PositiveMoney

A SCOTTISH CURRENCY?

5 Lessons from the Design Flaws of Pound Sterling

CONTENTS

A SCOTTISH CURRENCY?

In September 2014, Scotland will hold a referendum to decide whether to separate from the UK. A major question concerns which currency an independent Scotland would use: the pound, the euro, or a new Scottish currency?

The Scottish government has stated that it will keep the pound sterling following a successful Yes vote for independence[1]. But an independent Scotland, making up just 8.5% of a pound sterling monetary union, would have no sway over monetary policy set by the Bank of England. Meanwhile the governor of the Bank of England, Mark Carney, and senior government ministers have been vocal about the challenges of an independent Scotland using the pound. For this reason, an independent Scotland may have to abandon the pound and establish its own currency, to regain control over its own monetary policy and economic affairs.

What could Scotland learn from the design flaws of both the pound sterling and the euro? In both the UK and the Eurozone, the banking and monetary systems have spectacularly failed, throwing millions into unemployment and wiping years of growth off GDP. There is little point in replicating a system that doesn't work.

This briefing highlights the worst design flaws of pound sterling and explains how Scotland can avoid them.

DISCLAIMER

Positive Money has no view on Scottish independence, as we have no expertise on this issue. In addition, we are not making a recommendation for an independent Scotland to establish its own currency; merely pointing out some of the pitfalls that it should avoid if it did so.

THE DESIGN FLAWS OF THE POUND

1. The amount of money in the economy depends on the confidence of bankers

Many people would assume the Bank of England or Treasury is in charge of how much money there is in the UK economy. But in reality, this depends on the lending decisions of banks, because it is banks that create the vast majority of the UK's money.

According to the Bank of England, metal coins and paper notes now make up less than 3% of all the money in the UK. The remaining 97% of money consists of bank deposits - essentially numbers stored in the computers of high-street banks.

The Bank of England plays no part in creating these electronic bank deposits. Instead, this new electronic money is created by banks, through a simple accounting process whenever someone takes out a loan. Every new loan creates new money. This means that when you take out a mortgage, the money you borrow doesn't come from a pensioner's life savings. Instead, it is just created as an entry into the bank's computer system. In the words of the Bank of England:

> *"When banks make loans, they create additional [bank] deposits for those that have borrowed the money"*[2]

When banks are confident, they increase their lending, flooding the property and financial markets with newly created money. Through their lending, UK banks created more than a trillion pounds of new money - and new debt - in the 8 years preceding the financial crisis. This was economically devastating. Of the extra new money that banks created in the decade running up to the financial crisis, 51% went straight into the residential and commercial property market, artificially inflating house prices, with salaries unable to keep up. A further 32% went into the financial markets, fuelling the good times for the City of London but storing up problems for the future. Just 8% went to the (non-financial) businesses that create jobs and employment, whilst the remaining 8% went on personal loans and credit cards[3].

SUMMARY: When the amount of money in an economy depends on whether bankers are confident and willing to lend, then the health of the economy depends on the decisions of senior bankers.

HOW SCOTLAND COULD AVOID THIS DESIGN FLAW

Relying on banks to create Scotland's currency would be repeating the mistakes of the pound. Instead, Scotland could bring the creation of money under the sole responsibility of a Scottish Central Bank. Current account customers would end up holding electronic money issued by the Scottish Central Bank, rather than uncertain IOUs from a high street bank.

Banks would act as middlemen between savers/investors and borrowers, but would have no ability to create money in the process of lending.

With these changes the Scottish Central Bank could ensure that the amount of Scottish money grows roughly in line with the real economy, rather than being dependent on the confidence of bankers. If money creation started to fuel inflation, the Scottish Central Bank would slow down the rate of money creation. This would offer more stability to the Scottish economy. (These changes are explained in much more detail in the book ***Modernising Money,*** written by the authors of this paper.)

2. Any attempt to reduce household debt can lead to a recession

Banks create new money when people take out loans, through a simple accounting process. But when people repay loans, the reverse process happens, and the money that was used to repay the loan effectively disappears from the economy.

