



THE POSITIVE MONEY SYSTEM IN PLAIN ENGLISH

This paper is now out of date (as of July 2014) and should not be quoted.

**Please see the following link for the current proposals:
<http://bit.ly/1mdt7Yo>**

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INTRODUCTION

This proposal to reform the banking system would stop commercial banks creating money, and move the power to create money into the hands of a transparent and accountable body. It is a plain English explanation of the proposals outlined in *Modernising Money* (2013) by Andrew Jackson and Ben Dyson. The proposal builds on the work of Henry Simons and Irving Fisher in the 1930s, and James Robertson and Joseph Huber in *Creating New Money* (2000).

Taking the power to create money out of the hands of banks would end the instability and boom-and-bust cycles caused when banks create too much money in a short period of time. It would also ensure that banks could be allowed to fail without bailouts from taxpayers. It would ensure that newly created money is spent into the economy, so that it can reduce the overall debt burden of the public, rather than being lent into existence as happens currently.

A more detailed description of the reforms is available in the book **MODERNISING MONEY**, which is available from www.positivemoney.org

A QUICK OVERVIEW OF THE REFORMS

The principles of the Positive Money system are as follows:

PRIVATE BANKS WILL NO LONGER BE ABLE TO CREATE MONEY

Currently the money that we use for the majority of transactions consists of bank deposits created by banks when they make loans. These deposits – the numbers that appear in your bank account – are accounting entries and an accounting liability (like an IOU) from the bank to the customer. Because banks can create these deposits through the accounting process they use when they make loans, it means that most of the money in our economy (over 97%) consists of this bank-issued money.

The reform would convert these deposits on banks' balance sheets into an account held at the Bank of England. Instead of a customer's bank account representing an IOU or promise to pay from the bank, it would represent electronic money held at the Bank of England. Banks would lose the ability to create money, as they could no longer create the demand deposits that are used as money today.

AN ACCOUNTABLE AND TRANSPARENT BODY WILL TAKE OVER MONEY CREATION

The Bank of England would then take over the role of creating the new money that the economy requires each year to run smoothly. The task of deciding how much money will be injected into the economy would be taken by the Money Creation Committee (MCC), which replaces the Bank of England's existing Monetary Policy Committee. The MCC would be completely separate and insulated from any kind of political control or influence. The elected government would not be able to specify the quantity of money that should be created, to avoid conflicts of interest and abuse of the power to create money for political ends.

MONEY IS ONLY TO BE CREATED WHEN INFLATION IS LOW AND STABLE

The MCC would create money in line with inflation targets set by the government. An increase in inflation above this target would see the MCC lower the amount of money they created, and possibly stop creating money all together.

NEWLY CREATED MONEY TO ENTER THE ECONOMY FREE OF ANY CORRESPONDING DEBT

Upon making a decision to increase the money supply, the MCC would authorise the Bank of England to create the new money by increasing the balance of the government's 'Central Government Account'. This newly created money would be non-repayable and therefore debt-free. The newly created money would then be added to tax revenue and distributed according to the elected government's manifesto and priorities.

NEWLY CREATED MONEY TO ENTER THROUGH THE REAL ECONOMY INSTEAD OF FINANCIAL MARKETS

Newly created money would be used to increase government spending, to pay down the national debt, reduce taxes or pay a citizens' dividend. The exact mix of these options would depend entirely on the elected government of the day.

BANKS TO GIVE INDIVIDUALS CONTROL OVER HOW THEIR MONEY IS INVESTED

If an individual wants to invest their money (i.e. to lend it to someone else) then they will have the choice, in very broad terms, over where their money is invested. For example, customers may be offered an Investment Account that directs funds to small and medium businesses, or to renewable energy, or to mortgages, etc. The effect is to democratise finance, so that the banks' investment and lending decisions start to reflect the priorities of their customers and as a result society in general.

THE REFORMS

CHANGES TO BANK ACCOUNTS

To the average person, banks will appear to work much as they do now. However, the ‘behind the scenes’ changes required to prevent banks from creating money will mean that there would need to be a few subtle changes to the terms of service on current accounts and savings accounts. As a customer of a bank, you would have two options:

1. Keep your money in a Transaction Account and ensure that it is 100% secure. Regardless of how much money you keep in that account, there will be no cap on the amount that is guaranteed.
2. Put your money into an Investment Account and accept some risk in exchange for a return (i.e. interest).

TRANSACTION ACCOUNTS (SIMILAR TO TODAY’S CURRENT ACCOUNTS)

Present-day ‘current’ accounts are used to make and receive payments (e.g. with cheques, debit cards, cash machines, electronic fund transfers, etc.). Your ‘current account’ will be replaced by a Transaction Account, which will provide most of the same services, but will be 100% safe and secure.

To the customer, a Transaction Account will appear to be the same as a present-day current account. However, to distinguish between the pre- and post-reform accounts, we’ll be using the term Transaction Accounts.

The bank will manage their customers’ accounts at the Bank of England, acting as the middleman between the Bank of England and the customer.

WHAT IS STILL THE SAME

- Transaction Accounts will still provide cheques, debit cards, cash machines, and electronic fund transfers.
- Employers will still pay salaries into Transaction Accounts.
- Individuals and businesses will still make payments from one Transaction Account to another.
- Customers will still have instant access to money in the Transaction Accounts.
- These accounts may still offer overdrafts.

