fatally undermined the academic and policy-making reputations of monetarists.

The Chicago Plan re-visited

Despite the abject failure of monetarist theory in the 1980s, the 'fractional reserve banking' fiction is widely accepted, and informs much of the debate around banking reform. A recent IMF Working Paper by Michael Kumhof and Jaromir Benes, 'The

Chicago Plan re-visited' [26] has been pounced on, not just by monetarists, but by progressive activists and economists. The latter supporters of the Kumhof and Benes proposal are concerned to subordinate the finance sector to society's wider interests, and prevent another explosion of debt such as the one that crashed the global economy in 2007-9.

But the build-up of debt that led to the crash was not the fault of private credit creation alone. It was largely due to decisions by elected politicians and other public authorities to remove a) constraints on capital mobility, b) long-standing and successful regulatory 'ceilings' on private credit creation, and c) ceilings on interest rates. Above all, these public authorities chose to turn a blind eye to the fraudulent and criminal activities of private bankers.

That failure has seriously undermined public confidence in the banking system, but also in public authorities. That is why, we can surmise, progressive economists like Josh Ryan-Collins of the new economics foundation defend the Kumhof and Benes proposal. In a recent blog Ryan-Collins explained that the original Chicago Plan was produced in the 1930s by

> "the US's top economic minds Henry Simons and Irving Fisher (who) came to the conclusion that the best way to reform the financial sector following the Great Depression was not to constrain bank's ability to create the money but simply remove this privilege and hand it over to the state.
>
> … Banks would still exist but they would only have the power to intermediate and allocate *state money*, not to create it…. Instead, the sovereign would decide on the quantity of money in circulation and it would be issued interest free as it was for many hundreds of years in Britain prior to the emergence of fractional reserve banking in the late 18th century…" [27]

The Kumhof and Benes proposal is indeed based on the monetarist ideas of the Chicago School, one that seeks to limit the quantity of money, and that would restore the role of banks to intermediaries between savers and borrowers. Only now the proposal is to eclipse the role of the private sector in credit creation altogether, and

[26] *The Chicago Plan Revisited* by Jaromir Benes and Michael Kumhof. IMF Working Paper: August, 2012. http://www.imf.org/external/pubs/ft/wp/2012/wp12202.pdf
[27] From *A return to Sovereign Money?* Blog on Open Democracy site by Josh Ryan-Collins, 17 December 2012. http://www.opendemocracy.net/ourkingdom/josh-ryan-collins/return-to-sovereign-money

only allow lending backed by a 100% reserve requirement. In other words, all banks or lenders would first have to mobilise 100% of the funds needed for lending. This would massively constrain the availability of credit. Second, the plan is to limit the *quantity of credit* created to decisions by 'the sovereign' – presumably central bank civil servants and their colleagues in finance ministries who "would decide upon the correct quantity of money in circulation". [28]

Given that credit creation should ideally reflect a multitude of risk assessments of society's varied and complex needs for finance to kick-start economic activity, should a) the quantity of credit be a limited sum? (decided by 'the sovereign'), and b) should the task of allocating interest-free credit be limited to civil servants in central banks and finance ministries?

I think not.

First, limiting credit creation to a fixed quantity assumes that there is a fixed quantity of potential economic activity: employment, investment, innovation, caring for the vulnerable, creating works of art, conservation etc. Linking all current and future activity to a fixed quantity of reserves (or bars of gold, or supplies of fossil fuel) limits the ability of the (public and private) banking system to generate sufficient and varied credit for society's purposeful and hopefully expanding economic activity. (By economic activity I mean all forms of gainful employment.)

Limiting the quantity of credit is certainly one way of limiting employment. Thus monetarist theory and policies both tolerated and sustained a massive rise in unemployment in the 1930s and 1980s.

The Kumhof and Benes proposal is no more than a revival of these policies: the 'barbaric relic' that was the gold standard.

