

# **The confusing world of modern monetary theory.**

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## **Abstract**

This paper explores some of the confusions and contradictions within modern monetary theory. After providing an overview of the main themes/ participants within the field the paper will concentrate on two broad views of the issue and circulation of money. These are a bank dominated system built on debt-credit and a fiat system based on state issued money. These can be seen as two distinct money circuits (state issue/tax reflux or debt issue/repayment) or as interwoven circuits as in Keynesianism. This distinction/ relationship throws up its own confusions – which form of money circuit is dominant? Has one emerged from the other or undermined the other – for example has the dominance in contemporary economies of money issue through bank debt eclipsed state direct money issue? Is there still such a thing as high powered money or has the banking system broken free as a privatised forum of money issue? How relevant is the distinction between endogenous and exogenous money in this context? What does the recent financial crisis tell us about these questions? The paper explores contrasting proposals that have been put forward for monetary reform and suggests a way forward that sees money as a public resource. This paper builds on a number of previous publications including The Future of Money (Pluto 2010).

## **Introduction**

My interest in modern monetary theory is political as much as theoretical. I want to see a change in the social order that creates an ecologically sustainable and socially just economy. I want to know if modern monetary theory (MMT) can help me with that.

The threads of modern monetary theory are complex and contradictory. One of the most important is to see money as important in economic analysis as against the idea of money as a neutral veil representing the 'real' economy. It is not without note that Marx's *Capital* opens with a discussion of money (I have discussed Marx's view of money elsewhere 2002, 2005). Keynes also put money at the centre of his analysis. Another major thread is the rejection of the commodity theory of monetary history, the barter to metal, gold to paper history of money and banking. Major figures in this regard were Georg Knapp and A Mitchell Innes.

Georg Knapp set out his state theory of money in the early 1900s (1924). He rejected the commodity theory of money in favour of a view of all money as a chartal or token (chartal comes from the Latin for token). Central to Knapp's ideas was a link between the issue and circulation of this token money and state taxation. For Knapp, money historically did not emerge from the market, but was created by a monetary authority. The money was then used by the state to pay for goods and services, rather than demanding goods and services in kind. The question then arises why should people give up their crops and labour for mere tokens? The answer lies in taxation. The state demands its tokens back from all its citizens. This requires people to obtain those tokens either directly from the state in payment for services or through extra-governmental trade. Taxation and money/token issue are inextricably linked. The state demands taxes which have to be paid in the money it has already issued and spent.

The rejection of the commodity view of money in favour of a more social/institutional view was presented in the carefully researched work on the history of coinage by Innes (1913, 1914). He pointed out that although coins have historically been associated with precious metal such as silver and gold, the amount of precious metal they contained has varied widely over time. So much so, that rarely has the nominal value of coins been the same as the value of the metal of which they are made (Innes 1913/2004). Given the varying amount of precious metal in coins, the only guarantee of the worth of the coin was the face or signature of the issuer, basically the authority behind the minting. Far from being a precious commodity that had emerged as money through the process of trading as the barter theorists thought, money as coin had generally been issued by fiat, that is, issued and guaranteed by an authority, such as a powerful leader, an office-holder or a religious organisation. In fact, as Davies has argued, when coins were too closely associated with scarce precious metal, economic activities became restricted. Economies flourished where coins were plentiful and/or debased (Davies 2002:646-7).

In his discussion of money Keynes appears to start from the perspective of chartalism, opening his discussion with the statement that 'today all civilised money...is chartalist' (Keynes 1971:4). He also follows Knapp's view of the role of the state: "Knapp's chartalism...the doctrine that money is peculiarly a creation of the state- is fully realised' (1971:4). It is the state which enforces contracts and the nature of the things that stand as money and Keynes argued that this had been the case for four thousand years. Unlike the commodity theorists who see money as a medium of exchange that emerges out of barter, Keynes is quite clear that money as an accounting mechanism is much more important than the role of money as a medium. A 'money of account' must precede a 'money of payment' as debt and prices must come before the medium of payment (Keynes 1971:3). However he still retains a key notion of the tangibility of money in the 'thing' that answers to the money of account. This leads to a confusion in his account of 'money proper'. While 'money proper...can only exist in relation to a money of account' (Keynes 1971:3), it is only 'money proper' that can finally discharge a debt. For Keynes state money is 'money proper' (1971:5). This contrasts with bank money an

issue that will be discussed later. Confusingly, state money also seems to include non-state forms:

‘ I propose to include as State money not only money which is itself compulsory legal tender but also money which the State or the central bank undertakes to accept in payments to itself or to exchange for compulsory legal-tender money’ (Keynes 1971:6).