WHAT IS DIFFERENT

- Transaction Accounts will not be liabilities of the commercial banks.
- Any money paid into a Transaction Account will not become the property of the commercial bank. As a result commercial banks will not be able to lend the money held in Transaction Accounts.
- All the money paid into Transaction Accounts will be held in an aggregated account at the Bank of England, which will be known as the 'Customers' Funds Account'. These accounts will be the digital equivalent of putting the money into a safe-deposit box with the customer's name written on it.
- Money in Transaction Accounts is therefore 100% secure and can never be 'lost'. The bank could repay all the money in these accounts at any time, without having any impact on the bank's overall financial health. Even a bankrupt bank would still be able to repay all its Transaction Account holders. It would be impossible to suffer a run on Transaction Accounts.

This guarantee does not expose the government or the Bank of England to any financial risk. It also means the government can withdraw its guarantee on the first £85,000 of every bank account, since Transaction Accounts are inherently risk-free for the customer. If a bank collapsed, it would only be an administrative procedure to move the Transaction Accounts over to other banks, and no money would ever be at risk. The money in those Transaction Accounts would remain at the Bank of England, but another healthy bank would take over the role of managing the accounts for customers.

- Because the banks cannot use the funds placed in these accounts to invest or lend, they will be unable to earn a return on these funds. As they will still incur the costs of providing payment services (cheque books, ATM cards, cash handling, etc.), they will need to charge account fees to cover these costs.
- Transaction Accounts will not pay interest, because the banks cannot lend this money. As the rates of interest on current accounts are rarely higher than 0.5%, this is not a significant loss.

COSTS OF THE CHANGES – ACCOUNT FEES

Banks will no longer be able to profit by lending the money placed in Transaction Accounts. But they will still incur the costs of providing payment services, and will need to pass on these costs by charging account fees. How much would the fees be? The following page shows a realistic breakdown of the current yearly costs of providing a current account, provided by a consultancy firm that advises on the setting up new banks (Tusmor):

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Cheque Book	£10 (per book)
Debit Card	£2
Branch	£5
Call Centre	£8
Staff	£15
Banking IT systems	£4
Customer Due Diligence (on account opening)	£8
MasterCard/Visa	£2
Link (cash machine network)	£2
BACS and other payment systems	£5
Other IT infrastructure	£2
Total	£63

This equates to a cost of around £5 per month per account, plus a little extra for profit.

While no-one likes to start paying for something that was previously free, a few points should be noted. First, even today, the bank incurs the cost of running payment services, and recovers these costs from customers through unauthorised overdraft charges and other unexpected charges. Second, the payments system after the reform may be significantly cheaper to run, as there would be no need for a complex 'clearing' system. (Transactions could be instant and final, depending on how the authorities implemented the reforms). This means that the main significant costs would be creating the physical ATM cards and cheque books, offering customer service, and maintaining the bank's main computer systems. In addition, many banks are already starting to charge account fees in the UK.

In practice, there will be significant market pressure to keep account fees as low as possible. For example, customers with a Transaction Account with a specific bank are more likely to use the bank for other services, such as loans, and therefore fees on accounts may be kept low as a 'loss leader' to attract and keep customers. As a result, competition between banks means that some of the costs of payment services may be 'absorbed' by the banks to gain market share. Some of the costs may be recouped from their investment earnings.

INVESTMENT ACCOUNTS (SIMILAR TO TODAY'S SAVINGS ACCOUNTS)

Your savings account would be replaced by an 'Investment Account'. We call them Investment Accounts for the sake of clarity and because it more accurately describes the purpose of these accounts – as a risk-bearing investment rather than as a 'safe' place to 'save' your money.

After the reform, the bank would need to attract the funds that it wants to use for any investment purpose (whether it is for loans, credit cards, mortgages, long-term investing in stocks or

short-term trading in financial markets). Customers would provide these funds via their Investment Accounts. To lend money, banks will need to find customers who are willing to give up access to their money for a certain period of time. In practice, this means the customer will need to invest their money for a defined time period (for example 4 weeks, 6 months, 2 years, etc.) or set a minimum notice period that must be given before the money can be withdrawn (e.g. 28 days, 56 days, 6 months, etc.).

Banks will then work in the way that most people think they currently do – by taking money from savers and lending it to borrowers (rather than creating new money whenever they make a loan). This means customers of the bank will only be able to earn a rate of return (interest) if they are willing to give up access to their money for a certain period of time.

WHAT IS STILL THE SAME

- Investment Accounts will still be used by customers who wish to ‘put money aside’ or earn interest on their spare money (‘savings’).
- These accounts would still pay varying rates of interest.
- They would still be provided by normal ‘high-street’ banks.

WHAT IS DIFFERENT

- At the point of investment, customers lose access to their money for a pre-agreed period of time. There would no longer be any form of ‘Instant Access Savings Accounts’.
- Customers would agree to either a ‘maturity date’ or a ‘notice period’ that would apply to the account. The maturity date is a specific date on which the customer wishes to be repaid the full amount of the investment, plus any interest. The notice period refers to an agreed number of days or weeks notice the customer will give to the bank before demanding repayment.
- The Investment Account will never actually hold any money. Any money ‘placed in’ an Investment Account by a customer will be immediately transferred to a central ‘Investment Pool’ held by the bank, and then be used for making various investments. At this point, the money will belong to the bank, rather than the Investment Account holder, and the bank will note that it owes the Investment Account holder the amount of money that they invested.
- At the point of opening an account, the bank should be required to inform the customer of the intended uses for the money that will be invested, along with the expected risk level. The broad categories of investment, and a consumer-friendly rating system for the risk of those investments, will be set by the authorities.
- The risk of the investment now stays with the bank and the investor, rather than falling on a third party (i.e. the taxpayer). Any investor opening an Investment Account will be fully aware of

the risks at the time of the investment. Those who do not wish to take any risk will be able to opt for a low-risk (and consequently low-return) account, or a Transaction Account instead.