Orthodox monetary theory is largely informed by the interests of creditors. The gold standard was largely designed to protect the interests of moneylenders concerned to protect the value of their assets – loans – and to ensure their assets were not eroded by inflation. To this end it was argued that society could only afford, or be trusted to employ a fixed sum of economic activity – equal and limited to a quantity of scarce lumps of gold dug out of the earth – and used by moneylenders as collateral. And so it was that the gold standard operated as a fantastic machinery for protecting the interests of creditors, while constraining and depressing economic activity, in particular employment. That is, until society rebelled against the moneylenders and demanded change. Change was duly brought about in the UK in 1931 and the US in 1933: first as a result of the influence of Keynes and then as a result of the leadership of President Roosevelt.

---

[28] Ibid.

This is not to deny that limits or ceilings must be placed both on private credit creation but also on the level of interest rates. The purpose of such regulation will be to maintain economic stability and minimise speculation; to ensure that projects are both productive and sustainable, and not speculative purposes; that they are affordable, i.e. that the income generated will cover repayment of the debt; and that the rate of interest is repayable and sustainable.

But monetarists are on the whole opposed to democratic *regulation* of the private sector, believing wrongly, that 'the invisible hand' is best placed to manage the quantity of credit, its allocation and pricing.

I beg to disagree. The public authorities, guided by democratic institutions, are best placed to design and build a regulatory framework for the management of the great public good that is credit – in the interests of society as a whole, not just financial elites. We know that it is possible to create such a framework, because that is what the public authorities took responsibility for during the 'golden age' of economics (1945-70) when the finance sector was more carefully managed and regulated.

However, whilst public authorities may best set the regulatory framework, I do not believe that civil servants are best placed to make the myriad daily decisions on the risk-assessment and allocation of credit to small and large borrowers. Private commercial bankers and their loan clerks, on the other hand, operating within a well regulated and legally enforceable framework which must include capital control, have a legitimate role to play in assessing the risk of millions of small and large projects seeking finance; and in allocating credit. For this, they would be entitled to earn a small but reasonable fee, as was so in the past.

Let's not throw out the baby with the bathwater…

Today society faces multiple challenges, including the resolution of the gravest financial crisis in history, the revival of economic activity, and the restoration of full employment.

However, the most formidable challenge we face is climate change: extreme weather events caused by a warming planet, fuelled by toxic fossil fuel emissions. UN agencies estimate that immense sums are needed to protect both human and other species – by e.g. shoring up coastlines, bio-diversity conservation, energy efficiency and investment in renewable energy etc.

Limiting *the quantity of credit* creation to a fixed sum to be decided by civil servants would impose deflationary forces on the economy – just as the gold standard did. It would limit the ability of society to finance the multitude of varied, complex, affordable and sustainable activities needed to achieve the transformation of the global economy away from fossil fuels.

But limiting the quantity of credit is also a hopeless endeavour in a world of innovative and subversive finance: peer-to-peer lending, crowd-funding and alternative currencies.

Far better for the achievement of economic, political and ecological stability would be *regulation of the commercial banking system; and of the quality, issuance and 'price' of the public good that is credit.*

There are severe limitations on our ability to tackle climate change. These include the degree to which we have already degraded the earth's atmosphere and made species extinct; our limited political will, intelligence and ingenuity; the scarce physical resources available; the second law of thermodynamics. All these are serious, physical limitations on our capacity to save the planet.

Credit, by contrast, faces no such limitation. Credit is an intangible *public good*, a little like clean air or water. It is based on trust in each other; trust that can be destroyed, but if bolstered by sound institutions, has infinite capacity. Because of the frailty of human nature; because of our experience of financial fraudsters and criminals, this trust must be grounded in democratic public institutions, including a sound, well-managed and regulated banking system and an impartial judicial and criminal justice system. With these in place, trust manifests itself as unlimited supplies of finance for the achievement of society's goals. That is why the 'there is no money' myth pedlars are so wrong. In countries with sound monetary and banking systems, there need never be a shortage of finance. By contrast, in low-income (sic) countries without sound democratic public institutions, the banking system does not function, is not supported by regulation, or by judicial and criminal justice systems. As a result economic activity (investment and employment) is severely curtailed.

