Would a sovereign money system be flexible enough?

Ben Dyson, Graham Hodgson and Andrew Jackson
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This briefing paper considers a monetary system in which only the state is permitted to create money (a ‘Sovereign Money System’), and outlines a range of policy options with regards to the criteria under which new money is created. By changing the criteria that trigger the creation of new money, we can adjust the flexibility, or responsiveness, of the stock of money to economic conditions. The authorities can therefore choose from a range of possible monetary policy regimes, ranging from a monetary system in which the supply of money is fixed and therefore completely inflexible, through to systems in which the supply of money responds flexibly to changes in economic conditions. At one extreme, the authorities could fix the supply of money on the day of conversion to a sovereign money system, creating a system in which the supply of money does not respond at all to changes in the economy. At the other extreme, money creation could be made completely endogenous to (i.e. determined by) the demand for loans from the private sector, mimicking the current monetary system in terms of money creation. It is therefore a logical error to assume that transferring the power to create money from banks to the state will automatically lead to a less flexible (or ‘responsive’) money supply.
1. SUMMARY

Positive Money proposes that the power to create money should be removed from banks\(^1\) and returned to an agency of state, such as the central bank. We describe such an arrangement as a ‘sovereign money system’\(^2\). The appendix provides a brief overview of how a sovereign money system would be structured, with links to more detail.

A number of economists and commentators\(^3\) have claimed that such an arrangement would leave the economy with a money and credit supply that is rigid, inflexible and unresponsive to the needs of the wider economy. According to one critique, such a system would result in “a shortage of money, high unemployment and low economic activity”.\(^4\)

It is correct that the particular implementation of a sovereign money system described in *Modernising Money*\(^5\) is less flexible than the current monetary system. But that is by design. In the current system, new money is created every time a bank issues a loan, and is destroyed whenever part of the principal is repaid. The resulting ‘flexibility’ in the money supply has translated not into greater economic growth, but into speculative bubbles in property and financial assets. This has fuelled house price bubbles in many developed countries and exacerbated the rise in inequality.

Clearly it would be a mistake to assume that greater flexibility is always better; there is likely to be some optimal level. This paper does not attempt to determine what that optimal level of flexibility would be. Instead, we want to show that a sovereign money system is not synonymous with an inflexible system.

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1. Around 97% of the broad money supply consists of deposits – accounting entries – issued by banks primarily when borrowers take out loans. This process of money creation is explained in detail by the Bank of England in its March 2014 Quarterly Bulletin: http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/ qb14q1prereleasemoneycreation.pdf

2. Similar but technically different proposals are known as ‘100% reserve banking’ or ‘full reserve banking’ proposals. The term ‘narrow banking’ is often used in a similar context, although narrow banking is significantly different from a sovereign money system, both in its aims and its feasibility.

3. Many of these claims are in draft papers that have been shared with the authors, but are yet to be published.


5. See the appendix, or for more detail see: Jackson, A. and Dyson, B. 2013, Modernising Money: Why our monetary system is broken and how it can be fixed.
The confusion arises because critics who argue that a sovereign money system is inherently inflexible conflate two separate policy choices:

1. Which entity should be authorised to create new money: an agency of the state, or private banks?
2. What criteria or process should trigger the creation of new money?

Crucially, the flexibility of money supply depends not on who creates the money, but on which criteria trigger the creation of new money. By changing the criteria that trigger the creation of new money, we can choose between monetary systems that range from being completely inflexible through to extremely flexible (for example, one in which money supply is determined entirely by the demand for loans). In plain English, the inflexible extreme could be characterised as “The money supply is £2 trillion and so it will always be”, whilst one flexible extreme would be “Money will be created whenever there’s someone willing to borrow it”.

It is therefore a logical error to assume that transferring the power to create money from banks to the state will automatically lead to a less flexible (or ‘responsive’) money supply. In fact, if certain policy choices are made, a sovereign money system may be even more flexible than the existing monetary system.