GUARANTEES ON INVESTMENT ACCOUNTS

In order to ensure risk and reward are aligned, Investment Accounts would not be guaranteed by the government in any way. Customers who wish to keep their money completely free of risk can put their money into Transaction Accounts. Customers who want to earn a return will need to take on some risk (rather than having the risk passed onto the taxpayer through the present-day guarantee on the first £85,000 in an account).

However, this in itself could create new problems. For example, if the bank simply passes all the risk on to the Investment Account holder, then the bank takes the upside of its lending decisions but little of the downside. This would encourage the bank to use customers' money to pursue only high-risk, high-return activities. Alternatively, if the bank retained all the risk on its lending, customers would want to put their money into the highest risk, highest return Investment Accounts. This would mean that 'safer' but lower return investments would struggle to secure funding, while the bank's investments would become increasingly risky.

To avoid this situation and ensure that incentives are correctly aligned, both the bank and the Investment Account holder must share in the downside if things go wrong. Therefore, the reforms will allow banks to offer the Investment Account holder a guarantee on a percentage of their initial investment. For example, as well as offering a return of 5% a year if the investments are successful, banks may guarantee that 95% of the value of an Investment Account will be repaid. The bank would then cover any fall in the value of the account below 95% out of its own profits. In each case, investors would have been made aware of the guarantees and made their decision to invest in a particular Investment Account, knowing the risks as well as the potential upside.

Banks will vary the guarantees they offer on Investment Accounts according to the degree of risk in the underlying investments. This means they will be able to compete by offering a range of products that cater to different risk appetites. Investors who are happy with a low rate of return will be able to invest almost risk-free, with the bank promising to make up any shortfalls on the investment with profits from its other investments and activities. Investors who want a high rate of return will need to take on some of the risk themselves.

Of course, these guarantees will only be valid as long as the bank is solvent. If a bank becomes bankrupt, Investment Account holders would be creditors of the bank. They would have to wait for normal liquidation procedures to find out what percentage of their investment they will get back (as the bank's assets are valued and sold). The Treasury and government do not back the guarantees made by the banks, and will not use taxpayer funds to pay back customers of failed banks. This is likely to be unpopular with savers who have so far been able to save without taking any risk at all (thanks to the taxpayer-funded guarantee). However, there is no justifiable

economic or moral reason why savers/investors should be able to pass the downside of their investments onto UK taxpayers as a whole.

THE FINANCIAL REGULATOR MAY FORBID SPECIFIC GUARANTEES

The current financial regulator will be able to forbid a bank from offering a particular rate of return on a particular Investment Account product. This provision is necessary to prevent banks from offering unrealistic guarantees.

For example, a bank may offer an Investment Account product with a guaranteed rate of return of 8%. However, if the investments themselves are unlikely to earn 8%, the bank will end up with a shortfall, and be more likely to go bankrupt or appeal to the Bank of England for emergency funding. In short, offering a guarantee which bears no relation to the real risks of the investment makes it more likely that the bank will run into financial difficulties. Therefore, the FSA or Bank of England should be allowed to forbid guarantees from being made in order to maintain the stability of the banking system.

THE BANK OF ENGLAND AND THE PAYMENTS SYSTEM

We now look at the bigger picture and explain how the payments system works after the reforms. It is important to understand that money – at least 97% of it – now has no physical form. It is merely numbers in computer systems. With that in mind, it should be remembered that unless we are discussing physical cash, money is never actually ‘kept’ or ‘stored’ anywhere; it is only recorded in one computer system or another. This is important because our reform requires some subtle changes to the computer systems used in the banking network, and these changes are easily misunderstood if the nature of money itself is misunderstood.

CHANGES AT THE BANK OF ENGLAND

All digital money (other than cash and coin) would be ‘held’ in a central computer system under control of the Bank of England. The Bank of England already has a computer system which records the amount of ‘central bank money’ or ‘reserves’ in the reserve account of each bank in the UK. This system is known as the ‘RTGS (Real-Time Gross Settlement) Processor’, and already handles hundreds of thousands of large transactions between banks every day.

After the reform, the accounts that each commercial bank held with the Bank of England would be stored within this computer system. For example, in the same way that you or I might hold personal bank accounts with HSBC or Nationwide, HSBC and Nationwide (and every other bank) would in turn hold accounts with the Bank of England. Each individual bank would have three main accounts (stored in the Bank of England’s RTGS Processor).

1. THE CUSTOMER FUNDS ACCOUNT

This is the account in which the bank’s customers’ Transaction Account funds are held. While the Bank of England would hold the real ‘money’ (in digital form), it would not hold any information on individual customers or customer accounts. This would be the responsibility of the individual banks. When someone at another bank pays a Transaction Account holder, the balance of the Customer Funds Account will increase. When a Transaction Account holder pays someone who uses a different bank, the balance of this account will decrease. The money in this account is not owned by the commercial bank nor is the account an asset of that bank. The bank merely manages this account for its customers.