Credit, well managed and regulated, enables society to do what we can do. As Keynes remarked "we can afford what we can do". He despaired of "the imbecile idiom of the financial fashion" that implied:

> "We destroy the beauty of the countryside because the unappropriated splendors of nature have no economic value. We are capable of shutting off the sun and the stars because they do not pay a dividend. London is one of the richest cities in the history of civilization, but it cannot 'afford' the highest standards of achievement of which its own living citizens are capable, because they do not 'pay'" [29]

[29] John Maynard Keynes, "National Self-Sufficiency," The Yale Review, Vol. 22, no. 4 (June 1933), pp. 755-769. https://www.mtholyoke.edu/acad/intrel/interwar/keynes.htm

Of course we cannot afford that which we cannot do; or that which is unsustainable in economic or ecological terms. That is why a well-managed credit system will be regulated so that it does not exceed the potential and capacity of the economy - and thus inflame inflationary forces. It will not contract credit and so induce a deflationary spiral. It will not exceed the ecosystem's assets (e.g. forests, fish, land) to provide resources for debt repayment. A well-managed and regulated system of credit will inhibit the exponential exploitation of labour. Above all it will protect the public good that is trust.

Above all our credit creation system must be managed to make it possible for society as a whole – not just a tiny financial elite – to mobilise the resources needed to achieve that which is in the interests of society (and the ecosystem) as a whole.

Regulating private banking's creation of credit so that it is aimed at society's determination of sound, productive activity and not a speculation, it is fundamental to achieving that goal.

So let's not throw the baby out with the bathwater. Let's not give up on a great civilizational advance: sound banking, legal and other institutions for the protection of trust and the creation of credit at affordable and morally acceptable rates of interest. Credit that enables society to do what we can do.

Central banks and quantitative easing (QE)

The phenomenon of QE – when central banks inject money into the banking system by purchasing assets (e.g. bonds) - has taught the public that new money or liquidity for both private banks and for governments is not dependent on existing 'savings'. Instead it can be conjured out of thin air.

That wider public understanding is a reason for optimism.

Today, over five years since 'debtonation day' on 9th August, 2007, central bank support for the economy is largely, but not exclusively directed *with virtually no conditionality* at the commercial banking system. QE, coupled with low and effectively negative rates of interest for bankers (not for the rest of the economy); government guarantees for too-big-to-fail banks; aided by capital mobility – all this taxpayer-backed support has helped rich investors mobilise resources to speculate in, and inflate the prices of assets in all parts of the world. [30]

But QE has done little to ensure wider economic recovery.

[30] For more on this, see the Bank of England's report: *The distributional effects of asset purchases*, in the Quarterly Bulletin. 2012 Q3 | Volume 52 No. 3
http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb1203.pdf

This is because QE is not aimed at the interests of society as a whole. Both orthodox economic theory and central bank regulation prevents central banks from linking and co-ordinating monetary policy with fiscal policy.

This reveals a key flaw in debates about monetary policy. Namely that it is not enough for central banks or even private banks to create finance. Far more important is *the spending* of that finance.

In today's climate of financial crisis and austerity, private, heavily indebted firms are fearful of undertaking investment. Individual, household and company debts in all leading economies are at very high levels, and de-leveraging or extinguishing these debts is slow, if it happens at all. At the same time around the world, government policies are directly aimed at shrinking the economy, causing bankruptcies and unemployment to rise. No wonder indebted private firms are hoarding what cash they have, and refusing to invest.

Governments have had to compensate for economic failure caused by banking crises, fraud and theft - by increasing public debt. They are doing this while shrinking economic activity, and therefore also the income (tax revenues) needed to pay down public debt. But raising taxes in this Great Recession is also counter-productive because that would further shrink the economy.

