

Sustainable Money for a Sustainable Economy

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The reason our financial system has routinely gotten into trouble, with periodic waves of depression like the one we're battling now, may be due to a flawed perception not just of the roles of banking and credit but of the nature of money itself. In our economic adolescence, we have regarded money as a "thing"—something independent of the relationship it facilitates. But today there is no gold or silver backing our money. Instead, nearly all money is [created by banks](#) when they make loans. Money originates simply as credit or debt, a legal agreement to pay in the future.

Money as Relationship

In an illuminating dissertation called "[Toward a General Theory of Credit and Money](#)" in [The Review of Austrian Economics](#) (vol. 14:4, pages 267-317, 2001), Mostafa Moini, Professor of Economics at Oklahoma City University, argues that money has *never* actually been a "commodity" or "thing." It has *always* been merely a "relation," a legal agreement, a credit/debit arrangement, an acknowledgment of a debt owed and a promise to repay.

Contrary to popular belief, money did not begin with gold coins and evolve into a sophisticated accounting system. It began as an accounting system and evolved into the use of precious metal coins. Money as a "unit of account" (a tally of sums paid and owed) predated money as a "store of value" (a "commodity" or "thing") by two millennia. The Sumerian and Egyptian civilizations using these accounting-entry payment systems lasted not just hundreds of years (as with some civilizations using gold) but thousands of years. Their bank-like ancient payment systems were *public* systems—operated by the government the way that courts, libraries and post offices are operated as public services today.

In the payment system of ancient Sumeria, goods were given a value in terms of weight and were measured in these units against each other. The unit of weight was the "shekel," something that was not originally a coin but was a standardized measure. *She* was the word for barley, suggesting the original unit of measure was a weight of grain. This was valued against other commodities by weight: So many shekels of wheat equaled so many cows equaled so many shekels of silver, etc. Prices of major commodities were fixed by the government. Hammurabi, Babylonian king and lawmaker, has detailed tables of them. Interest was also fixed and invariable, making economic life predictable.

Grain was stored in granaries, which served as a form of “bank.” But grain was perishable, so silver eventually became the standard tally representing sums owed. A farmer could go to market and exchange his perishable goods for a weight of silver, and come back at his leisure to redeem this market credit in other goods as needed. But it was still simply a tally of a debt owed, and a right to make good on it later. Later there were wooden tallies, then paper tallies, then electronic tallies.

The Credit Revolution

The problem with gold coins was that they could not expand to meet the needs of trade. The revolutionary advance of medieval bankers was that they succeeded in creating a flexible money supply, one that could keep pace with a vigorously expanding mercantile trade. They did this through the use of credit, something they created by allowing overdrafts in the accounts of their depositors. Under what came to be called “fractional reserve” banking, the bankers would issue paper receipts called banknotes for more gold than they actually had. Their shipping clients would sail away with their wares and return with silver or gold, settling accounts and allowing the bankers’ books to balance.

The credit thus created was in high demand in the rapidly expanding economy; but because it was based on the presumption that money was a “thing” (gold), the bankers had to engage in a shell game that periodically got them into trouble. They were gambling that their customers would not all come for their gold at the same time; but when they miscalculated, or when people got suspicious for some reason, there would be a run on the banks, the financial system would collapse, and the economy would sink into depression.

Paper money is no longer redeemable in gold; but money is still perceived to be a “thing,” something that has to “be there” before credit can be advanced. Banks engage in money creation by advancing bank credit, which becomes a deposit in the borrower’s account, which becomes checkbook money. But in order for their outgoing checks to clear, the banks have to borrow from a pool of money deposited by their customers; and if they don’t have enough deposits, they have to borrow from the money market or other banks.

Today, they can get this money very cheaply. U.S. banks can borrow from each other at the Fed Funds rate of 0.25%, and European banks can borrow from the European Central Bank at 1%. Meanwhile, Euroland governments have been forced to borrow on the open market at exorbitant rates (for Greece it was over 30% last March), an unsustainable situation.

British author [Ann Pettifor](#), fellow of the New Economics Foundation in London, writes:

[T]he banking system . . . has failed in its primary purpose: to act as a machine for

lending into the real economy. Instead the banking system has been turned on its head, and become a borrowing machine.

The banks suck up cheap money and return it as more expensive money, if they return it at all. The banks control the money spigots and can deny credit to small players, who wind up defaulting on their loans, allowing the big players with access to cheap credit to buy up the underlying assets very cheaply.

That's one systemic flaw in the current scheme. Another is that the borrowed money backing the banks' loans usually comes from shorter-term loans. Like Jimmy Stewart's beleaguered savings and loan in the popular movie *It's a Wonderful Life*, the banks are "borrowing short to lend long," and if the money market suddenly dries up, the banks will be in trouble. That is what happened in September 2008: According to Rep. Paul Kanjorski, speaking on C-Span in February 2009, there was a [\\$550 billion run](#) on the money markets.

