Chapter 10

On the Nature of Bank-Money

Most of the money used in the modern world consists of what in this study will be called bank-money.

Most of the exploitation of man by man—of the inhumanity of man to man in its modernized and legalized respectable forms—is made possible by the abuse of power which commercial banks exercise when they issue and create bank-money. Most of the millionaires and billionaires in the modern world on one hand and most of the poverty in the midst of plenty on the other, is made possible by this same abuse. And the ironic fact that most of the commercial bankers, and those working hard at their desks and counters in these banks, do not know that they are engaged in this kind of illegitimate activity, is due to the mis-education of everybody by the economists in our schools, colleges and universities; by those who ought to know what is taking place and who ought to be teaching the truth about it. What makes this possible is the incredibly ingenious and the incredibly complicated way in which the perfectly proper issuance and creation of bank-money is mixed up with its abuse. It is this which makes possible the rationalization of what is indefensible and inexcusable.

Yet the truth about it becomes obvious the moment an effort is made to understand the nature of bank-money, the manner in which it comes into existence, and the one basic principle which should govern the purpose for which it alone should be created.

There was a time when banks both in the North and South of the United States, and all those employed in them, financed directly or indirectly the ownership of slaves. Bankers and those working for them thought no more about whether it was right or wrong to finance slavery than they now think about whether the financing of speculation and of government deficits is right or wrong. I hope that there will come a day when nobody will be able to ignore the fact that there is an equally important moral distinction between financing legitimate business transactions and financing illegitimate speculative and government transactions.

Slavery was a visible evil. Speculation and similar respectable evils, thanks to the ignorance of our economists, is an invisible one. This not only makes it difficult to fix the responsibility for the exploitation this causes; it even makes it possible for speculators themselves to be ignorant of the fact that what they are doing is in a sense the same thing which slave owners used to do—engaging in the exploitation of their fellow men.

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Bank-money, as the term will be used in this study, consists of the demand deposits created by commercial banks when they make loans to borrowers and, instead of giving them cash, credit them with a deposit for the amount loaned to them and make it possible for them to use it by drawing checks on the deposits with which they have been credited.

It is impossible to determine the exact proportion of all the money issued which consists of bank-money because banks do not keep separate records of (1) demand deposits which consist of money previously saved and owned by their depositors, and (2) demand deposits which banks create when they credit their borrowers with deposits of the amount they lend them. It is of the utmost importance to understand the significance of the difference.

It is customary for economists and statisticians to approximate the amount of bank-money in existence by equating it with that part of the total money supply (the total money-supply is defined as the sum total of (a) the amount of demand deposits in all the banks of the nation, and (b) the amount of paper-money and coinage in circulation outside of the banks) which consists of the demand deposits in banks at any given time. On this basis, the amount of bank-money in the United States in 1970 consisted of 77.3% of the total money supply.

It is necessary to distinguish more clearly between these two kinds of money and two kinds of deposits. The first kind—the kind which consists of money saved and already in existence—consists of money received by those working for wages or salaries, of money received by an "entrepreneur" in the ordinary course of operations of a farm, store, or any other kind of enterprise, or of money received from the sale of some kind of property—perhaps from the sale of real estate.

If the depositor needs to use this money currently, he deposits it in a checking account and draws it out from time to time by writing checks. Deposits of this kind are demand-deposits; the depositor can draw them out without any prior notice to the bank.

If he does not need what he has deposited for current use, he is apt to put it in a savings account so as to receive interest on it. It then becomes a time-deposit. The bank is sure of having it on hand for a period of time; it can delay repayment of the deposit for an agreed upon time. Time deposits and savings deposits, whether in commercial or savings banks, are one and the same thing;

The second kind of deposit which consists of bank-money newly issued and not money already in existence, comes into existence only when a borrower from a bank is credited with a deposit of the amount he had borrowed. What it is of the utmost importance to bear in mind is that today bank-money comes into existence in two ways, one legitimate and one illegitimate. Legitimately it can come into existence only if made for strictly commercial purposes. It comes into existence illegitimately if it is made, as unfortunately is the case today, for the purposes of financing investments, speculations, or government deficits.

Deposits which consist of money already in existence cannot be used to inflate the money supply. Being already in existence they are already a part of the money supply. To inflate the money supply, new money must be created and issued and unfortunately new bank-money can be created and added to the money supply to an almost limitless extent. When represented by legitimate commercial loans, the new money can be readily redeemed. When represented by loans for investment purposes, it cannot be redeemed on demand. When represented by loans for speculation, its value can be entirely wiped out whenever a speculative bubble bursts. We have had dozens of such "bursts" on a grand scale. The worst one came with the Great Depression in 1929 after the banks had created billions of dollars of new money to finance the speculative orgy during the New Era of the 1920's.

Yet the lesson has not been learned. The issuance of new money to finance investments is bad enough; the issuance of new money to finance government deficits is worse; the issuance of new money to finance speculation is worst of all.

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What makes this all possible is the fact that banks do not need to have on hand all the money they have on deposit; all they need to have is a reserve of "cash" sufficiently large to take care of all daily withdrawals by their depositors. It is the amount of this reserve, the so-called reserve rate, which is of crucial importance so far as inflation is concerned.

Reserve rates today are not left to the discretion of each individual bank. Ever since government regulation of banks was instituted, banking laws have prescribed a uniform rate to be fixed by designated public authorities. This has enabled each government, directly through a public official or indirectly through a central bank, to increase or decrease the amount of bank-money commercial banks create. It has enabled the government to inflate or deflate the money supply. If the reserve rate is reduced, the money supply expands because banks then find that they can add to their profits by creating new bank-money and increasing the amount of loans they make. If the reserve rate is increased, it forces the banks to reduce the money supply by making them call in loans they have previously made.