Structure of the paper
Part 2 elaborates on the distinction between the two policy choices over (1) the entity that creates money, and (2) the criteria that trigger the creation of new money.

Part 3 considers those two policy choices as they apply to the current monetary policy regime.

Part 4 outlines the range of monetary policy options that exist with regards to flexibility of the money supply within a sovereign money system (in which only the state is permitted to create money). We have highlighted the dangers of both extreme inflexibility and extreme flexibility, and consider the pros and cons of the more moderate options.

For each policy regime, we have clarified whether the proposal is rules based or authority based; that is, whether there is a hard-and-fast rule about how to increase the money supply, or whether it depend on the discretion of those individuals or committees that have been given authority to make such decisions.

In Part 5, we highlight the two moderate policy options that, in our view, would offer the best outcome for the economy when used together.

Part 6 concludes, and an Appendix provides a brief overview of the Sovereign Money System advocated by Positive Money, with links to more detail.
Before exploring how a Sovereign Money System can be as flexible as the current monetary system, it’s important to draw a distinction between two policy choices:

1) Which entity should be authorised to create new money: private banks, or an agency of the state?

2) What criteria or economic events should trigger the creation of new money?

First, let’s consider choice (1): which entity should be authorised to create new money? Today, 97% of money in the hands of the public takes the form of bank deposits. Banks create these deposits when they make loans (or buy financial assets) simply by making accounting entries into the appropriate bank accounts. In the words of the Bank of England:

“Commercial [i.e. high-street] banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. At that moment, new money is created.”

But this process of money creation could just as easily be undertaken by the state, through the central bank. Instead of allowing banks to create money by entering new digits into customers’ current accounts (which are just accounting liabilities of the bank), the central bank could create money directly by entering digits into accounts held directly at the central bank. In a sovereign money system, current accounts would not hold liabilities of a commercial bank. Instead, they would hold electronic deposits held at the central bank (these deposits would be liabilities of the central bank). So if the central bank wished to provide funds that banks could lend on to businesses, it could credit the accounts that those banks hold at the central bank.

When the banks then use these funds to make loans to businesses, the new money would be transferred to the accounts of the borrowers. Alternatively, if the money the central bank created were credited to the account of the government, the new money would be transferred to the accounts of recipients whenever the government pays pensions, welfare benefits or public sector salaries.

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6 http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q1prereleasemoneycreation.pdf#page=1
(Note that the creation of money by the state (rather than banks) in this way can be done in a way that is entirely consistent with existing accounting principles and payment systems\(^7\).)

So both the state and banks have the capacity to create money, but our first question was: which entity *should* be authorised to create money? This question is important because the creator of money gets the proceeds of that creation, a profit that is known as ‘seigniorage’ (when it is earned by the state). In the current monetary system, the proceeds of creating new money go to the banking sector, which is able to charge interest on money that was created at the point of making the loan\(^8\). Transferring the responsibility for electronic money creation to the state would generate considerable revenue for the state and a saving for taxpayers.

**However, the second question – what criteria should trigger the creation of money? – is even more significant for the health of the economy than the matter of which entity creates the money.** Choose the wrong criteria and money creation would be too flexible, accommodating speculative bubbles in property and financial assets, and financing businesses that can only be profitable as long as consumers continue spending on credit. Alternatively, choose the wrong criteria and money creation could be too inflexible, making it impossible for the economy to grow as fast as it potentially could, or even creating deflation and unemployment.

Before we consider the possible criteria that can be chosen in a sovereign money system, we will briefly analyse the criteria that govern money creation in the current monetary system.

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\(^7\) See the discussion in Chapter 7 and *Appendix 3 of Modernising Money*, by Andrew Jackson and Ben Dyson.