Securitization: "Monetizing" Loans Not with Gold But with Homes

The money markets are part of the "shadow banking system" where large institutional investors park their funds. The shadow banking system allows banks to get around the capital and reserve requirements now imposed on depository institutions, by moving loans off their books. Large institutional investors use the shadow banking system because the conventional banking system guarantees deposits only up to \$250,000, and large institutional investors have much more than that to move around on a daily basis.

The money market is very liquid, and what protects it in place of FDIC insurance is that it is "securitized," or backed by securities of some sort. Often, the collateral consists of mortgage-backed securities (MBS), the securitized units into which American real estate has been sliced and packaged, sausage-fashion.

As with the gold that was lent many times over in the 17th century, the same home may be pledged as "security" for [several different investor groups](#) at the same time. In the U.S., this is all done behind an electronic curtain called MERS (an acronym for Mortgage Electronic Registration Systems, Inc.), which has allowed houses to be shuffled around among multiple, rapidly changing owners while circumventing local recording laws.

As in the 17th century, however, the scheme has run into trouble when more than one investor group has tried to foreclose at the same time. And the securitization model has now crashed against the hard rock of hundreds of years of state real estate law, which has certain requirements that the banks have not met—and cannot meet, if they are to comply with the tax laws for mortgage-backed securities. (For more on this, see [here](#).)

The bankers have engaged in what amounts to a massive fraud, not necessarily because they started out with criminal intent (although that cannot be ruled out), but because they have been required to in order to come up with the commodities (in this case real estate) to back their loans. It is the way our system is set up: The banks are not really creating credit and advancing it to us, counting on our future productivity to pay it off, the way they once did under the deceptive but functional façade of fractional reserve lending. Instead, they are vacuuming up our money and lending it back to us at higher rates. In the shadow banking system, they are sucking up our real estate and using it as the “pawns” in the pawnshop of the shadow banking system. The result is a mathematically impossible pyramid scheme, which is inherently prone to systemic failure.

The Public Credit Solution

The flaws in the current scheme are now being exposed in the major media, and it may well be coming down. The question then is what to replace it with. What is the next logical phase in our economic evolution?

We need to acknowledge that “money” is merely “credit”—and that we as a community can create *our own* credit, without having to engage in the sort of impossible pyramid scheme in which we’re always borrowing from Peter to pay Paul at compound interest. We can avoid the pitfalls of privately-issued credit with a *public* credit system, a system banking on the future productivity of its members, guaranteed not by “things” (gold, oil, houses) that are shuffled around furtively in a shell game vulnerable to exposure, but by the community itself.

The simplest public credit model is the electronic community currency system. The participating Internet community does not have to begin with a fund of capital or reserves, as is now required of private banking institutions; nor do members need to borrow from a pool of pre-existing money on which they pay interest to the pool’s owners. They create their own credit, simply by debiting their own accounts and crediting someone else’s. If Jane bakes cookies for Sue, Sue credits Jane’s account with 5 community currency units and debits her own by 5. They have “created” money in the same way that banks do, but the result is not inflationary. Jane’s plus-5 is balanced against Sue’s minus-5, and when Sue pays her debt by doing something for someone else, it all nets out. It is a zero-sum game.

Community currency systems can be very functional on a small scale, but because they do not trade in the national currency, they tend to be too limited for large-scale businesses and projects. If they were to grow substantially larger, however, they could run up against the sort of exchange rate problems afflicting small countries.

There is a way, however, that the functional equivalent of this community system can be achieved using the national currency. That is by forming a network of publicly owned banks.

By turning banking into a public utility operated for the benefit of the community, the virtues of the expandable credit system of the medieval bankers can be retained, while avoiding the parasitic exploitation to which private banking schemes are prone. Profits generated by the community can be returned to the community. Rather than feeding off the economy, the bank feeds the economy, recycling local credit back into the local community.

A public bank that generates credit in the national currency could be established by a community or group of any size. But as long as we have capital and reserve requirements and other stringent banking laws, states, counties and cities are the most feasible option, since they can most easily meet those requirements without jeopardizing the solvency of their collective owners.

For precedent, the U.S. has the [Bank of North Dakota](#), the country's only state-owned depository bank. Its performance has been stellar, and North Dakota is the only state to have escaped the recent credit crisis.

Internationally, there is also substantial precedent. [Forty percent of banks globally](#) are publicly-owned. These are largely in the BRIC countries—Brazil, Russia, India, and China—which contain nearly 40% of the global population. Like North Dakota, they have generally escaped the global credit crisis and have been the [main locus of world economic growth](#) in the last decade.

The Global Clearing House: Back to Keynes?