2. THE INVESTMENT POOL ACCOUNT

This account represents the lending side of the bank. Money is transferred out of this account whenever the bank makes loans to borrowers or interest payments and repayments to Investment Account holders. Money is transferred into this account whenever banks take loan repay-

ments or interest charges from borrowers, or when Investment Account holders make new investments. The money in this account is owned by the bank and the account is an asset of the bank.

Because this money technically belongs to the bank, the bank would not have corresponding records to divide this pool up between customers. However, each bank would need to keep records of all its ‘contracts’ and agreements, both to Investment Account holders and to borrowers. For borrowers, it needs to know the amount lent, the agreed interest rate, the date of monthly repayments, the quantity of repayments to be taken, etc. For each Investment Account, the bank will need to have a record of:

- the amount invested
- the date the investment was made
- the maturity date or minimum notice period
- whether the minimum notice period has been given
- the interest rate agreed.

3. THE BANK’S OPERATIONAL ACCOUNTS

This is the account where the bank can hold funds for its own purposes – retained profits, own capital, money to pay staff wages, etc. The money in this account is owned by the bank and the account is an asset of the bank. Each of these accounts could be split into sub-accounts to help the bank manage and segment its own funds.

THE THREE ACCOUNTS TOGETHER

The three accounts at the Bank of England can be imagined as huge pots of money. For its Customer Funds Account, each bank would record the amount of this money that is owned by every one of its individual customers, and the transactions made in and out of each customer’s account. As a simplistic example, a bank’s database may look something like this:

MegaBank’s record of the Transaction Accounts it administers	
Customer	Balance
Mrs K Smith	£546.21
Mr W Riley	£1942.52
Mr J Heath	£26.78
...	...
Total Balance of Customer Funds Account:	£168,023,163,295.72

However, the Bank of England would not need any data on the individual breakdown of the Customer Funds Account. As a result, the Bank of England’s accounts would only show the aggregate (total) amount for each bank, as shown below:

Bank of England accounts	
Commercial Bank	Account Balance
MegaBank Administered Customer Funds Account	£168,023,163,295.72
MegaBank Investment Pool	£145,023.00
MegaBank Operational Account	£295,451.72
RegalBank Administered Customer Funds Account	£192,923,670,202.12
...	...
Total Balance of all accounts:	£868,023,163,295.72

PAYMENTS BETWEEN ACCOUNTS IN A REFORMED SYSTEM

The process of making payments is very simple. In the following example Jack wants to pay for a van by transferring money to a van dealer. There are however differences depending on whether Jack and the van dealer bank at the same or at different banks.

CUSTOMERS AT THE SAME BANK

If both Jack and the van dealer have accounts at MegaBank, then the transfer can be made internally within the bank’s computer systems:

MegaBank’s record of Transaction Accounts	
Customer	Balance
Jack	£10,000 → £0
Van dealer	£0 → £10,000
...	...
Total Balance of Customer Funds Account:	£168,023,163,295.72 (No change)

In effect, Jack has simply transferred his ownership of £10,000 at the Bank of England to the van dealer. From Jack and the van dealer’s perspective as bank customers, they will simply see money transferred between the two Transaction Accounts. Note however that no money moves between accounts at the Bank of England, as all the money still sits in the Customer Funds Account administered by MegaBank at the Bank of England.

CUSTOMERS AT DIFFERENT BANKS

If the van dealer actually wants to receive the £10,000 into a separate account at Regal Bank, then the money belonging to Jack, which is stored in the Customer Funds Account at MegaBank, will be transferred across to the Customer Funds Account at Regal Bank. The money will then be the property of the van dealer.

When Jack asks his bank to send £10,000 to the van dealer's account at Regal Bank, then MegaBank will send an instruction to the Bank of England to transfer £10,000 from the Customer Funds Account it administers to the Customer Funds Account at Regal Bank. As the transfer is carried out, MegaBank reduces the recorded balance of Jack's account, and RegalBank increases the recorded balance of the van dealer's account. The transfer at the Bank of England is shown diagrammatically here:

Bank of England record of Customer Funds Accounts	
Bank	Customer Funds Account Balance
MegaBank Customer Funds Account	£168,023,110,000 → £168,023,100,000
Regal Bank Customer Funds Account	£192,923,600,000 → £192,923,610,000
Total Balance of all Accounts:	£868,023,163,295.72 (no change)

With an understanding of the post-reform payments system, we can now look at how loans will be made after the reform.

LOANS IN A REFORMED SYSTEM

The following section explains how banks will normally make loans (including via overdrafts) under the reformed system. Note that for the purpose of the demonstration, we will consider an example where one customer's investment of £1,000 is funding an equal loan to another individual customer. In reality, the amounts loaned may be smaller than the investment and spread across multiple customers, or alternatively, multiple investments may fund one larger loan. There does not need to be any direct link between individual savers and borrowers.

After the reform, the process of making loans is mechanical. The process would move money from one account to another, rather than creating new money (as it does in the current system). For a bank to make a loan it must already have funds on hand. It can acquire those funds from one of four sources:

- The money that bank customers have given to the bank for the purposes of investment (specifically, the money that bank customers have used to open Investment Accounts).
- Money that other banks have lent to the bank (which would involve a transfer of funds from one bank's Operational Account or Investment Pool to another).

- The bank's own funds, for example from shareholders or retained profits.
- Any borrowings from the Bank of England (when permitted).

Money in Transaction Accounts does not belong to the bank, and therefore cannot be used to make loans.