\(^8\) The interest is shared with depositors, but since 2004 the banking sector has benefited from over half of the £800bn received in interest from UK households and businesses, a third of which was paid to shareholders.
3. THE EXISTING MONETARY POLICY REGIME

In the existing monetary policy regime, money is created primarily by banks as they issue loans. Ultimately, banks will issue loans if they believe it will be profitable for them to do so (after factoring in the risk of defaults). Consequently, in the existing monetary system, the criteria for creating new money are:

1) A borrower must request a loan (or be offered one by bank staff)

2) The bank must believe that the borrower will be able to repay the loan and service the interest from either existing and expected future income, or asset sales (assuming the bank does not plan to sell the loan before maturity). For an individual, this existing income is determined by their salary. For a business, income depends on existing sales and likely future revenue.

3) If there’s a risk the borrower may not be able to repay, there must be sufficient collateral (such as a house) that the bank could repossess in the event of a default.

The flexibility of the money supply therefore depends ultimately on a) the willingness of banks to make loans and b) the demand for loans from borrowers. In turn, both of these factors depend greatly on the economic circumstances at the time, and the expected conditions in the near future.

However, those economic circumstances themselves are determined partly by banks’ past lending decisions. So for instance, an expansion in lending (and money creation) for mortgages can cause house prices to rise, increasing both the willingness of banks to issue larger mortgages, and the demand for larger loans from house buyers. This dynamic means that money creation in the existing monetary regime can be highly pro-cyclical. In economic booms, banks will grant larger loans to a wider range of borrowers, meaning that the money supply will be highly flexible and responsive to demand. However, in a recession, banks will be reluctant to lend regardless of the demand for loans, and therefore the monetary system will be highly inflexible and unresponsive. This dynamic was evident in both the run-up to and the aftermath of the 2007-2009 financial crisis.

In conclusion, rather than being a responsive and accommodative money system, the current system swings between being excessively flexible and excessively inflexible.
4. **Policy Options: What Would Trigger the Creation of Money in a Sovereign Money System?**

We will now consider the full range of possible criteria used to trigger money creation under a sovereign money system, starting with the most inflexible monetary system, and ranging through to the most flexible.

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**No Money Creation: Fully Fixed (Exogenous) Money Supply**

**Flexibility:** None

In a ‘digital hard money’ regime, the stock of money in the economy would be fixed at a certain level on day one, and never altered regardless of the economic circumstances. No new money would be created, regardless of whether the population or productive capacity of the economy were growing, or whether the economy was in a deep recession. Likewise, no money would ever be removed from circulation either. This is a strictly rules-based approach, with a simple rule: no money will be created under any circumstances.

There are significant problems with such an approach. In an economy where productivity is growing (as a result of technological progress), and where there is a growing population, a fixed currency would be inherently deflationary. Deflation can cause significant problems because the production cycle takes time and debts are fixed in nominal terms. Deflation increases the real value of debt, meaning that ever more goods and services would have to be sold at lower prices, or more hours worked at falling wages, to meet successive fixed monthly payments. This can lead to a damaging debt deflation process, as outlined by Fisher (1933).[^9]

Without repeating all the arguments against deflation here, it is likely that a fixed money supply would cause severe economic problems and limit economic growth.

Such a monetary policy regime, whilst entirely possible under a sovereign monetary system, would almost certainly not be in the interests of the wider economy.

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4. POLICY OPTIONS: WHAT WOULD TRIGGER THE CREATION OF MONEY IN A SOVEREIGN MONEY SYSTEM?

Money Created at Fixed Growth Rate
Flexibility: Limited

In this scheme, the money supply would be increased at a fixed nominal or percentage amount each year, according to an essentially arbitrary rule. For instance, the rule might be that the money supply should grow by 2% a year, every year, regardless of the growth of the economy, or population and regardless of current levels of inflation.

This strict rules-based regime would be similar to the monetarist approach advocated by Milton Friedman. Friedman proposed a “k-percent rule” in which the money stock increased at a fixed annual rate per year, irrespective of economic conditions.