Keynes also seems to embrace a commodity view of money. He sees two broad forms of money: commodity and representative, with the latter represented either as fiat (having no convertible base or rooted ‘objective standard’) or managed where it is related to some ‘objective standard’. The use of terms such as representative and ‘objective standard’ indicates that Keynes thought there was, or should be, some concrete base to money where ‘commodity money and managed money are ...related to an objective standard of value’ (1971:7). Keynes sees managed money as a hybrid between a commodity money and fiat money. It is the most common form of modern money ‘ the most generalised form of money’ (1971:7). Fiat money is when the objective standard is abandoned:

‘chartalism begins when the State designates the objective standard for the money of account.. representative money begins when money is no longer composed of the objective standard’ (Keynes 1971:10).

Keynes sees the Bank Act of 1844 as cementing the role of managed representative money. In seeing representative money as a modern phenomenon Keynes has to ‘leave aside’ ancient Chinese paper money or the John Law epoch (Keynes 1971:13). This leads to one of the most confusing thing about MMT. Is modern monetary theory about modern money as Keynes seems to suggest, or is it a modern theory about the ahistorical nature of money?

In this paper I will look at two distinct approaches in modern monetary theory: exponents of state fiat money as the basis of money systems and money circuit theorists who stress the role of banks as issuers of credit-money. I will then go on to look at contrasting proposals for monetary reform before drawing some conclusions that may help to clarify some of the confusions that arise from the overlapping and contradictory views presented.

## **State Theories of Money**

The key elements for the first group are a fiat view of money with the government (or a universal monetary authority of some sort) responsible for money issue and circulation. Knapp, Innes and Keynes are strong influences but so is Abba Lerner’s work in the 1940s on ‘functional finance’ stressing the need for the state to take an active financial role in supporting real economic performance (1943). Exponents of the state approach argue that the monetary/fiscal circuit has been misunderstood. Far from taxes being raised

to pay for public expenditure the money circuit is entirely the other way around. Governments create money through public expenditure that is credited to private/business bank accounts. This increases the overall money in circulation. When the government imposes taxes it withdraws money by taking money from bank accounts. Taxation is not imposed to raise money to spend, but to remove money that would be inflationary if left in circulation. Given the state's ability to create or withdraw money there should be no problem with the stock of money in the economy, flow is the problem, too much or too little. The state can also use its money creating capacity to sustain the economy directly such as building infrastructure or acting as employer of last resort (Wray 2009).

As Warren Mosler argues, there is, in practice, no direct link between state expenditure and taxation. They are two separate mechanisms linked by accounting systems. Tax is not paid into a 'fund' that the state draws upon. There is no treasury 'store' of money. Mosler identifies what he sees as the 'seven deadly innocent frauds' of economic policy (2010). He takes his title from John Kenneth Galbraith's last book 'The Economics of Innocent Fraud'. The idea of innocence here is important. There is a tendency within MMT (particularly among the monetary reformers) to see an intention, even a conspiracy, at work in the banking system. In particular, fractional reserve banking tends to be seen as a fraud perpetrated upon an innocent public whereby huge amounts of bank credit are issued with very little 'real' money in reserve. This view depends on a view that there are (at least) two types of money that will be discussed below.

For Warren, the first 'error' is to see the state as being like a household having to 'live within its means'. This might be true of a local or regional state, but any state that is responsible for issuing its own money supply and able to float its currency against others cannot be insolvent within its own monetary boundaries. Most of the other frauds stem from the first mistake of ignoring the state as an issuer of money. Deficits do not 'burden' our children and grandchildren as we owe them to nobody but ourselves. Nor do deficits destroy savings, in fact without deficit (excess government issue/expenditure of money over taxation) there would be no money to save. As a money issuer the state can also easily deal with the costs of pensions and health care. Any money it issues goes straight to the bank accounts of the public and there provides the basis for investment and savings unless removed again through taxation, charging for state services or the issue of government bonds. Even international debt is not a problem if it is designated in the national currency. For example, American dollars held by the Chinese can only be used within the dollar ambit. Much of Mosler's analysis rests on the idea that all money is merely accounting, crediting and debiting accounts, and the idea of 'hard' money or even cash is an irrelevance. As James Galbraith says in his introduction to Mosler's book 'modern money is a spreadsheet' (2010:2).

