The Need of Reforming Our Monetary System

by Mark Joób

Today more and more people realize that money is more than just a neutral means for business, money actually governs business. The monetary system rules finance, which largely shapes the economy. How is the present monetary system affecting the economy and thereby society and nature, and why is it failing? I will outline the problematic aspects of our current monetary system in ten points.

1. Money is created as debt. Today, money comes into existence by debt creation when commercial banks borrow from central banks and when governments, producers or consumers borrow from commercial banks. Thus, the money supply of the economy can only be maintained if the private or public economic actors get into debt. Economic growth requires a proportionate increase in the money supply in order to avoid deflation that would paralyze business, but an increase in the quantity of money involves a simultaneous increase in debt. This way, economic actors run into danger of excessive indebtedness and bankruptcy. It is not necessary to say that overindebtedness causes serious problems to societies and individuals in the face of the ongoing debt crisis. It began as a debt crisis of private homeowners in the United States and then transformed into a debt crisis of commercial banks and insurance companies before being absorbed by national treasuries and so turned into a sovereign debt crisis. Reductions in national expenditure required to pay off public debt often lead to social unrest and are inequitable, because they impose burdens on citizens who did not profit equally from debt creation.

2. The money supply is under private control. Only a small fraction of the money circulating in public has been created by central banks. Central banks issue coins and banknotes which in most countries account for just between 5 % and 15 % of the money supply. The rest is created by commercial banks in an electronic form as account money when granting loans to customers or buying securities and goods. In fact, all money, whether cash or account money, is brought into circulation by commercial banks. Therefore, commercial banks *de facto* control the money supply. Commercial banks principally bear the credit risk for the loans they grant, which should induce them to carefully examine the creditworthiness of their customers. However, commercial banks decide which customers are granted loans and which investments are made according to their interest in maximizing their own profits. Whether an investment is socially desirable is definitively not the decisive criterion for commercial banks. This way, investments serving the common good but not being profitable enough are not supported by the banking system and have to be financed by government spending that depends on tax revenues and public debt creation. Instead of financing long-term investments in the interest of society as a whole, commercial banks with their credit business support short-term financial speculation and over the last two decades have actually established a gigantic global casino beyond any public control.

3. Bank deposits are not secure. Bank deposits refer to account money which in contrast to cash is not legal tender although it is handled as if it were legal tender. Account money is a substitute for money, just a promise from the bank to disburse the corresponding amount of money in legal tender if requested by the customer. In the present fractional reserve banking system, usually only a very small proportion of account money is backed by legal tender. Banks hold only a few percent of their deposits as cash and reserves at the central bank. That is the reason why banks are reliant on the trust of their customers. In the case of a bank run, when too many customers demand cash at the same time, they would run out of cash and such a shortage of liquidity can lead to sudden bankruptcy. Hence deposit insurance systems have been established to avoid the loss of bank deposits. In the case of chain reactions and large-scale bankruptcy as in 2008, however, government bailouts of commercial banks may be necessary, eventually with the assistance of the central bank as lender of last resort.

4. The money supply is pro-cyclical. Commercial banks grant loans by creating account money in order to maximize their interest revenues. The more money they issue, the higher their profits – as long as the debtors are able to pay. In times of economic growth, banks most willingly grant loans so as to profit from the boom, while in times of economic decline they restrict granting of credit in order to reduce their risks. This is how commercial banks induce an oversupply of money in booms and an undersupply of money in recessions, thus amplifying business cycles as well as financial market fluctuations and creating asset bubbles in real estate and commodities. Such asset bubbles may cause heavy damages to society and to the banking system itself when they burst. Again, the

2008 mortgage-triggered banking crisis after the burst of the US real estate bubble is the most illustrative example.

5. The money supply fosters inflation. Besides its pro-cyclical character in the short term, in the long term the money creation of commercial banks induces an oversupply of money that leads to consumer price inflation as well as asset price inflation. An oversupply of money arises if the increase in the quantity of the money in circulation exceeds the growth of the production of goods and services. The long-term oversupply of money results not only from traditional granting of credit to governments, corporations and individuals but also from credit-leveraged financial speculation of hedge funds and investment banks. Due to inflation, consumers usually face an annual loss of purchasing power, which means that they have to increase their nominal income in order to maintain their level of consumption. Since the ability to gain compensation for the loss of purchasing power by increasing one's nominal income varies among individuals, inflation causes a redistribution of purchasing power to the disadvantage of those individuals who are not in the position to effectively advocate for their own interests.