While the percentage increase in the stock of money could in theory be set at an amount which reflected the long-term growth rate of the economy (plus an allowance for inflation), the arbitrary rule-based regime suffers from some of the same weaknesses as the fully-fixed money supply regime listed above. In the short run, the growth rate of the money supply may bear little relation to the current state of the economy. Many economists would assume that such a scheme would be deflationary, but it could just as well be inflationary if the growth in the money stock was set at a level that significantly exceeded the growth in productive capacity of the economy.

Such a fixed growth rate regime is highly unlikely to be optimal for the economy. In the same way that a stopped clock is correct twice a day, such a regime might work well when the economy happens to grow at a similar rate to the pre-set growth rate of money supply, but in most other situations it would be inappropriate.

Money Created at Index-Based or Correlation-Based Growth Rate
Flexibility: Tied to rate of change in an external variable

In this scheme, the money supply is increased at the same rate as a specific index. For example, the money supply may be increased at the same growth rate as the population, or according to some index of productivity growth, or a composite index. This is also a rule-based regime.

This is a crude way of managing the growth of money supply, but it does ensure that the growth rate bears some relation to economic reality, incorporating the more flexible proposals of monetarists Brunner and Meltzer\(^\text{10}\) who advocated rules to relate monetary growth to prevailing economic conditions. In this, it is likely to be

\(^{10}\) [http://www.econlib.org/library/Enc/Monetarism.html](http://www.econlib.org/library/Enc/Monetarism.html)
moderately effective in growing the money supply quickly enough to allow economic growth whilst not fuelling property bubbles and speculative behaviour.

Such a rules-based regime would appeal to those who appreciate the need for the money supply to expand in line with a growing economy, but who have little faith in the ability of economists and central bank officials to make judgements about the appropriate rate of growth.

One significant challenge with such an index-based regime is in choosing and measuring the index. For instance, in the UK, population is accurately measured only every 10 years in the official census, and interim figures are mostly guesswork, extrapolations or based on aggregating small-scale survey data. Changes in productivity are also equally tricky to measure.

A conceptual challenge to this regime comes from understanding how money facilitates production and economic growth. This policy regime assumes that economic growth happens first, and then the money supply can be adjusted to ‘catch up’. In short, it assumes that money is neutral and is merely required to oil the wheels of trade. It does not allow for the possibility that economic growth may be dependent on money creation or that the creation of additional money might drive further demand, further production and therefore greater economic growth. In short, it presumes that money creation is used only as a reactive process to manage inflation, rather than as a pro-active process that can drive economic activity.

Money Created to Meet Economic Targets

Flexibility: Moderate

We now step into authority-based regimes that rely on the judgement and discretion of central bank officials. In a target-based regime, the government would set a target for monetary policy, such as a specific inflation rate, and monetary policy would be directed at maintaining the future level of the chosen metric as close as possible to the target. The Money Creation Committee (MCC) would have complete authority to adjust the rate of growth in the money supply as it sees fit, consistent with its forecast as to the effects on the future level of the target metric.

For example, with an inflation target, it would increase the rate of money creation when inflation is expected to be below target, and slow the rate of money creation when inflation is expected to rise above the target. This responsiveness to existing and expected inflation rates means that such a regime is highly unlikely to be highly inflationary or deflationary, as some critics have argued.
The choice of the specific target is a decision for a democratically elected government, and may include employment and wider economic objectives. The UK government’s current monetary policy is to target an inflation rate of 2%, plus or minus 1%, and subject to that constraint, to support the government’s objectives for employment and growth.

This regime is similar to the regime under which the Monetary Policy Committee operates in the current system, except that in the current system, the target is addressed by adjusting up or down the interest rate that the central bank charges the commercial banks for reserves, in order to indirectly influence borrowing and money creation by the banking sector.

Such a regime gives significant discretion to Committee members, and relies on them having good judgement, a good and holistic feel for what is happening in the wider economy, and good timing with regards to when they should change the rate of growth of the money supply.