AN EXAMPLE OF THE LOAN PROCESS

John wants to make an investment using some of the funds currently in his Transaction Account. He first needs to open an Investment Account at the bank and 'fund' it with a transfer from his Transaction Account. John sees the balance of his Transaction Account fall by £1,000, and sees the balance of his new Investment Account increase by £1,000. However, in reality the money from his Transaction Account has moved to Regal Bank's Investment Pool at the Bank of England. The Bank of England's balance sheet has changed as follows:

Accounts at the Bank of England	
Commercial Bank	Account balance
Regal Bank's Customer Funds Account	£1000 → £0 (John's TA)
Regal Bank's Investment Pool	£0 → £1000

On Regal Bank's balance sheet, the funds are transferred from John's Transaction Account to the bank's Investment Pool. The bank simultaneously makes a record that it owes John £1000 (by creating a new liability of £1,000), which is John's new Investment Account.

Regal Bank Balance Sheet – Loans		
Assets	Liabilities	Regal Bank Administered Customer Funds
Investment Pool £0 → £1000	John's Investment Account £0 → £1000	John's TA £1000 → £0

The money in Regal Bank's Investment Pool is then used to make a loan to a borrower, David. David signs a contract with the bank confirming that he will repay £1,000 plus interest. This legally enforceable contract represents an asset for the bank, and is recorded on the balance sheet. Simultaneously, money is moved from Regal Bank's Investment Pool at the Bank of England to the Customer Funds Account managed by Regal Bank, and Regal Bank increases the value of David's Transaction Account.

Regal Bank Balance Sheet – Loans

Assets	Liabilities	Regal Bank Administered Customer Funds
Investment Pool £1000 → £0	John's Investment Account £1000	John's TA £0
New Loan to David £0 → £1000		David's TA £0 → £1000

The balance sheet still balances, with the Investment Account liability to John offset by the loan asset made to David. Throughout the process, electronic money in the accounts at the Bank of England has moved from the Customer Funds Account to the Investment Pool, and back to the Customer Funds Account. Ownership of the money has moved from John to David. (When an Investment Account reaches its maturity date or notice period, the bank will reverse this process by transferring the money that it owes to its customer from its Investment Pool into the Customer Funds Account, and updating the balance of the customer's Transaction Account.)

Regal Bank Balance Sheet – After making the Loan

Assets	Liabilities	Regal Bank Administered Customer Funds
Investment Pool £0	John's Investment Account £1000	John's TA £0
New Loan to David £1000		David's TA £1000

At no point did any money leave the Bank of England's Balance Sheet, and no additional deposits were created anywhere in the system. This ensures the act of lending does not increase the level of purchasing power in the economy, in contrast to bank lending in the current system.

CREATING NEW MONEY

Banks would now be unable to create new money by making loans. The Bank of England would take over the role of creating the new money the economy needs each year to run smoothly, in line with inflation targets set by the government.

WHO SHOULD DECIDE HOW MUCH NEW MONEY TO CREATE?

The last few decades show that we cannot trust profit-seeking banks with the power to create money. Their incentives usually stack up firmly on the side of always lending more money, and therefore always increasing the money supply, regardless of the needs of the economy as a whole. But elected politicians are unlikely to do much better. They would be tempted to increase the money supply to pay for things such as high speed rail and university tuition fees, which would result in money being created without any concern for the needs of the wider economy.

There is a conflict of interest when the person or organisation who decides whether to increase or decrease the money supply can also benefit from that decision. This conflict of interest applies to both profit-seeking banks and to vote-seeking politicians. In this scenario, the conflict of interest will affect the decision over how much money should be created.

So if we can't trust profit-seeking bankers or vote-seeking politicians, then we must find a neutral, independent body who have no misaligned incentives and who do not benefit personally from increasing the money supply. Under our proposals the Bank of England's existing Monetary Policy Committee will be replaced by a Money Creation Committee (MCC). The MCC will be responsible for deciding how much new money should be injected into the economy in each period of time.

The current Monetary Policy Committee (MPC) will be abolished and will stop making decisions to raise or lower the base rate of interest. Instead, the MCC will be responsible for deciding to directly increase or reduce the money supply. Interest rates will be set by the markets rather than by the central bank.

The MCC will need to be politically independent and neutral. This is important, as it prevents harmful political 'tinkering' with the economy. It is important the MCC cannot be overruled by politicians, whose decisions will be swayed by political matters rather than the long-term health of the economy. It is also important that the MCC is sheltered from conflicts of interest, and lobbyists for the financial sector.

The Money Creation Committee will be subject to all the rules regarding transparency of its decisions that currently apply to the Monetary Policy Committee. The authorised increase in the money supply will be made publicly known every month. Note that the MCC will not be creating as much money as the government needs to fulfil its election manifesto promises – the needs

of the government will not be considered. Therefore suggestions that this reform would cause a Zimbabwe-style hyperinflation have no basis in reality.

HOW MUCH MONEY SHOULD THE MCC CREATE?

As is the case today, the target of monetary policy will be the rate of inflation. However, in line with democratic principles, if Parliament agrees that targets other than price stability are more desirable, it will have the ability to change the MCC's mandate.

In deciding how much money to add or remove from circulation, the MCC would aim to change the growth rate of the money supply in order to keep inflation at around the 2% a year target. Creation of new money by the MCC will increase spending in the economy. Depending on the state of the economy at the time, this may push up the inflation rate. If inflation is above the target rate, then it is unlikely the MCC will choose to further increase the money supply.