While Mosler stresses the role of the state as a source of money supply, he sees this as beneficial for a strong private market. While the 'functions of the government are those that best serve the community by being done collectively' (with a high priority to the military!) he wants low taxes so that

people have plenty of money to spend privately (2010:99). Banks should be provided with unlimited liquidity and insurance, but be subject to strict regulation on what they do with the money (2010:102). He argues that with the government directly supporting banks and fully backing mortgage agencies, there would be no need for an interbank money market or a secondary market in credit. Nor should the state need to borrow, why then is there a public debt? Partly this is ideological with the analogy of a state as household money earner-spender rather than as a money issuer. The state is not politically 'allowed' to issue new money. More important according to Mosler, is the need for banks and other institutions to have somewhere to lodge their 'spare' money, and where better than re-investing in their own local source of money, the state. Holding bank reserves as 'cash' earns no income, holding bank reserves as 'treasuries' or 'gilts' provides a secure income. To eliminate the national debt would remove an important avenue of safe savings. However this is mainly a source of benefit to the already wealthy who can directly or indirectly 'buy' the debt. As Mosler points out, issuing new money as direct public expenditure would be more socially just.

The link between state expenditure and money supply is central to the state theory of money. As Mosler points out, US government surplus in the Clinton years was mirrored by the public's need to access money as debt, whereas in 2009 savings were back at 5%, the highest since 1995, which was, in turn, mirrored by a federal deficit of 5%. As Wray argues, 'if government emits more in its payments than it redeems in taxes, currency is accumulated by the non-government sector as financial wealth' (2011:7). State theorists of money challenge what Nersisyan and Wray call 'deficit hysteria' (2010). They point out that all US governments have accrued debt except for 1835 when Jackson's government eliminated the national debt. This was followed by a deep recession in 1837 (2010:116). The hysteria about government deficits, they argue, is due to a flawed understanding about how the monetary system works. In particular, they reiterate Mosler's point that no government that issues its own money and has floating exchange rates can become insolvent. It can always meet all its debts and obligations. Deficits are not a problem, in fact a deficit is necessary, more money must always be issued than is reclaimed otherwise there would be no money in the system. Mosler points to the fact that in 1997-2001 the US had the largest and longest government surplus since 1927-1930. He goes on to note that most periods of government surplus have been followed by recession. For the UK, Victoria Chick and Ann Pettifor found a similar pattern. They conclude that apart from the two world wars 'there is a very strong negative association between public expenditure and the public debt ... as public expenditure increases, public debt falls and vice versa' (2010:2)

While advocates of the state theory of money focus upon the role of the state as a monetary authority with the capacity to issue its national tender by fiat, the next group of theorists see the banking system as playing a more central role in money issue and circulation.

## Money Circuit Theorists

Money circuit theorists take an endogenous, horizontal, view of the monetary circuit with banks playing a central role. Like the state money theorists, they reject totally the commodity view of money with its exogenous imposition of financial discipline by a 'natural' money such as gold. They also reject the Keynesian and monetarist notion that governments can control or influence money systems. In particular they reject the role of the 'money multiplier' led by state control of central bank reserves. Against the state theory of money they stress the importance of bank-issued money through the credit-debt system of money flow. As Rossi argues 'Contrary to what the advocates of chartalism claim, taxation powers, fiscal policy and government are not necessary conditions to account for, and to explain, the origins, nature and value of money' (2007:20).

For Rossi, money is 'a creature' of banks, rather than the state (2007:21). Money is issued by banks as demanded by the commercial and productive economy. The link between money as credit and production is central such that bank credit is issued when producers borrow money in order to launch the circuit of production. For Rossi 'Money's value is based ...on production and banking systems working together to associate a real object (that is, produced output) to a numerical counter (money)' (2007:20). Without production 'financial markets would be meaningless' (Rossi 2007:34). The new money issued pays the cost of production this is then repaid in the process of exchange and consumption, and the circle turns again. In money circuit theory the banking system is seen as the 'third partner' in commodity exchange. Banks agree to honour a trader's debt to their creditor pending later payment to the bank by the debtor. The person who had made the sale need no longer wait for the purchaser to complete the next stage of the trade (i.e. sell on the good), or raise funds to repay the debt. The bank would issue credit immediately and collect the payment later extracting a fee on the way.