There are some valid criticisms of using inflation as a target. For instance, inflation can also be a result of non-monetary factors: inflation can be imported when the price of foreign goods rise. A myopic focus on inflation as the target would ignore all of these other possible sources of inflation and may lead the central bank to respond in the wrong way to inflation that is not a result of money creation. However, these problems with inflation targeting apply equally to the existing monetary policy regime, and the debate is beyond the scope of this paper.

**Money Created to Satisfy Demand from GDP-Contributing Business Loans from Banks**

*Flexibility: High*

In this regime, the central bank would offer to create and lend money to private banks, on demand, on the condition that these banks then lend the money to businesses outside the FIRE (Finance, Insurance, Real Estate) sector.

This would channel newly created money to businesses whose activities contribute to GDP. For instance, loans for an investment in new technology that allows a firm to produce more (and more efficiently) may be justifiable grounds for the creation of new money. However, the central bank would refuse to create money to finance mortgages or the purchase of pre-existing assets, as these purchases do not increase the productive capacity or output of the economy. The FIRE-sector is therefore excluded, because only a small part of its activity counts towards GDP, and finance provided to this sector is likely to be used to bid on existing property or financial assets, causing asset price inflation but no increase in GDP.
One underlying assumption here is that much of the money would be used to invest in increasing businesses’ productive capacity, and therefore the productive capacity of the economy as a whole. In practice, some of this lending will also be to allow businesses to manage their cashflow, so not all of this lending will lead directly to an expansion in productive capacity.

Since the money is to be lent to banks for onward lending to businesses, the Monetary Creation Committee would need to charge a rate of interest on the money lent to banks. This gives the Committee a further policy option. They could specify the quantity of new money to be made available and conduct an auction between banks to set the interest rate to be charged. The new money would then be lent to the banks offering the highest rates to borrow it. Alternatively, if economic conditions warranted, they could set the interest rate to be paid by banks and create as much new money as banks wished to borrow at that rate.

Such a regime in itself is unlikely to be economically harmful. By only creating money to finance activities that increase productive capacity, it would ensure that newly created money is directed into something economically productive. The increase in capacity means that the inflationary impact of the spending financed by new money should be offset by the corresponding increase in output.

However, one significant problem with such a regime is that it would rely exclusively on investment by firms as the main channel for newly created money to enter the economy. But it may be that the economy as a whole needs a greater increase in money supply than can be channelled through this single mechanism. It also means that all money would come into the economy with a corresponding rise in the levels of corporate debt. Whilst this new debt may be serviceable, in certain circumstances there may be a need for debt-free money creation (i.e. the spending into the economy of money that is not borrowed) in order to maintain economic growth and overcome some of the debt-overhang from the existing monetary system.

For these reasons, further on in this paper we advocate a hybrid regime that combines this regime with the “Target-based” regime outlined above.

**Money Created on Demand for Loans to Finance Any GDP-Contributing Purchase**

**Flexibility: Very High**

In this regime, the central bank would offer to create money on-demand to finance banks’ loans to households and businesses, but only for purchases that contribute to GDP. This criteria is much broader than the preceding regime. In addition to providing
4. Policy Options: What Would Trigger the Creation of Money in a Sovereign Money System?

Finance for investment by businesses that contribute to GDP, it would also permit money creation for consumer borrowing (i.e. to finance credit cards, or buying e.g. washing machines on credit). However, it would still prohibit the creation of money to finance the purchase of existing property or existing financial assets, as neither of these activities contributes significantly\textsuperscript{11} to GDP\textsuperscript{12}.

Providing new money to finance consumer demand would only be inflationary if there were not a corresponding increase in productive capacity, although in practice most firms operate at below full capacity and so can increase production to respond to greater demand.

Financing consumer spending with newly created money via credit cards and personal loans will lead to a short-term boost in spending. In the long run, however, it may lead to lower growth. This is because as consumers become more indebted, they must use a higher proportion of their future income to service the resulting debts and therefore have lower disposable income to spend in the real economy. The ultimate effect will depend on what banks do with their interest income: if it is used to make payments to staff or shareholders with a higher propensity to consume on average than debtors, the net effect on domestic demand will be positive, but if much of the interest income is redistributed to staff and shareholders with a lower propensity to consume than debtors then this is likely to have a net negative effect on domestic demand and may result in any additional productive capacity installed during the period of growth eventually falling into disuse. It may also have impacts on the exchange rate, since a significant proportion of consumer spending will go on imports (depending on the country in question).