The Money Creation Committee would decide how much money to create in order to meet the inflation target by analysing the economy as a whole – not the spending needs of the government, nor the needs of the banking sector. They would use 'big picture' statistics to judge whether meeting the inflation targets requires more or less money injecting each month. They would also have access to all the research that they need to make an informed decision.

THE MECHANICS OF CREATING NEW MONEY

When the Money Creation Committee has authorised the creation of a specified amount of new money, it will be created in the following way:

- The government will hold an account, known as the 'Central Government Account' with the Bank of England.
- The Bank of England will simply increase the balance of this account by the amount authorised by the Money Creation Committee. They will not simultaneously reduce the balance of any other account – thus creating new money.
- This newly created money would be non-repayable and therefore debt-free.
- The government can then withdraw the money from its Central Government Account and add it to the pool of tax revenue. It can then use the money following the principles discussed in the next section.

Printing physical cash or coins costs a few pence for every £1 created (according to the Bank of England's annual reports, they spent £38million in 2010 printing physical banknotes). In contrast, creating money electronically is almost costless.

HOW WILL NEW MONEY ENTER THE ECONOMY?

Newly created money would then be added to tax revenue and spent according to the elected government's manifesto and priorities. The newly created money could be used to increase spending, to pay down the national debt, reduce taxes or pay a citizens' dividend. The exact mix of these options would depend on the elected government of the day. We will now look at each of the options in more detail.

INCREASING GOVERNMENT SPENDING

By using the newly created money to increase government spending, the government can increase the provision or quality of public services such as education, health care or public transport, without increasing the tax burden on the public.

What if the government uses the money to increase its spending but wastes it on something that has limited benefits for society or taxpayers? First, this consideration applies to all tax revenue already. If there is a risk that the newly created money will be spent foolishly by the government, then the same risk applies to the rest of the money the government spends each year. Second, we must avoid making the error of thinking that money can only be spent once. As an individual, you have a limited amount of money. If you spend it foolishly and 'waste' it the money is gone for good. But that money doesn't disappear; once you've spent it, it is in the hands of someone else and may be spent again. In the same way, even if the government wastes newly created money, the money will end up in the hands of government employees and contractors, who will then go on to spend it in the real economy.

CUTTING TAXES

Rather than increasing government spending, the elected government of the day could choose to reduce the overall tax burden. This could be achieved by cancelling or reducing particular taxes, therefore collecting less money from taxation and using newly created money to make up the shortfall.

As a general principle, any government using the proceeds of this reform to reduce taxation could aim to reduce or cancel some of the most regressive or market distorting taxes. There are however problems with this approach: while changes in taxes are made infrequently, the amount of newly created money spent into the economy will be determined on a monthly basis. The government will not be able to predict or influence the decisions of the MCC, and so will have little idea how much new money will be created each year and therefore by how much it will be able to reduce taxes. Therefore, cancelling or reducing taxes may not be the most effective way (in terms of the government's financial planning) of distributing newly created money into the economy.

MAKING DIRECT PAYMENTS TO CITIZENS

One alternative is for the newly created money to be shared equally between all citizens (or all adults, or all registered taxpayers). This would also mean that the newly created money is most widely distributed across the economy, rather than being concentrated in particular areas of the country or sectors of the economy as a result of large government projects.

PAYING DOWN THE NATIONAL DEBT

The government could use the newly created money to retire (pay down) some of the national debt. However, there are problems with this approach. The newly created money would go first to holders of government bonds and would stay circulating within the financial markets, rather than reaching the real economy. Many of the bonds that make up the national debt are held by pension funds and insurance companies. This means that although some of the newly created money paid to these bondholders would end up in the hands of pensioners or insurance claimants, the majority will stay within financial markets, providing no stimulus to the real (non-financial) economy. In addition, the national debt is far cheaper (i.e. the interest rate is lower) and smaller than private debt. Therefore the priority should be to get new money into the real economy to allow households and businesses to reduce their own debts, rather than prioritising the reduction of the national debt.

ADVANTAGES OF THE POSITIVE MONEY SYSTEM

ADVANTAGES FOR ECONOMIC STABILITY

In the existing monetary system, the total amount of money (defined as ‘bank deposits’ – the numbers in your bank account, plus notes and coins) is increased whenever a bank makes a loan. Consequently, the money supply increases as a result of the individual decisions of thousands of loan officers and mortgage advisors, who themselves act on the lending priorities of the senior board members of the big banks. In relatively stable periods banks make more profit the more loans they make, and therefore the staff are incentivised by bonuses to make as many loans as possible. This unconstrained money creation has real economic effects.

For example, bank lending – i.e. money creation – for the purchase of pre-existing assets, such as property, leads to an increase in its price (as the supply of houses doesn’t respond quickly, or at all, to price changes). This price increase over time leads to a self-reinforcing and destabilising process whereby price increases lead to more demand for houses (as people ‘invest’ in houses) which leads to more lending, higher house prices and increasing debt. Eventually the debt burden becomes too large for some borrowers and the asset bubble bursts.

Then defaults and the fall in the demand for loans slow the demand for mortgages, which stops (and then reverses) the rise in house prices. Individuals who bought houses with the intention of selling them off later at a higher price find that their mortgage is worth more than their house, and may be forced to default on their loan. This in turn causes a recession, as banks tighten their lending and individuals lower their spending. In the most extreme cases it may also cause a financial crisis, as defaults on loans start a chain of events that results in bank runs, bankruptcies and potential downward spiral effect (known as ‘debt deflation’). Thus booms and busts, asset price bubbles, financial crises, depressions, and even debt deflations all occur in the normal functioning of a debt-based monetary system. In short, as long as banks are allowed create money the economy will be inherently unstable.