In these circumstances, central bank finance (conjured 'out of thin air') could be used to support public investment (spending) in sound, productive projects; this would begin the process of reviving employment and economic activity. This could be undertaken via the private banking sector, or by direct support for public investment.

Central bank finance could also be used to address the threat of energy insecurity and climate change. Above all, by supporting investment and economic recovery, it would begin the process of *generating income* for the repayment of both public and private debts.

However none of this is possible because of the forbidding 'imbecile idiom' of orthodox economic theory – backed by political parties, both conservative and social democratic. And so the global financial crisis stumbles on…

Instead central bank support for the *private* banking system has led to the phenomenon that President Dilma Rousseff of Brazil called a "liquidity tsunami"[31]: a large pool of speculative capital that originated within the western banking system, and is now aimed at countries like Brazil. The owners of this capital have used low *central bank* rates of interest (available only to banks and financial institutions) and government guarantees to borrow and seek out high returns in markets beyond their

[31] See the Rio Times of 16 April 2012. http://riotimesonline.com/brazil-news/rio-politics/rousseff-warns-of-tsunami-of-money/#

home market. They have done this by speculation in food and commodities, in property and other emerging market assets. This has caused inflation, overheating and asset bubbles in those economies.[32] These are new and possibly bigger asset bubbles and Ponzi schemes than those that emerged before the 2007-9 crisis.

Emerging market asset bubbles are likely to implode and threaten more banking failures and future global financial stability. Only this time, central banks responsible for the activities of unregulated western financial institutions, will have limited resources or tools with which to rescue too-big-to fail banks, and to stabilise the system.

Governments, 'independent' central banks and money

Nevertheless, governments have benefited from the creation of liquidity. Britain is a good example. Here, the government in the form of the Chancellor of the Exchequer and the Bank of England's Monetary Policy Committee have authorised Bank staff to purchase up to a quarter of all UK Government debt – well in excess of £300bn.[33]

In other words, the British government has required its own nationalised bank, the Bank of England to help finance its outstanding debt, albeit in a roundabout way, by purchasing UK government bonds or gilts in the capital markets. By purchasing and thus removing gilts from the bond market, and placing them on the BoE balance sheet, the Bank raised the price of gilts and lowered the yield. These gilts attract regular coupon payments from the UK Treasury. As a result, the Bank of England has now accumulated a large 'cash balance' or profit on these purchases.

Since 2009, the Bank of England has therefore effectively financed the Coalition government's deficit and made it less reliant on 'the international bond markets' or 'bond vigilantes' for funding.

As Jo Owen remarked in the Financial Times on 12 March, 2012:

> "As a result of QE the public sector (the Treasury) is paying interest to itself (the BoE) on debt that it owes to itself…" [34]

And we might add, at a rate of interest determined by the 'independent' committee of men appointed and mandated by the British Chancellor, and based at the Bank of England.

---

[32] For more on the inflationary impact of global liquidity, see the Bubble Bubble: The Emerging Markets Bubble (or The "BRIC" Bubble) by Jesse Colombo http://www.thebubblebubble.com/emerging-markets-bubble/
[33] For more on the Bank of England's Asset Purchase facility, visit the Bank of England's website: http://www.bankofengland.co.uk/markets/Pages/apf/default.aspx

[34] Financial Times, 12 March, 2012: *The Bank of England should make the QE debts disappear* by Jo Owen.

The recent furore over the British Chancellor's decision to transfer £35bn of the 'cash balance' back to the Exchequer from the Bank of England's Quantitative Easing facility,[35] revealed just how unfamiliar is the Bank of England's role in financing the British government, to the British media and economic establishment.

Chris Giles, the chief economic correspondent of the Financial Times had his 'faith' in the system shaken:

> "It is rare to have a moment of epiphany in economic commentary. Few developments disprove your previous beliefs entirely and such is the economic uncertainty that it is easy and comforting to hold on to views far too long. At 11:30 last Friday, I had such a moment.
>
> A Treasury press release entitled 'Changes to cash management operations' showed my faith in the credibility of the UK government's economic strategy to be misplaced."[36]

Epiphanies such as that outlined above are experienced by those who place their understanding of economic processes and of the 'independence' of the nationalised Bank of England on 'faith'.