According to money circuit theory there should be no need to have exogenous, vertical management of the money system as any issue of new credit would always be accompanied by new production and consumption. This endogenous view of the emergence of (capitalist) money in commercial trade arguably has more in common with conventional economic theory than with the state money theorists. However money circuit theorists reject the conventional fractional reserve/money multiplier view of the issue of bank money. Instead of top down monetary discipline via the central banks, money circuit theorists argue that banks drive the demand for central bank reserves. The central bank moves to support the level of borrowing demanded rather than controlling it (Keen 2001:303). As Lavoie points out 'lending officers do not make their lending decisions after checking the reserve position of their bank at the central bank' (2010:17).

Money circuit theorists also forcefully reject the conventional notion that bank deposits create the basis for loans. Loans must precede deposits as 'loans can never be financed by some pre-existing deposits' (Parguez and

Seccareccia 2000:106-7). Keynes agrees, 'far from actively created deposits being the offspring of the passively created deposits it is the other way round' (1971:22). This is because only credit can start the monetary circuit and the basis of the flexibility of bank issued money is that it is independent of deposits: 'This *creation* of credit-money by lending in the form of issued notes and bills, which exist independently of any particular level of incoming deposits, is the critical development that Schumpeter and others identified as the *differentia specifica* of capitalism' (Ingham 2004:115). For Smithin, 'credit creation is the actual business of banking' (2009:66). Even writing in 1930 Keynes acknowledged that bank money formed around nine-tenths of current usage at that time (1971:27).

For Smithin, money is a social relation that makes possible 'both market exchange and the more extensive set of relationships known as capitalism' (Smithin 2009:59). For Ingham, 'the essence of capitalism lies in the elastic creation of money by means of readily transferable debt' (2004:108). For full elasticity of credit to be available it is necessary that bank money creation has no artificial limits such as the need to match loans to deposits. Far from money representing prior market activities as the barter theorists claimed, it is the prior issuing of bank credit that is essential to bringing profit-seeking activities into being. If debt creation ceases it is disastrous for capitalist economies as the credit crunch that finally triggered the 2007-8 financial crisis showed. Endogenous credit creation proved to be as unstable as Minsky had predicted (Nesvetailova 2007). Minsky argued that the credit-driven financial system goes in destructive cycles as a productive circuit of money gives way to a speculative wave and crash.

Steve Keen has taken a particular interest in the current crisis of indebtedness and argues that the position today is much worse than in the 1930s as countries like the USA and Australia went into the recession at a higher level of private indebtedness. He totally rejects the monetarist notion of poor financial regulation by the authorities as 'the real cause of Depression-scale financial crises is excessive private debt accumulated during a preceding speculative bubble' ((2009a:3). On his Debtwatch blog [www.debtdeflation.com/blogs](http://www.debtdeflation.com/blogs) he berates 'the roving cavaliers of credit' as identified by Marx (Debtwatch No 31 February 2009b). As Toporowski points out, Marx saw problems inherent in capitalism's reliance on bank credit, where the continuity of the reproduction process rests upon credit and the revenue generated may not be sufficient to repay the advance (2010: 4-5). Despite this, there is no extensive left analysis of the capitalist banking system. As Smithin argues, 'Marxian theory does not deal at all adequately with the role of the banking system and credit creation' (2009:12). The political debate about reform of the monetary system has been left to a disparate group of monetary reformers who largely work outside of formal academic or political institutions.

## Monetary Reformers

Monetary reformers fall into broadly two groups who share a common critique of the modern monetary and banking system but make very different proposals for reform. One group leans very much towards the state (or public) (re) capture of money issue while the other advocates a radical market approach to money.

Unlike the money circuit theorists who see banks as functional intermediaries in trading systems, monetary reformers (particularly from the market group) tend to recount the 'goldsmith's story' (there are several versions of this on the web). The story recounts how people left their gold for safe keeping with goldsmiths who then issued paper to represent the gold. When the goldsmiths found that people didn't come back for the actual gold they lent paper against the gold over and over again, in increasing volume, making more profit each time. This led to the widespread development of fractional reserve banking in modern banking systems. The fractional reserve notion implies that there are two types of money, the 'real' money that is a deposit/reserve that is backed in some way and bank issued money as credit which is not. Banks are seen as creating a vast mountain of 'credit money' on a very small reserve of 'real' money. They are 'lending money they haven't got'. Rather than seeing banking as a service to capitalism as the money circuit theorists do, it is represented as a fraud against the depositors, even in some more extreme approaches, as a conspiracy of greedy and dishonest bankers.