Conversely, after the reforms banks will no longer be able to create money when making loans. This reduces the likelihood of asset price bubbles and the subsequent financial crises, recessions and depressions. Instead of money entering the economy with a corresponding debt, it will enter the economy ‘debt-free’, and the health of the whole economy will be considered before a decision is made to increase or decrease the money supply. While there are always issues when decisions are made by small committees of ‘wise men’, we believe that it would be hard for the Money Creation Committee to do a worse job of managing the money supply than the banks have done to date.

Greater economic stability should lead to higher levels of private investment, employment and economic growth. Likewise by providing a further source of revenue to government it will be more able to facilitate growth in the private sector, either through reducing taxes, increasing spending (for example on infrastructure, education, health, etc.), or lowering borrowing.

ADVANTAGES FOR BANKS

Most of the bank's investment funds will come from Investment Accounts, and every Investment Account has a defined repayment date (or a maturity date). This means the amounts that the bank will need to repay on any one day will be statistically far more predictable than under the current system. For Investment Accounts with maturity dates, they will know the exact amount that must be repaid on any particular date. They will also know, from experience, what percentage of customers with maturing accounts will ask for the investment to be rolled over for another period (in other words, what percentage of accounts will not need to be repaid on the maturity date).

With regards to minimum notice periods, they will know the statistical likelihood of an account being redeemed within the next 'x' days, and so be able to plan the payments that will come due on any particular day for up to 6 months into the future. As a result the banks' computer systems will easily be able to forecast cash flow (money coming in and out) with a much greater degree of certainty than under the present-day banking system. It could also identify any future shortfalls that need to be prepared for (for example, by scaling back loan making activity and building up a buffer). At the same time, they will be able to identify periods when the money coming in will be greater than the repayments due to customers. They can then increase loan making activity to soak up the surplus.

THE LOWER LEVEL OF SYSTEMIC RISK

We believe that the risk of any bank or all banks suffering a 'cash-flow crisis' is significantly lower post-reform than under the existing banking system. Unlike the present day banking system, the post-reform banking system is counter-cyclical rather than pro-cyclical. This means that the banking system will not create debt-fuelled booms that soon turn into economic crashes, causing a wave of defaults. With fewer and less severe recessions, each bank's loan portfolio is likely to be far safer than under the current system.

ADVANTAGES FOR TAXPAYERS

REMOVAL OF INSURANCE/SUBSIDIES

Deposit insurance: Under the existing system, if a bank fails due to bad investments, a third party (the taxpayer) will reimburse the savers who have money invested with that bank. This scheme is called deposit insurance, or the 'Financial Services Compensation Scheme' in the UK. In the USA a similar scheme is run by the FDIC (Federal Deposit Insurance Corporation).

Deposit insurance removes the incentive for a bank's creditors (i.e. savers and investors) to monitor the bank's behaviour. Currently the saver stands to gain if an investment by a bank goes well, but it is the taxpayer that stands to lose. This means that risk and reward are not aligned. As a result banks can borrow from depositors at a much lower rate than they otherwise would do, which is in effect a subsidy the government provides to banks.

Conversely, in a system without deposit insurance, depositors and bank creditors have a big incentive to monitor their bank's behaviour, to ensure it does not act in a manner which may endanger its solvency. While Investment Account holders may benefit from the upside of an investment (by receiving interest on their deposits/lending), they also suffer the downside if things go wrong (i.e. they may not receive the full value of their deposit back). Risk and reward are aligned, and the subsidy to banks is removed.

TOO BIG/SYSTEMICALLY IMPORTANT TO FAIL: Currently, many banks are considered too big or too systemically important to fail. This is largely because of the costs to the economy of a large bank failing – in particular, the loss of deposits (i.e. money) – would be disastrous for the government that had to reimburse depositors. It would also be disastrous for the economy as panic spread from one bank to another, causing a cascade of bank failures in the process.

Being 'too big to fail' means that banks can gamble with their customers' money in the knowledge that the government will step in to cover any serious losses. This creates 'moral hazard' and encourages the banks to take greater risks in their investments. While one group stands to benefit if the bank is successful in its investments, another group (taxpayers) stands to lose if the bank is unsuccessful. As with deposit insurance, being too big to fail means banks can borrow at much lower rates than they would otherwise do (because lenders are not worried that their money won't be repaid). This constitutes another subsidy.

Conversely, in a reformed banking system taxpayers will never again have to bail out a bank. This will have the effect of removing a subsidy to the banking sector, as well as the added benefit that banks will be far more concerned with the types of loans they are making.

ENDING "TOO BIG TO FAIL"

Because a customer making an investment has explicitly agreed to accept the risks of the investment, there is no need (nor a justifiable case) for the government to guarantee any investments. If a bank makes bad decisions and loses money, the customers who provided the money for those investments will lose money. In this situation the bank in question would be wound down, broken up and sold off. Borrowers would continue to pay off their loans (at the same rate as before) to whoever bought their loan contracts. This would be far easier and cheaper to do than under the existing system, for the following reasons:

The funds placed in Transaction Accounts are 100% safe. The bank does not own their customers' Transaction Accounts, nor do they appear on its balance sheets, and these are in any case held separately from the bank's Investments Accounts.