It is therefore uncertain whether allowing additional money to be created for consumer credit will lead to a higher level of growth in the economy, or whether it will simply result in a short-term boom accompanied by growing household debt and an eventual fall in spending.

\textsuperscript{11} from a sovereign money system, both in its aims and its feasibility. Although the professional fees incurred in house sales (such as estate agents and solicitors) are recorded as a contribution to GDP.

\textsuperscript{12} Lending for the purchase of existing property and existing financial assets would still be financed by loans of pre-existing money. It is also likely that we would want to allow the creation of new money to finance the construction of new housing, since this does contribute to GDP, and increases the real wealth of the economy.
Money created on demand for any loan, without conditions
Flexibility: Extreme

Finally, we reach the opposite extreme: an infinitely flexible money supply. In this situation, the central bank would stand willing to create any amount of money, on demand, upon request from any bank. It would lend funds at a particular interest rate, which would have to be set by the Monetary Policy Committee. No conditions would be attached to the use of that money, although the banks would remain liable to repay the full amount borrowed regardless of whether their own loans perform or default, ensuring that the risk of lending remains with the banks.

To advocate such an arrangement, one would have to believe that “banks know best” with regards to whom they should lend to, how much they should lend and for what purposes. In theory, so long as the risk of loss due to defaults remains with the banks, we could assume that a bank working in its own self-interest would not make loans to someone who is unable to repay. If this assumption holds, then it follows that banks would only ever lend to credit-worthy borrowers who were safely able to service the resulting debts via their own income, and/or who had sufficient collateral to guard against the risk of default. Under this assumption, reckless lending to speculative bubbles (in property or financial markets) would never occur because banks’ self-interest would discourage them from taking such risks.

Clearly, these assumptions will be discarded as unrealistic by anyone who has followed the recent financial crisis. There would be, however, two significant changes in the banking environment which could make it more likely that these assumptions would hold. First, under a Sovereign Money regime the payments system would be insulated from the solvency of the entire commercial banking sector, so banks would not be able to rely on an implicit government guarantee underwriting their operations. This may give them a much stronger incentive to be cautious in lending to more speculative activities, and therefore limit some of their more reckless lending (although this is by no means certain). Second, a normal bank/customer relationship would exist between the central bank and each commercial bank so that the central bank would need to conduct the same due diligence into the conduct and finances of the banks to which it lends as do those banks into the affairs of their borrowers.

A further concern is that under this regime, as with the two “on demand” regimes described previously, the central bank would be exposed to the risk of insolvency and bankruptcy of any commercial bank to which it had lent. As the central bank would be receiving interest payments from those banks without having to pay any interest to them (unlike the case at present), it should be able to use some of this interest income to make normal commercial provision against default. However, since the government,
and therefore the taxpayer, stands behind the central bank, these three regimes cannot eliminate entirely the possibility that a market belief in an implicit guarantee will permit some banks to be deemed to be “too big to fail.” The broader the range of criteria that the central bank is willing to lend for, the greater is that risk.\(^\text{13}\)

A further problem with this regime is that the interest rate set by the central bank ultimately sets the ceiling for interest rates across the economy, since no bank would borrow from savers at a rate higher than that offered by the central bank. If the central bank decides that a rate of 3% is ideal, no private sector saver is likely to find savings products that offer greater than 3%. This may lead to a search by savers for yield in foreign financial markets, which could lead to exchange rate movements and could expose domestic lenders to exchange rate risk. Further consideration needs to be given to the consequences of such a ceiling on interest rates.

Consequently, as in the current system, we see considerable risks with this extremely flexible monetary policy regime.