One of the recent cheer-leaders of the market approach to monetary reform is the Spanish Professor of Political Economy, Jesus Huerta de Soto. He sees the origin of boom and busts in 'artificial credit expansions' in the banking system as against 'the prior or genuine savings of citizens'. He sees the banks as issuing 'huge doses of fiduciary media' based on the limited 'gold originally deposited in their vaults' (2010:2). This distorts the 'real productive structure' of the 'spontaneous.. unhampered free market' which otherwise would 'correctly invest all funds previously saved by economic agents' (2010:5). 'Prior, genuine, real savings' should be the only basis for investment as this restricts consumption of existing production to leave space for new 'spontaneous' businesses to emerge (2010:8). De Soto puts the blame for the financial crisis squarely on the credit bubble 'orchestrated and directed by Central Banks', pointing out that in recent years money supply has been growing at an average rate of ten per cent a year (2010:15). As there was no concurrent increase in the price of consumer goods and services this level of money expansion was largely ignored. Personal debt and collapsed savings avoided the 'necessary sacrifice and discipline...of voluntary saving' (2010:16). He critiques the 'mark to market' accounting systems that pro-cyclically drive both booms and busts (2010:20), but is adamant that the 'spontaneous order of the unhampered market is not responsible' (2010:21).

For de Soto, the financial system is not a 'spontaneous' market because of legal tender rules. He agrees with the state/public approach to monetary reform that the administration of national currency supply has been handed as

a 'legal privilege given by the state to private bankers' (2010:22). National tender is a form of 'real socialism' for de Soto as he sees it as the nationalisation of previously private money (2010:21-2). Central banks have been created 'precisely to bail out banks' and create liquidity at points of crisis (2010:4). His solution is to return total control of money to the private sector by freezing the money supply at its current level, shrinking the state, 'freeing' the labour market and thus (he assumes) liberating money for 'real' investment. Demand deposits would become mere storage and banks would return to being intermediaries between savers and borrowers (something with which other monetary reformers would agree). The question then becomes whether there should be any source of money supply and on what basis. De Soto's prescription is predictable, 'full privatization of the current, monopolistic, and fiduciary state-issued paper base money, and its replacement with a classic pure gold standard' (2010:30). As a transition he advocates the printing of new bank notes to match all current deposit accounts which would be handed to the banks to 'back' sight deposits. All the existing assets of the banks would be used at market value to 'liberate' treasury bonds. Thus would the utopian Hayekian year zero private money regime be created with all current inequalities frozen in time.

The main difference between the market and other groups of monetary reformers is that the market analysis rests on a commodity theory of the intrinsic value of precious metals as the historical basis of the money system rather than a state/credit-debt/token analysis. They have a much more 'natural' view of money while more socially oriented reformers look for a democratic and social basis for money issue and circulation. As Cook points out, within the monetary reform movement there is a 'raging controversy' over whether to advocate a return to a gold standard (2007).

The question at issue for the more socially oriented group of monetary reformers is the role of debt in bank money issue. This is contrasted to the state issue of money free of debt at the point of issue. One of their main concerns is that state issued money (as notes and coin) has shrunk to around 3% of money issue in a country like Britain leaving bank credit money as the only effective source of new money. They seek to reverse what they see as the historical trend from state issue to bank issue. To reverse this trend, money issue must be removed from the banking sector and made the focus of democratic decision-making as to its issue and allocation (Douthwaite 1999, Huber and Robertson 1999, Robertson and Bunzl 2003). This can be done in various ways. National money should be returned to state issue. This would enable the state to exercise 'seigniorage' that is, get the benefit of first use of the money issued for public, hopefully social and environmental, priorities. Many social and environmental campaigners also link money issue with a commitment to local production and exchange with experiments in issuing their own local currencies (North 2007).

Early campaigners for monetary reform tended to focus on the distributional aspect of a bank dominated monetary system while later campaigners were particularly concerned with the environmental impact of debt-based money issue (Hutchinson, Mellor and Olsen 2002). In relation to distribution, banks

are seen as issuing credit for private benefit when it should be issued by right to the wider public. The green concern is that when most money is issued as bank debt, growth becomes endemic to the system. More money must constantly be borrowed to make repayments with interest, entailing destructive pressure for continuing growth and expansion in the economy (Douthwaite 2000:30, Scott Cato 2009:38). Ecofeminists are also concerned that a gendered, debt driven economy can never be the basis of a sustainable provisioning economy (Hutchinson, Mellor and Olsen 2002, Mellor 2010a, 2010b). The case for socially oriented monetary reform in the UK has been supported by organisations such as the New Economics Foundation.