If trade can be conducted at the local and national levels simply with credits and debits, then why not at the international level? Today the dominant global reserve currency is the U.S. dollar, essentially backed by guns and oil; but even the world's strongest military is having trouble maintaining the scheme.

Before 1971, international trade balances were cleared interchangeably with U.S. dollars and gold. The dollars were considered “as good as gold” because the U.S. had agreed to redeem them for gold on demand. But the Vietnam War drove the country heavily into debt, and French President Charles DeGaulle, seeing that the United States was spending far more than it had in gold reserves, cashed in 300 million of France's U.S. dollars for gold, seriously depleting U.S. gold reserves. In 1969, the IMF attempted to supplement this shortage by creating “Special Drawing Rights,” which were credits drawn on the IMF; but in 1971, the British followed the French and tried to cash in their gold-backed U.S. dollars for gold. The sum was fully one-third the gold reserves of the United States, forcing President Nixon to renege on the gold deal and close the “gold window” permanently.

As a result, the dollar dropped precipitously in international markets. According to William Engdahl in his 2009 book [The Gods of Money](#) (pages 265-273), a group of powerful financiers and politicians then met secretly in Sweden in 1973 and discussed an arrangement that would effectively “back” the dollar with oil. In 1974, the price of oil quadrupled, following an oil embargo along with a clandestine agreement between Henry Kissinger and the Shah of Iran. In 1975, an arrangement was finalized in which, in return for military protection and an engineered boost in oil prices, the oil-producing countries of OPEC would sell their oil only in U.S. dollars. The dollars would wind up in Wall Street and London banks and would fund the burgeoning U.S. debt. The upshot was that countries without sufficient dollar reserves had to borrow from Wall Street and London banks to buy the oil they needed.

Despite massive military backing, however, this arrangement is now collapsing; and it has been disastrous for the U.S. trade balance. As John Maynard Keynes warned in 1944, any country undertaking to provide the reserve currency for the world would wind up with unsustainable trade imbalances (a problem later called “Triffin’s dilemma”).

A number of authorities have proposed returning to the Keynesian solution or some variant of it, including Joseph Stiglitz, George Soros, and the Chinese—who now seem to have enough leverage to get their way. At Bretton Woods in 1944, [Keynes proposed](#) that rather than clearing trade balances with gold or a particular national currency, they should be run through a global bank. He called it the International Clearing Union. The bank would issue its own unit of account, called the “bancor.” It would not be a commercial currency but would just be a reference unit for keeping track of debits and credits between nations, a yardstick for measuring a country's trade deficit or surplus.

The bancor was not a “one world currency” threatening the financial sovereignty of nations. It differed from the SDR, the U.S. dollar, the Euro and gold, in that it was not a store of value and was not a medium of exchange. It was merely a unit of account, a reference unit like inches or pounds for comparing the value of different currencies.

In the plan proposed by Keynes, every country would have an overdraft facility in its bancor account at the International Clearing Union, equivalent to half the average value of its trade over a five-year period. To keep countries from abusing this facility, any country racking up a large trade deficit (equal to more than half of its bancor overdraft allowance) would be charged interest and other penalties; and so would any country with a bancor credit balance that was more than half the size of its overdraft facility. If its credit balance exceeded the total value of its permitted overdraft by the end of the year, the surplus would be confiscated. The nations with a surplus would thus have a powerful incentive to get rid of it, and in the process would automatically clear other nations' deficits.

For valuing the currency reference unit, various alternatives have been proposed. Keynes' idea was that the bancor would be calculated as the value of a basket of 30 commodities. But in Occupy Wall Street: A Global Roadmap for Radical Economic and Political Reform (2012), Ross Jackson suggests that a basket of 25 major currencies would be more stable. Commodity prices can and often do all move in the same direction. Currencies, on the other hand, cannot all fall at the same time.

In Jackson's proposal, interest would be charged on debit balances, but no interest would be paid on credit balances. Penalties would also be charged for exceeding certain trade parameters in either direction. Funds from the interest and penalties would create an income stream to finance climate mitigation, ecosystem restoration, and so on.

There are a number of other interesting proposals for valuing a currency unit, including the consumer price index and the use of energy as the fundamental measure of price, cost and value (the proposal featured in this conference).

Money as Credit

Whatever the unit chosen, the point stressed here is that money today is not a commodity but a relationship, a series of legal agreements that are secured by no more and no less than the full faith and credit of the people and their governments. Money is simply credit, a monetization of the borrower's promise to repay. When the lender is a bank, when the bank is owned by the community, and when the profits return to the community, the extension of credit need not be backed by commodities or capital or loans of other people's money. The borrower, not the lender, backs the loan, either with collateral or with future income or with projected productivity.

Credit is the bloodstream of the economy, carrying nutrients to the organs and cells. Like highways, water and electricity, it needs to flow freely for the economy to work efficiently. When banking is made a public utility, the result can be a functional, efficient, and sustainable system of finance.

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