Private credit-money and the subordination of the state

Ingham follows a review of those economists who, in his view, added to our fundamental understanding of capitalism, with a brief history of the founding of the Bank of England in 1694. He explores and illuminates the

> "mechanism that connects capitalist finance with the state in a relationship of mutual advantage in which each has an interest in the survival and prosperity of the other". (ibid. p 73)

And he makes the important point that the fusion of private bank credit and state currency was made possible back in 1694 by the balance of power between the monarch and the bourgeoisie and their acceptance of mutual dependence.

---

[35] 09 November 2012, *Changes to cash management operations.* HMT Press Release*:* *http://www.hm-treasury.gov.uk/press_109_12.htm*
[36] *Policy ploys risk UK economic credibility* Financial Times, 14 November, 2012. http://www.ft.com/cms/s/0/2dba8ab0-2da3-11e2-9988-00144feabdc0.html#ixzz2EfbvTKDy

"It represented a delicate balance between too much state power, which might readily have suppressed the private alternative credit-money, and too little state power, which would not have been able to impose an acceptable public currency denominated in a stable money of account." (ibid. p.73.)

That 'delicate balance' has been disrupted by a succession of financial crises. Today capitalist finance has created a vast web of complex financial products that are traded outside the sound regulatory frameworks of states, and that confound central bankers. Nevertheless, by these means, the finance sector creates liquidity needed for transactions across global borders and markets. This unlimited credit-creation is designed to defy the limits of central bank regulation. As Andy Haldane noted in his aforementioned Jackson Hole speech to central bankers, since even computers can't track all the necessary variables in the massively interlinked financial world, there is little hope that humans can.

Private markets as a 'creditor-god'

But there is a deeper point here, one that Ingham understands. Since 1694 the Bank of England has appeared to have a monopoly over the creation of money, the issue of bank notes, and the generation of liquidity. By undertaking monetary operations– the selling of state debt – the Bank has since 1694 monopolised the injection of liquidity into the banking system.

But that has changed. Central bankers have steadily conceded their monopoly over the creation of liquidity to private bankers/financiers/speculators.

Rather than restraining finance capitalism the ongoing crisis of capitalism has accelerated a process that began with dismantling of measures for maintaining the balance between state and finance. This dismantling includes the dissolution of the Bretton Woods System, the de-regulation of financial markets, and the expansion of markets in complex derivatives and securitisation.

As a consequence, central banks no longer hold a monopoly over the creation of liquidity. This loss of a dominant role can be understood as a result of the radically changed relationship between capitalist finance and states. This in turn is an outcome of economic orthodoxy's contempt for the state; or for what Keynes called "the *general* organisation of resources as distinct from the *particular* problems of production and distribution which are the province of the individual business technician and engineer." [37]

---

[37] Keynes broadcast on 14 March, 1931 on state planning. Reproduced on page 87 of the Collected Writings of John Maynard Keynes, Vol XXI. *Activities 1931-9: World Crises and Policies in Britain and America.*

The awful truth is that central banks have lost control over private and international financial markets, which have extended and consolidated their global power – and their ability to disrupt global economic activity.

Ironically even as capitalism continues its attack on the state and as prolonged economic weakness and financial failure persists, capitalist finance has become more dependent on state financing. It has succeeded in capturing, effectively looting, and then subordinating states to the interests of – capitalist finance.