### **What is modern about modern monetary theory?**

Modern monetary theory can be seen as making a statement about the nature of the contemporary money system, that it is modern as opposed to historical (in which case how and why has it evolved this way?) or implying that more modern theories have replaced previous flawed theory. Monetary reformers tend to take the approach that state money/real money has been replaced by bank issued money. For the state/public group the critical difference is that state money issue is debt free (historically notes and coin) while bank 'credit-deposit' issue is debt-based and therefore dependent on permanent growth, or at least a permanent capacity to absorb debt. The market group sees a corruption of the original 'hard' money system in modern bank credit. Money circuit theorists see conventional economics as failing to appreciate the autonomy of the banking system, but it is unclear whether its endogenous theory represents the operation of money under capitalism or is seen as a more universal theory of money.

Those who follow Knapp's state theory of money can be seen as arguing that state money is historically prior to bank money but also as chartalists appear to hold a more universalist perspective of money as a social phenomenon. This is a problem for Marxist theorists such as Lapavitsas. He challenges the social view of money as expressed by social money theorists such as Ingham (2004) (see below) and argues strongly for a non-universal approach to the nature of money (2005). Lapavitsas sees capitalist commodity money as an emergent historical form. Rather like conventional commodity theorists he sees this money arising in 'the spontaneous process of commodity commensuration in the course of exchange' (2005:399). Money emerges because commodity owners are 'foreign' to each other. However unlike conventional economists Lapavitsas would not turn this into a universal theory of money.

Carruthers and Ariovich reflect the confusing views. They see what they call modern standardized money as 'the product of a long history of institution building and experimentation with different media and varying coordination mechanisms' (Carruthers and Ariovich 2010:167). Money and credit are both presented as 'social artifacts'. However they also quote Diana Wood's view that 'throughout history, rulership has included, as one of its core traits, the

right to issue money for use within a given political jurisdiction' (Carruthers and Ariovich 2010:167 citing Wood 2002:100). How, then, do we understand money as a phenomenon?

## What is Money?

The starting point for state and social money theorists is that all money is fiat money, rejecting the conventional economists' ubiquitous history of barter and commodity money. Money as currency is therefore not valuable because of its metal or other physical content as the metallist, commodity theory of money claims, rather it is a socially created token of value. From the social perspective, whatever form money takes, that form does not embody a real value in itself. It is a token representing a notional value that is universally accepted and can be readily transferred. Whatever form money takes, what matters is that people agree to honour the value it represents. As Dodd argues, 'money depends for its existence and circulation in society on a generalised level of trust in its abstract properties' (1994:160). For Ingham money is 'a socially (including politically) constructed promise ... money is always an abstract claim or credit'... 'Money' is provided by whatever is agreed as 'money of account', (Ingham 2004:198). Holding money is a claim on society, and all money is therefore a credit that can command resources based on whatever value it carries at any point in time (Wray 2004:234). Ingham maintains that 'all money is debt in so far as issuers promise to accept their own money for *any* debt payment by *any* bearer of money' (Ingham 2004:198 italics in the original). Where the issuer is the state it must guarantee the money as a universal means of access to goods and services.

If all money is a token are banks creating credit or creating money? Innes argued that 'if banks could not issue money they could not carry on their business' (1914/2004:53). Galbraith is famous for his statement that 'the process by which banks create money is so simple that the mind is repelled' (1975:18). Tobin has written of 'fountain pen money' (1963: 408). Is this money the same as state money? If so, where does this leave the Keynesian notion of high-powered money? For Keynes state money is 'money proper' (1971:5). The importance of money proper is that it will finally discharge a debt. What does that mean? While individual debts can be paid, as long as money exists in some form it can continue to be 'spent'. Money only ceases to exist as either a credit-debt (which has to be repaid) or a credit (money free of debt) when it is removed from the money system. For state and money circuit theorists this is at the end of the circuit, when taxes are paid or banks debts repaid. Keynes tries to dissociate bank money from money proper by seeing it as 'private debt' (1971:5-6). Bank money is 'acknowledgements of debt' (1971:5). However Keynes argued the State can monetise this debt by using 'its chartalist prerogative to declare that the debt itself is an acceptable discharge of liability' (1971:5).