5. **Our Recommendations: A Hybrid System**

We advocate a hybrid system in which the bulk of the money supply would be created according to the “target-based” regime, whilst a smaller amount would be created to finance lending to businesses outside the FIRE sector.

In this hybrid regime, the central bank’s Money Creation Committee would have a target set by parliament (and ultimately by the Chancellor/Finance Minister). The current target in the UK is an inflation rate of 2%, and subject to that, to support the Government’s economic objectives. Inflation between 1-3% is considered acceptable, and anything outside that range requires the Governor of the Bank of England to write an open letter of explanation to the Chancellor (finance minister) outlining his/her plans to bring inflation back within the target range. This allows the Monetary Policy Committee of the central bank flexibility to allow slightly higher or lower inflation if he or she thinks it is in the best interests of the economy to do so.

If inflation were significantly above target, this would be taken by the Money Creation Committee as a sign that it should slow or limit the rate of new money creation (unless it was clear that a rise in inflation was due to non-monetary factors, such as a rise in the price of imports, or unless it was judged that the costs of reducing inflation exceed

\(^\text{13}\)However, the central bank becoming insolvent does not affect its ability to function in the same way that a private bank’s insolvency affects the private bank’s ability to function. Consequently an enlightened central bank could credibly commit to allowing banks to fail that had large outstanding debts to the central bank.
the benefits from doing so, at least in the short term). If inflation were significantly below target, this would be taken by the Money Creation Committee as an indication that it should increase the rate of money creation, subject to similar caveats to those outlined above.

Any newly created money would be transferred to central government and then spent into the economy through a) government spending programmes, b) by reducing taxes (and using the newly created money to make up the difference) or c) by making direct payments to citizens. (Further details on this process are outlined in the appendix.)

Such a process would provide the bulk of the necessary increase in money supply each year. But it is true that such a process, as the sole source of money creation, would not be as responsive as the current system to demand from borrowers.

To build in some flexibility, the central bank could also include elements of the regime in which money is created on-demand to finance lending to non-FIRE sector businesses\textsuperscript{14}. The central bank would be willing to create additional money, on demand, in response to banks that are able to lend that money to non-FIRE sector businesses. This protects the level of lending to businesses. In addition, assuming that much of the financing to businesses is used to invest in increasing their productive capacity, it means that if the creation of money through the first process were to result in increased demand, businesses would be able to expand their production to meet this demand.

However, we would view the risks of creating money on demand for anything other than investment in productive businesses as being too great to justify.

\textsuperscript{14}Businesses outside the Finance, Insurance and Real Estate sectors.
Negative critiques of sovereign money proposals have assumed that a sovereign money system is by nature rigid, inflexible and unresponsive to the needs of the real economy. Such assumptions are based on a failure to realise that the decision over the criteria that trigger the creation of money is independent of the entity that creates money. A sovereign money system could be designed to be significantly more flexible than the existing monetary system, although that would probably be unwise, given the damage done by the existing overly-flexible system.

However, it is certainly possible to create a sovereign money system that is more responsive to the needs of the real economy (rather than the financial sector) than the system that we have today.

As we have seen, the current system is bipolar, verging from overly-flexible in booms, and overly-inflexible in recessions, when banks refuse to lend even to credit-worthy businesses and households. In contrast, a sovereign money system, if designed well, can be countercyclical, leading to greater economic stability at the same time as being more responsive to demand from businesses and real 'wealth creators' for loans to finance productive investment.
APPENDIX: POSITIVE MONEY’S PROPOSALS

The following is a brief overview of Positive Money’s proposals for a sovereign money system.

First, the power to create all money, both cash and electronic, would be restricted to the state via the central bank (such as the Bank of England, European Central Bank or Federal Reserve). Changes to the rules governing how banks operate would still permit them to make loans, but would make it impossible for them to create new money in the process.

Banks would then serve two functions:

1) The payments function: Administering payment services between members of the public and businesses, and holding funds safe at the central bank until they need to be spent.