As the Humboldt professor of literature, Prof. Josef Vogl reminded economists at the 2012 meeting of George Soros's Institute for New Economic Thinking in Berlin:

> "central banks and states have monetized the liabilities of capital markets; once 'lenders of last resort', they have become 'investors' or 'borrowers of last resort'. The debts of private banks were financed [by governments] by raising loans from private banks. Contrary processes have been installed, in which the socialization of private debts corresponds with the privatization of national debts. Financial markets became integral to the administration of public debts, *accompanied by an expansion of their logic, their rules, their imperatives and interests*. This implies, finally, the shifting of the reserves of sovereignty. The financialization of government structures, the mediation between public and private debts have mechanized political decisions as market-driven decisions; the markets themselves have become a sort of creditor-god, whose final authority decides the fate of currencies, social systems, public infrastructures, private savings, etc." (My emphasis) From: *Sovereignty Effects,* INET Conference Berlin, April 12, 2012, Panel: Which Way Forward?"[38]

The challenge now facing the world is this: can democratic states regain control over "the fate of currencies, social systems, public infrastructures, private savings etc." – or are we forever beholden and victim to unseen and unaccountable 'creditor-gods'?

---

[38] http://ineteconomics.org/conference/berlin/sovereignty-effects

Are the world's people, their social and political organisations, their small and large businesses going to tolerate regular financial and economic crises, in which the 'creditor-gods' make all the gains, raid the balance sheets of taxpayer-backed central banks, while real incomes of taxpayers fall, governments remain supine, opportunities for this and future generations diminish, and social and political breakdown threaten? Or is it inevitable that people will mobilise – behind reactionary as well as democratic political organisations – to resist such onslaughts on their taxes and living standards?

Given the challenge posed to Haute Finance by right-wing and fascist political parties in for example the Eurozone, and given the weakness of more progressive political organisations, my own prognosis is pessimistic.

Blaming the inflation of the 1970s on its victims

Another point of disagreement with Geoffrey Ingham's *Capitalism* is his analysis of the inflation of the 1970s (ibid. p 86) – an analysis he shares with many progressive academics, including for example, the highly regarded Philip Pilkington in a series of essays on monetarism for the website *Naked Capitalism (*17 July, 2012*)*.

Ingham effectively endorses the overwhelming neoliberal consensus on the causes of inflation: namely that

> "increases in commodity prices, especially oil, added impetus to the underlying structural causes of increased government expenditure and the power of monopoly capital and their labour forces to mark up their respective prices." (ibid p. 86)

Along with most economists, he confuses cause with effect. Like many, many others, he effectively blames Keynes for the inflation of the 1970s, arguing that

> "the commitment to full employment meant that….corporations and their labour forces, empowered by the absence of the 'reserve army of the unemployed' used their leverage continuously to mark up prices and wages."

However, as Geoff Tily argued in *Keynes Betrayed*,[39] this analysis skates over the substantial financial de-regulation that began in the 1960s and climaxed first with President Nixon's unilateral dismantling of the regulated Bretton Woods system in

[39] *Keynes Betrayed: The General Theory, the Rate of Interest and 'Keynesian' Economics*, by Dr. Geoff Tily, Palgrave Macmillan http://www.palgrave.com/products/title.aspx?is=9780230277014http://www.palgrave.com/products/title.aspx?is=9780230277014

1971; and in the same year (in Britain) with the Conservative government's introduction of *Competition and Credit Control* (dubbed 'all competition and no control' by many economists.)

As we have argued above, the Bank of England's tacit agreement to the introduction of *Competition and Credit Control* removed restraints on the power of private bankers to create credit – and enhanced their powers to fix and increase the 'price' of credit, i.e. the rate of interest.

De-regulation led inevitably to a massive expansion of credit at effectively higher real rates of interest than had prevailed during the regulated Keynesian 'Golden Age'. This 'easy money' led in turn to inflation, first to price followed by wage inflation, and then by asset price inflation. Moreover, high borrowing costs constrained investment. These together eventually led to the implosion of unpayable debts and economic failure that we have witnessed in recent years.

Competition and Credit Control was amplified by the 'Big Bang' of 1986; but there can be no question that the origins of today's financial crisis lies, not with the 'Big Bang', but with 1960s and 70s de-regulation or liberalisation – by both the US authorities, the Bank of England and the British Treasury. (For more on this, see chapter one of my book *The coming first world debt crisis,* Palgrave, 2006).