It was arguably possible to distinguish 'money proper' from bank money when the two circuits were separate. The state issued legal tender in the form of

coin (and later notes) while banks issued credit notes upon themselves. This difference becomes less clear when the two systems are linked by the designation of sight deposits and notes as legal tender, i.e. state money. Before this point the only thing 'backing' bank credit was trust in the long term viability of the bank. If most people honoured their debts the bank would survive and prosper. If they did not it would fail, and many did. The problem with bringing the two money systems together was that the state became responsible for the integrity of the banking system. Far from issuing an inferior type of money, the banking sector was issuing the national currency. The money supply had effectively been privatised.

As Steve Keen has long argued, there is no link between government issued money and bank issued money. He refutes the money multiplier view that government money creation precedes credit issue. He argues that if this was the case the amount of money in the economy would equal the amount of credit plus the initial government money creation. In fact, Keen provides evidence that the total amount of money in circulation does not increase immediately since his study found that 'credit money was created first, and fiat money was then created about a year later' (Debtwatch No 31 February 2009b:4). Keen argues that the inability of the state to check unlimited growth of bank-issued private debt is the real issue. Commercially created credit is entirely driven by the profit motive leaving the state powerless to do anything but try to prevent crises.

### **Banks in the driving seat**

Banks have not been intermediating between savers and borrowers, channelling 'idle money' to 'productive use' as conventional theory would suggest, nor have they been creating credit in a benign monetary circuit. They have been involved in a feeding frenzy of monetary expansion. As Ozgur and Erturk argue, banks are not passive third parties in the monetary circuit, they play an active role in credit creation 'loan-pushing' that has broadened money supply into the non-banking financial sectors (2008:14). While the bulk of lending in recent years has gone to households, there has been a major expansion in loans (i.e. new money) to financial corporations. Erturk and Solari report that these rose from 4.3% in 1963 to 24.4% in 2005 while lending to nonfinancial corporations fell from 38.3% in 1963 to 21.2% in 2005 (2007:377). They describe this as 'finance feeding finance' (Erturk and Solari 2007:378). High street banks were not only lending to financial institutions but themselves borrowing from other banks and the wider money markets to support large scale speculative trading. The latter was a particular feature of investment banks. As Erturk and Solari note, proprietary trading accounted for two thirds of the revenues of Goldman Sachs and Lehmans, while Goldman Sachs became the largest hedge fund manager in the world (Erturk and Solari 2007:382). One of these survived and prospered the other failed dramatically. Writing presciently in 2007 Erturk and Solari saw banks as 'not so much institutions as unstable experiments in opportunist innovation' (2007:383). This was compounded by the fact that 'nobody from the outside understands

the sources of income in investment banking' with the suspicion that the resurgence of investment banking was resulting in the 'Enronisation of banks' (2007:385). Banks were not acting as intermediators between savers and borrowers, rather they were 'capitalist actors in their own right' (2007:386).

There appeared to be no longer any basis for 'high powered money', even states were borrowing from the 'money markets'. As most forms of money became electronic, there seemed to be little effective difference between bank deposits and cash. In the two monetary circuits money is designated as national tender. In both circuits money mainly exists in electronic form. Equally, there is little difference in their capacity as money suppliers to cause inflation or deflation. The state can overtax or overspend. Banks can over-lend fuelling an orgy of speculation while a loss of confidence can bring a credit crunch. However, there is still one clear point of difference between the state and the banking system as a source of money supply. The state can issue money without debt, whereas the profit-based capitalist banking system cannot. As Minsky pointed out the credit-fuelled capitalist financial system suffers from endemic crisis and as was clear in the recent financial crisis only the state can stabilise the financial situation. When the UK bank Northern Rock experienced a run in 2007 neither the bank's chief executive or the head of the Bank of England could stop it. Only when the Chancellor Alistair Darling put the strength of the Treasury behind the bank did the run stop. Equally, the financial crisis made it clear that if states were to secure their money systems they had to support the whole financial system, even the nonbank financial institutions, as the near meltdown after the Lehman failure showed (Mellor 2010a). In the contemporary privatised money supply system the distinction between high powered money and 'bank money' is not helpful. All money is supplied as national tender and has to be backed by the state. The high power the state holds is the capacity of the state/monetary authority to give its money and financial system credibility and issue money free of debt.

As Ingham points out, 'the state and the market share in the production of capitalist credit money' (2004:144). However in the last resort it is the state that is the most important. The elastic creation of credit-money is based on a 'hierarchy of debtors' which is topped by the state's total liability for the system. Without this structure of state-based finance, capitalism cannot operate. In a crisis the state must step in not because the money it issues is 'high powered' as a medium, but because its role as a monetary authority is unique. It is the state as issuer of money that is crucial, not the form of the money itself. However the power of the state is not unlimited. The main cause of the financial crisis was a vast increase in the supply of privatised money as debt. And yes, this was inflationary but as a financial boom which was celebrated as 'capital growth'. As all money is a credit to the holder and a debt on society (against goods and services) the relationship of money supply to GDP is important. On this basis many countries were insolvent as total bank assets outstripped GDP by many times, at least five times in the UK and US and ten times or more in Iceland.