6. The privilege of creating money is a subsidy to the banking sector. Since money is debt, it carries interest. Therefore, interest has to be paid on all the money in circulation and virtually nobody can escape paying interest. Interest is primarily paid by customers who take loans from commercial banks and thereby ensure the money supply. Secondly, everybody who pays taxes and buys goods and services makes a contribution to the interest payment of the original borrower, because taxes have to be raised partly in order to finance the interest payments on sovereign debt. Furthermore, corporations and individuals providing goods and services must include the costs of their loans in their prices. This way, by using money, society pays an enormous subsidy to the commercial banks, though the banks pass on a part of this subsidy to their customers as interest payments on deposits. Interest is a subsidy to the banks because the account money they create is handled as legal tender. The magnitude of the subsidy society pays to the banks is reflected in the disproportionately high salaries and premiums of bankers as well as in the disproportionately large banking sector.

7. Money as debt contributes to growth pressure. Money created as debt carries interest and thereby contributes to a twofold growth pressure on the monetary system and on the real economy. When customers repay their loans to the commercial banks, the banks write off the returned amount of money and the amount of money in circulation correspondingly decreases. However, debtors need more money than they have borrowed because they also have to pay interest on their loans. Even if the debtors replace their old loans by new ones, they need additional income for interest payments and must therefore realize profits. Business on the whole cannot be profitable unless the quantity of money continuously increases. This leads to the dynamics of growth which is a core characteristic of our economic system. The increase in the quantity of interest-bearing money exerts a monetary growth pressure on the real economy and the growth of the real economy simultaneously exerts an anti-deflationary growth pressure on the money supply. As a consequence of this twofold growth pressure, our economy is a kind of Ponzi scheme, since it cannot work properly without growing and therefore repeatedly falls into crises. Furthermore, the growth of the real economy, which is to a great extent forced by the monetary system, involves an excessive exploitation of natural resources and is a hindrance to sustainable development. Financial indebtedness thus leads to ecological indebtedness towards nature, which impoverishes mankind. Our current monetary system is just not compatible with a finite world.

8. Interest fosters wealth concentration. Interest is commonly seen as a lending charge for using the money of someone else. Not only the customers who borrow money from banks but also the banks which hold customer deposits pay interest. When commercial banks create money by granting loans, they credit customer accounts and thereby expand the total of bank deposits. Since accounts usually carry interest, the banks spend a part of their interest revenues for interest payments to the account holders. Now, bank deposits and loans are not equally distributed among the customers. Some have mainly loans on which they pay interest whereas others mainly have deposits on which they earn interest. Because in general poorer people have more loans than deposits and richer people have more deposits than loans, interest payments are in total a transfer of money from the poorer to the richer people, especially to the few super-rich. Interest thus fosters wealth concentration. This concentration of wealth favours to a great extent the commercial banks which both make investments themselves and also earn the amount resulting from the considerable interest spread between borrowing and lending rates. Moreover, interest is added regularly to the initial investment and thus carries interest itself turning into compound interest and generating an exponential growth of monetary assets. However, monetary assets do not grow in value by themselves since they are per se not productive. Value-increasing interest on monetary assets can only be generated through human labour; and human labour is permanently under monetary pressure to increase its productivity and lower its costs so as to satisfy the demands of exponentially growing compound interest. Interest is therefore a value transfer that favours capital investments to the disadvantage of labour income.

9. The monetary system is unstable. There is clear empirical evidence showing that the monetary system suffers from structural instability arising from the mechanisms described above. The financial crisis that started in 2008 and is still continuing, if not even worsening, is not a unique phenomenon. In the last decades, numerous crises related to the monetary system occurred around the world. Between 1970 and 2010 a total of 425 financial crises affecting member states of the International Monetary Fund was officially recorded: 145 banking crises, 208 monetary crashes and 72 sovereign-debt crises.[1] The multitude of financial crises and their contagious effect on different national economies plainly demonstrate their structural-systemic character. The present monetary system inevitably evokes crises in finance and consequently in the real economy.

10. The monetary system violates ethical values. An ethical value is something that is seen as valuable from a general perspective after careful consideration. Ethical values embody the most rational and most important values of society. Hence, society is badly arranged if its monetary values are in an indissoluble conflict with its ethical values and these ethical values are permanently suppressed because of monetary values. Since the monetary system largely shapes the economy and the economy broadly forms society, ethical values not contributing to the profitability of capital are systematically neglected in today's policy making. This way, our current monetary system violates ethical values such as stability, justice and sustainability – values that are essential for a liveable society. A monetary system that violates these values is quite unreasonable and should be reformed as soon as possible.

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[1] See: Lietaer, Bernard et al. *Money and Sustainability. The Missing Link.* Axminster: Triarchy Press, 2012.