'Too much money chasing too few goods and services' led, in turn, to the inflation of prices, which spiralled upwards. Both corporations and labour unions reacted predictably. Their actions were not causal. They were a *reaction* to the *cause* of inflation: the 'elastic production' by private bankers of credit-money.

Neither Ingham nor the many economists that share his view can explain why during 1945-71, when the Keynesian framework of managed finance was dominant, inflation was subdued, and "corporations and their labour forces" declined to use their "leverage to mark up prices and wages".

Ingham's list: the missing economists

Finally: Ingham's list of classical theorists of capitalism ends with Keynes, who died in 1946. He defends the limited number on the list:

> "I have reached the outrageous conclusion that no social scientist over the past half century has added anything that is *fundamentally* new to our understanding of the capitalist economic system." (Ibid. p.2)

I would disagree. Karl Polanyi (1886-1964) Hyman Minsky (1919-1996) and Herman Daly (1938 -) have added fundamentally to our understanding of the systemic nature of the capitalist economic system, and its impacts on both human society but also the ecosystem. Polanyi's analysis of neoliberalism and society's response is scandalously under-represented in economic and political literature. Ingham touches on his analysis of money, land and labour as false commodities, but takes it no further. This is disappointing given that, unlike all the other great economists identified by Ingham, Polanyi had the most acute understanding of the disastrous impact of the false commodity that is money on both labour and the environment. In that sense Polanyi's analysis of the systemic nature of capitalism was far ahead of most of the great economists identified by Ingham, but also of his time.

Second, there can be no question that Hyman Minsky's *Financial Instability Hypothesis* (summarised here by Professor Steve Keen) is fundamental to an understanding of the *systematic* instability of capitalism. Indeed it was what Minsky learned at the feet of Schumpeter - that investment is not financed by savings, but by the endogenous expansion of the money supply by banks – that remains fundamental to an understanding of capitalism, today's financial crisis, and to capitalism's inherent instability.

Conclusion

So while Ingham's book provides us with an incisive analysis of capitalism and its fundamental 'hallmark': the 'elastic production' of ever-expanding and inflationary credit money, it suffers by falling back at points on neoliberal analyses and assumptions. Thereby – though this is certainly not his intent - he reinforces some of the flawed thinking that lets the finance sector off the hook, and allows financiers to continue escaping both scrutiny and regulation while they flagrantly confiscate public assets.

But Ingham raises important issues: with a deeper understanding of capitalism's ability to create ever expanding amounts of credit-money, how does a democratic society once again rein in, regulate and subordinate the private finance sector to the wider public interest? How does society regain control over the public good that is credit and a sound banking system, and use both for financing society's most important needs – including the need to tackle the threat of climate change?

Second, as Professor Vogl asks: "how can public goods (including liquidity) avoid being confiscated by the finance economy?" And how can they be restored to public accountability?

If we can move on from Adam Smith's 300 year-old flawed analytical system to a proper understanding of the powers and public goods we have, due to ignorance, outsourced to the private banking sector – then perhaps as both economists and citizens we might finally be able to understand the creation of money – by both central and private banks - 'out of thin air'. Only with this understanding will it be possible to devise policies, regulation and strategies to tackle and once again subordinate global finance to the interests of society and the ecosystem.

That is why Ingham's work is so important: it helps us move on beyond Adam Smith towards a fuller understanding of the public good that is credit.

* Cover Image: *Alchemist's Laboratory showing original apparatus of the 16th and 17th Century*, Wellcome Images

Prime

Policy Research in Macroeconomics is a company limited by guarantee
Incorporated in England and Wales
Company no. 07438334

Registered office:
30 Percy Street
London
W1T 2DB

The PRIME team can be contacted at:
info@primeeconomics.org

51 Clarence Gate Gardens
Glentworth St
London NW1 6QS

For more information, please visit:
www.primeeconomics.org