Most of the time during the period of the Exeter experiments, the required reserve rate was ten percent. At various times in the past it has been nearly twice that high.

If the reserve rate is fixed at fifteen percent, it is possible for the banks to pyramid lending nine-fold; it becomes possible for them to lend over four hundred dollars of newly created bank-money for every hundred dollars of existing money deposited with them.

If the reserve rate is reduced to ten percent, it becomes possible to pyramid lending twenty-two fold; the banks can then lend over eight hundred dollars of newly created money for every hundred dollars with which they start.

It isn't just hyperbole to say that this provides the government with an almost limitless capacity for inflating the money supply. It is a mathematically irrefutable fact. So long as the banks of the nation cooperate, it is possible to inflate to whatever extent the government considers desirable. That they will cooperate is taken for granted because it is so profitable for them to do so.

Since interest rates rise along with everything else during inflation, their profits tend to become unconscionable. What used to be called usury has become respectable. It is doubtful if interest on short term commercial loans need ever exceed three percent. But if they are to be kept within the bounds of the real needs of the economy, commercial borrowers ought to do what the members of credit unions have been doing on an enormous scale for more than a century. They ought to organize cooperative banks. The competition such banks would furnish to our existing profit-oriented banks would keep them from fixing interest rates on the basis of all that the traffic will bear. The competition which credit unions furnish to loan sharks prevents what are called finance companies today from fixing their rates on the same basis. By providing loans for emergencies and other prudent purposes on a cooperative basis they make it possible for those with the most modest of incomes to keep out of the hands of loan sharks.

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In a genuinely free economy in which commercial banks were independent and were locally owned and controlled, they would tend to serve their own community. They would tend to resist the temptation to abuse the issuance and creation of new bank-money. They would profit from its proper use but its exploitation to finance speculation, for instance, would be recognized as a betrayal of the interests of the community of which they are a part.

The moment, however, local banks cease to be genuinely independent, as is the case with most of them today; the moment their operations, and the use they make of the local money entrusted to them, begins to be controlled by giant banks in the financial centers of the country, as is also the case today; and the moment they become subject to manipulation by so-called investment bankers so that they become outlets for the corporate securities these promoters create, as is also the case today, the local banks of the nation become part of a huge machine perfectly devised for exploitation.

Had all the commercial banks of the nation not been mobilized in this way to finance speculation in securities in the 1920's, there might have been a depression but there would have been no Great Depression. Recovery from the economic paralysis which that created—with most banks insolvent and finally shut down by the government, with bankruptcies large and small and farm foreclosures by the tens of thousands, and with a third of the labor force unemployed—would not have had to wait until the outbreak of the second World War, a long ten years later, to start turning the wheels of industry again.

It is the financing of speculation by the creation of new bank-money which is in large part responsible for the dangerous situation with which the nations of the free world are faced today. This threatening situation could have been avoided but for the failure of existing bank practices, existing monetary institutions, and existing economic teachings—particularly in promoting Keynesianism—to distinguish between the issuance and creation of new money for the legitimate needs of commerce, and the issuance and creation of new money to finance investment, to finance the government, and to finance speculation. Because of the general failure to recognize the illegitimacy and even the downright dishonesty of issuing new money for such purposes, we are literally sitting on a powder keg. All that is needed to explode it is a general loss of confidence in the value of the dollar.

One of the worst of existing abuses of power to create bank-money is caused by the government's control, usually exercised through its central bank, over the operations of commercial banks. It is this control which enables it literally to force them to create bank-money (a) to finance its deficits, (b) to finance growth of the national product, (c) to finance development if it is an underdeveloped nation, and finally by resorting to these activities (d) to finance full employment on one hand and avoidance of unemployment on the other.

(a) Every government deficit is an abuse of political authority and political power. Governments ought to operate on a "pay as you go" and "tax as you spend" basis. Overspending and under taxation are both political ploys. Politicians like to spend; there is support and there are votes to be garnered by spending. But politicians do not like to tax; nobody likes to be taxed and least of all likes to have taxes raised. The idea and the practice, since Keynesianism became institutionalized, of financing government deficits by creating bank-money is both a moral and economic outrage.

(b) Government participation in promoting growth of the national product—in promoting growth of the gross national product—is in a free economy equally anomalous. If the government nevertheless does engage in such activities, it should finance them as they should be financed in the public sector, not with newly created bank-money but with money saved and already in existence. Providing atomic power, one of the many ways in which government is now promoting growth, is in its essence no different from the provision long ago of steam power and more recently of electric power. Activities of this kind, both in the public, the quasi-public, and the private sectors of the economy, call for financing on a self-liquidating investment basis.

(c) What has been said above applies equally to the financing of what is called development by creating bank-money. "Development" of an underdeveloped nation is really the same thing as "growth" of a developed nation. Both are politically activated and only ostensibly economically motivated. Both should be financed as all investments should be financed with money saved and not with money newly created.

After thirty years of the abuse of the power to create bank-money for these purposes by all the members of the International Monetary Fund, all the nations belonging to it are operating on the brink of disaster. Inflation, they are discovering is uncontrollable. All that is necessary for the disaster to be precipitated, is for something to happen, as sooner or later it will, which finally undermines what is left of the confidence in the dollar. When confidence in the dollar, which is still the reserve currency of the IMF, ultimately collapses, the catastrophe into which the nations of the free world will find themselves plunged will make all previous depressions seem like mere picnics.