In the words of Mervyn King, former Governor of the Bank of England[4],

> *"What the banking system has been doing [after the crisis] is destroying money. As they reduce the size of their balance sheets [as people repay loans], they're reducing not just the size of their assets but the size of their liabilities too. And most of the money in our economy comprises the liabilities of banks in the form of bank deposits." [Our additions in brackets.]*

When people repay loans *en masse*, it can lead to the amount of money in the economy shrinking. After the financial crisis banks refused to make new loans to small and medium sized businesses. But those businesses had to continue making repayments on existing loans, meaning that over £100bn was withdrawn from the economy via loan repayments, leading to less spending in the economy.

SUMMARY: When money is created as a result of banks making loans, and destroyed when people repay loans, any significant attempt by households to pay down their debts risks draining the economy of money and tipping it into recession.

HOW SCOTLAND COULD AVOID THIS DESIGN FLAW

By allowing the Scottish Central Bank - rather than high street banks - to create Scotland's currency, it would be possible for Scotland to put new money into the economy at the same time as households pay down their existing debts. This extra spending would offset the effect of people repaying their debts, and would allow households to reduce their debts without tipping the economy into a recession.

3. The economy can only be stimulated through encouraging further indebtedness

One way to stimulate an economy out of recession or to higher levels of growth is to get new money into the hands of people who will spend it. Because the Bank of England abdicates responsibility for creating money to the high-street or commercial banks, if it wants to increase the amount of money in the economy, it must encourage these banks to lend more.

Consequently, in the aftermath of the crisis, the Bank of England slashed interest rates to their lowest level in three centuries, as if the answer to a crisis caused by reckless lending and excessive debt was to encourage people to borrow even more. The Funding for Lending and Help to Buy schemes that followed were both designed to encourage bank lending, and therefore the creation of new money by the banks.

But as the former head of Financial Services Authority, Lord Turner, put it:

> *"We got into this mess because of excessive creation of private credit and private [i.e. bank-issued] money. We should be concerned if our only escape route implies building up a future excess."*[5]

If excessive household debt was the root cause of the crisis, then stimulating the economy by encouraging households to go even further into debt may lay the foundations for the next financial crisis.

SUMMARY: When banks create the nation's money by making loans, it requires the authorities to respond to a crisis (caused by reckless lending and excessive debt) by encouraging households to borrow even more.

HOW SCOTLAND COULD AVOID THIS DESIGN FLAW

High-street banks will only create new money when they are willing to lend and someone is willing to borrow. But return the power to create Scotland's currency to a Scottish Central Bank and Scotland could stimulate the economy out of a recession without having to wait for banks to lend. It could do this by allowing the Scottish Central Bank to create new money, which would be granted to the Scottish government to spend into the economy. (Of course, Scottish politicians would not be allowed to decide *how much* money should be created, to avoid abuse of this power for short-term political ends).

4. The proceeds from the creation of money are captured by the banking sector rather than benefiting taxpayers

The UK Treasury currently earns a significant profit (known as 'seigniorage') when it creates £5, £10, £20 and £50 notes. Between 2000 and 2010, these proceeds raised a total of £16.7bn for the Treasury, reducing the total tax bill by the same amount.

However, notes and coins together make up just 3% of all the money in circulation. The other 97% is the electronic bank deposits created by banks as they make loans. This means that the proceeds from creating bank deposits goes not to the Treasury or the taxpayer, but to the banks. In the period that the government earned £16.7bn from creating paper bank notes, it lost hundreds of billions of potential revenue by allowing private banks to create money in place of the state.

SUMMARY: When banks create the nation's money, the proceeds go to the banks, rather than to the state and the taxpayer.

HOW SCOTLAND COULD AVOID THIS DESIGN FLAW

Transferring the power to create money from banks to a Scottish Central Bank would mean that the Scottish Treasury would earn the proceeds (or 'seigniorage') from creating electronic money as well as bank notes. The proceeds from creating bank notes for the UK can be up to £2bn a year; the proceeds from creating electronic money - even for a smaller country like Scotland - would be many times this.