The taxpayer and government has no exposure or responsibility whatsoever for the funds owed to holders of Investment Accounts. The Investment Account holders would become creditors of the liquidated bank, and insolvency law would govern whether and by how much they are repaid their original investment.

That is not to say that all insolvent banks will go bust. In extreme cases the Bank of England could provide a temporary loan to a bank suffering from a short term liquidity issue. However, these loans should not be used to keep insolvent banks alive.

COMMON MISCONCEPTIONS

HOW DO WE STOP INFLATION?

When we suggest that the state (or the Bank of England) should be allowed to create new money, some people automatically react with the suggestion that this would cause inflation. Indeed, the most common misguided criticism of the type of reform that we are proposing is that it will cause significant inflation. This rests on the idea that an irresponsible government will print as much money as it requires for its own needs.

There is absolutely no risk of this happening under the Modernising Money proposals. Decisions on changes in the money supply will be made not by vote-seeking politicians but by an independent body (the Money Creation Committee); politicians will have no influence whatsoever in the amount of money that will be created.

The Money Creation Committee will be instructed to consider the needs of the economy as a whole in deciding how much new money should be injected into the economy. The needs or desires of the elected government do not factor in this decision at all. In fact, the members of the MCC could be expressly forbidden from considering political matters or the intentions of the current government in making the decision.

HOW WELL HAS THE CURRENT SYSTEM PREVENTED INFLATION?

Between 1970 and 2010, the banks have been inflating the money supply by an average of 11.5% per year. While consumer prices have only experienced low levels of inflation during this period, the housing market has experienced significant levels of inflation. Indeed, between 1990 and 2007 house prices almost tripled!

WILL THERE BE ENOUGH LENDING AND CREDIT?

Considering that the authorities focused on the 'credit crunch' as the biggest problem in the recent financial crisis, the idea of significantly reducing the amount of available credit (lending) raises alarm bells for many people.

However, most of these concerns stem from an incomplete understanding of how the monetary system works. The reality is that our dependence on credit is not a natural aspect of the economy – it is a direct result of allowing banks to create the nation's money as debt. When over 97% of the existing money supply is created as debt, and is therefore earning interest, it creates inflation (especially in housing) that necessitates people borrowing more simply to survive. In practice, the current system provides too much credit. In contrast, a system that

provides less credit is much more likely to lead to a steady and stable economy, rather than the stop-go economy that we've had for the last few decades.

Before we explain why a reduction in credit (lending) will not be a problem after the reform, we need to clear up a few misconceptions about 'credit', 'debt' and 'lending'.

CREDIT = DEBT

The term 'credit' is used misleadingly. 'Credit' has positive associations – everyone wants a good credit rating, and your salary appears in your bank account under the 'credit' column. But in the case of 'getting credit flowing again', bank 'credit' means 'debt'. If we say that businesses depend on access to credit, we are saying that their financial situation is poor enough that they urgently need to go into debt. This poor financial health is not the natural state of affairs – it is a symptom of a monetary system where all new money is created by the banks. (Of course, very new businesses and businesses which are expanding rapidly will need access to credit/debt.)

WE ARE DEPENDENT ON CREDIT/DEBT BECAUSE OUR MONEY SUPPLY IS DEBT

The absolute dependence on 'credit', and the fact that the economy grinds to a halt whenever credit dries up, is used to point to the importance of credit in a modern economy. In reality, it points to a chronic shortage of debt-free money in the economy. By definition, if the economy needs 'credit' to continue functioning, we are dependent on debt.

Under the existing banking system, the only way the public can get money is to borrow it from banks. Consequently, if banks don't lend, the economy doesn't have a money supply. This is the main cause of our dependence on debt/credit.

While economists argue that easy access to credit is essential to a well-functioning economy, in reality, dependence on credit is a symptom of a malfunctioning economy and a malfunctioning money supply. The debt-based monetary system actually creates the need for companies and households to access credit (debt). In other words, we are all so far in debt because we allow our money to be created as debt.

The answer to our debt-dependency is not more debt (despite political leaders shouting "We must get banks lending again!") but newly created, debt-free money, which can help to pay down debts and reduce our debt-dependency.

AS DEBT-FREE MONEY PAYS DOWN DEBT, WE WILL HAVE LESS NEED FOR CREDIT

Debt-free money will be created and injected into the economy, via tax cuts, tax rebates and government spending or direct payments to citizens. This will allow individuals and companies to gradually pay down their own debts and start to increase their savings. With greater savings,

people have less dependence on debt, and therefore access to credit (debt) becomes less critical to the health of the economy.

This newly created debt-free money provides a stronger stimulus than debt-based money created by the banks over time, since there is no need to repay the money. As a result, the economy should improve, and people will be better able to pay off their existing debts, pay down mortgages, and improve their financial position. With lower taxes and a more buoyant economy, the need to go into debt will fall and apply to fewer people. In other words, the demand for credit will fall in tandem with the availability of credit.

The MCC can deal with any shortfalls in the amount of credit available to businesses by choosing to create more money (if all the other economic indicators also point to the need for more money). They could also lend newly created money directly to banks on the condition that this money goes into 'productive' lending – funding businesses rather than speculating on financial markets, for example.

FURTHER INFORMATION

MODERNISING MONEY gives a more detailed explanation of these reforms and also covers the transition process between the current and reformed monetary systems. It covers the economic, social and ecological consequences of the current monetary system and explains how the reforms would address these issues. You can get a copy from www.positivemoney.org

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