2) The lending/saving function: acting as an intermediary (middleman) between savers and borrowers.

The payments function would consist of Transaction Accounts held by businesses and members of the public. The funds in these accounts would not be deposits created by the banks (an IOU from the bank to a customer), but electronic sovereign money, created by the central bank. These transaction funds would be electronically stored at the central bank and would legally belong to the customer. The transaction funds would be entirely risk-free, as they could not be invested or placed at risk by the bank. The bank would provide the payment services (such as cheque books, debit cards, internet banking, and ATMs) that would allow customers to use their sovereign money to make payments. The accounts would be interest-free, and banks would be able to charge account fees for providing these services.

The intermediary function of banks would take place through Investment Accounts. A customer wishing to earn interest would transfer funds from their Transaction Account into an Investment Pool owned by the bank. The bank would then set up an Investment Account for the customer, which would be a liability of the bank representing the investment made and the bank’s obligation to repay the funds in the future. The customer would have to agree to either a notice period required before accessing his/her money, or a maturity date on which the investment will be repaid. There would be no ‘instant-access’ investment accounts.

Banks would perform the function of pooling funds from Investment Account holders, and then lending these funds to a range of borrowers and for a range of purposes, thus diversifying risk on behalf of savers. Investment Accounts would not be guaranteed by the government, and would therefore be risk-bearing, with the risk shared between the bank and the customer according to the type of account chosen by the customer.
Regulators might impose equity requirements and other prudential rules against such accounts to prevent reckless behaviour by banks.

Investment Account balances could not be reassigned to others as a means of payment, to prevent them functioning as a substitute for money. Banks would therefore become true intermediaries in the way that many people currently believe them to be.

The central bank would be exclusively responsible for creating as much new money as was necessary to hit the target given by government. (In the version of the proposals put forward in *Modernising Money* we assume the target of monetary policy would not change). It would manage money creation directly, rather than using interest rates to influence borrowing behaviour and money creation by banks (as is the case at present). Decisions on money creation would be taken independently of government, by a newly formed Money Creation Committee (or by the existing Monetary Policy Committee). The Committee would be accountable to the Treasury Select Committee, a cross-party committee of Members of Parliament who scrutinise the actions of the Bank of England and Treasury. The Committee would no longer set interest rates, which would now be set in the market.

The central bank would continue to follow the remit set for it by the nation’s finance minister or chancellor. In the UK this remit is currently to deliver “price stability” (defined by an inflation target of 2%), and subject to that, to “support the Government’s economic objectives including those for growth and employment.” The inflation target would act as a limiter to stop the creation of money becoming excessive (or as a trigger to increase money creation if deflation became a risk), but subject to that, the central bank would be able to create additional money.

Any new money the central bank created would be transferred to government and injected into the economy in four possible ways:

1) To finance additional government spending

2) To finance tax cuts (with newly created money substituting for the lost tax revenue)

3) To make direct payments to citizens, with each person able to spend the money as they see fit (or to invest or pay down existing debts)

4) To pay down the national debt

A fifth possibility (which would be central to the flexibility of the money supply) would allow the central bank to create money for the express purpose of funding lending to businesses. This money would be lent to banks with the requirement that the funds be used for “productive purposes”. Lending for speculative purposes, or for the purpose of
purchasing pre-existing assets, either financial or property, would not be allowed. The central bank could also create and lend funds to other intermediaries, such as business-oriented peer-to-peer lenders or regional or publicly owned business banks. This would ensure that a floor could be placed under the level of lending to businesses, guaranteeing support to the real economy. Within the limits imposed by the central bank on the broad purposes for which this money may be lent, lending decisions would be entirely at the discretion of the lending institutions.

All of the above mechanisms should be open to scrutiny by both parliament and the general public.

More detail on the proposals above is available in the paper *Creating a Sovereign Money System and in the book Modernising Money: Why our monetary system is broken and how it can be fixed*, by Andrew Jackson and Ben Dyson.