5. Banks cannot be allowed to fail, because if they did, the payments system would collapse

The electronic money that we use today is simply the accounting liabilities of banks, meaning that if a large bank fails, our money is frozen and can no longer be used to make payments.

In October 2008, RBS (Royal Bank of Scotland) went bust and turned to the UK government for a bailout. If RBS had been allowed to fail, more than 10 million current and business account holders would have found themselves unable to withdraw cash or make electronic payments.

The ripple effects of such a failure in the payments system could be economically devastating. As former Fed chairman Alan Greenspan put it:

> *"We'd always thought that if you wanted to cripple the US economy, you'd take out the payment systems. Banks would be forced to fall back on inefficient physical transfers of money. Businesses would resort to barter and IOUs; the level of economic activity across the country would drop like a rock."*[6]

Consequently, the government had little choice but to rescue RBS, at the expense of taxpayers, to prevent a much more harmful impact upon the economy.

SUMMARY: When we use the liabilities of banks as our main form of money, then badly run banks must be rescued in order to prevent the payments system collapsing.

HOW SCOTLAND COULD AVOID THIS DESIGN FLAW:

In a system where only the Scottish Central Bank was able to create money, current accounts would hold risk-free electronic money created by the state, rather than the uncertain IOUs of the banks. When a bank fails under this regime, the money in current accounts will still be safe and available to the customer to spend, regardless of what happened to the high-street bank. Customers that made risk-bearing investments through the bank would need to wait while the bank was liquidated to get their investments back. But there would be no need to bailout badly-managed banks in order to protect the payments system.

CONCLUSION

If an independent Scotland wished to establish its own currency, there is little sense in modelling the currency on a design that has already failed many times in the UK, Europe and the US. Repeating the mistakes of the past, by relying on high-street or commercial banks to create 97% of the nation's money (in the form of accounting entries made when they issue loans), would leave Scotland with an economy where:

- The amount of money in the economy would swell and contract depending on the confidence of the same banks that caused the financial crisis.
- Any attempt to reduce household debt would trigger a recession.
- The primary way to stimulate the economy after a crisis caused by excessive debt would be to encourage people to go further into debt.
- Banks, and not the state, would receive most of the profits ('seigniorage') on the creation of money.
- Badly-run banks would have to be rescued to protect the payments system on which the rest of the economy depends.

There is a better way. An independent Scotland should limit the creation of a Scottish currency to a Scottish Central Bank, which would be concerned with the long-term health of the Scottish economy rather than the short-term need to chase profits and market share. This would give Scotland an economy where:

- The amount of money in the economy would be stable regardless of the actions of banks.
- Households could reduce their debts without inadvertently triggering a recession.
- The economy could be stimulated without relying on rising household debt.
- The proceeds from creating money would go to the state rather than banks, resulting in a significant saving for taxpayers.
- Badly-run banks could be allowed to fail without threatening the payments system or the wider economy.

These changes would give Scotland a safer banking system and an economy that is more stable and far less dependent on debt.

MORE INFORMATION

Modernising Money, by the authors of this paper, explains why our current monetary system is broken and how it can be fixed. It offers a blueprint for a more stable currency and a banking system that does not rely on being rescued with taxpayer funds. It is available from:

www.positivemoney.org/modernising-money

The same proposals are outlined, in plain English, in this free 30-page paper:

www.positivemoney.org/our-proposals/positive-money-proposals-in-plain-english/

Further information, and videos, about the problems with our current debt-based monetary system are available from **www.positivemoney.org**

ENDNOTES

1. Scotland's Future: Your Guide to an Independent Scotland, Scottish Government, 2013
2. Bank of England 2007 Q3 Quarterly Bulletin, p 377
3. Bank of England figures, increase in lending between 1997 and 2007.
4. Mervyn King speaking to Treasury Select Committee, 25th October 2011,.
   Available at **http://www.bbc.co.uk/news/business-15446545**
5. Adair Turner, 6th Feb 2013,
   Available at **http://www.fsa.gov.uk/static/pubs/speeches/0206-at.pdf** Greenspan, A. (2007). The Age of Turbulence - Adventures in a New World. New York: Penguin.

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