What has been eclipsed in the modern monetary system is the state monetary circuit. It still exists in potential as evidenced by the bailout following the

financial crisis, particularly quantitative easing (although this was wrongly issued via the banking system). The financial crisis has shown that the only power within the financial system as a last resort is the state and its capacity to issue money free of debt. This is not a different money, it is a different mechanism of money issue from the debt-ridden banking sector. However the ability of a state to rescue its financial sector depends on the economic strength of the country itself and the extent to which its financial problems are limited to its own currency. Iceland had to let its banks fail because so much of their activities were conducted in other currencies. Britain and the US are in a stronger position. The eurozone nations like Ireland, Greece and Portugal (although the latter were not banking crises as such) cannot 'turn on the printing presses' although the European central bank is having to do this on their behalf (couched as 'borrowing' from countries such as Germany and France).

### **Implications for Monetary Policy**

What then, does modern monetary theory tell us about monetary policy? For the state/public group of monetary reformers and state money theorists policy rests with the state reclaiming its role as the primary issuer of money. For both, any capacity for money issue needs to be removed from the banking system. This would leave the banks with two forms of activities, deposit safety and transfer and term investment (money deposited for the term of the investment). Only the first form of banking would be backed by the state. All new money would come via public benefit in various ways: citizen income, development banks, public infrastructure and services etc. The private sector could 'earn' the money by providing democratically determined priorities. The market group of monetary reformers would totally oppose state monopoly of money supply and leave money circulation to the market without any form of state backing or insurance, but without bank credit, leaving a question mark over how any new money supply would take place.

The endogenous money circuit theorists leave open the role of the state. Are they saying this is how capitalism works, that is, this is an historical moment as Lapavistas suggests, or are they saying that all money is a system of credit-debt as an emergent structure in economic systems? In the latter case on what basis could the state 'reclaim' money issue? Certainly the money system cannot be managed in the way that theorists such as Keynes or Friedman thought, but the need to maintain confidence in the system has certainly fallen to the state. While the privatised banking sector has harnessed money creation for itself through the issue of debt, the state still remains as the final basis on which the whole tottering system rests (Wray 2004:260, Mellor 2010a: 160). Arestis and Sawyer argue that macroeconomic policy should acknowledge the need for budget deficits and for the central bank to take responsibility for financial stability (2010). As Wray argues, 'affordability is never the issue, rather the real debate should be over the proper role of government, how it should use the monetary system to achieve public purpose' (2011:17). Warren Mosler argues that the Central Bank and

Treasury should be merged as the heart of the money system. However given people's reservation about the integrity of states it might make sense to leave an independent central bank to act as a counterbalance to the political interests of the government e.g. a spending boom before an election.

One political implication of MMT was raised by Rousseas early on. Focussing on Minsky, Rousseas was concerned that Post-Keynsian ideas could be seen as introducing a 'neo-monetarism' (1992:118) implying that monetary action alone (government fiscal deficits/surpluses and the central bank as lender of last resort) was enough to confront basic economic problems. He concludes that 'American Post-Keynesian economics seeks to make capitalism ... a more workable and viable enterprise, while ignoring some fundamental problems...capitalism's instability is not rooted exclusively in uncertainty and problems associated with a credit money economy...it is also to be found in the struggle of the division of the surplus between capital and labour' (2010:121).

More recently Konings has argued that the financial crisis was not a failure of policy but a systemic crisis within the privatised financial system:

'the current crisis is not a product of politics and regulation having let the market spin out of control, but precisely a product of contradictions internal to the operation of power and control, of financial power having gone beyond its own conditions of possibility' (Konings 2009:123)

As I have argued elsewhere (Mellor 2010a: 142), private control of money issue is fundamentally flawed in that its neo-liberal claim to financial freedom is in contradiction to the social and political foundation of money systems. The implosion of deregulated finance has directly contradicted the neoliberal case that the market and its money system is a self-regulating process that will be distorted by state intervention. Under the illusion that money was a neutral representation of the wealth of the market, financial institutions operated far and wide, well beyond their home base. Financial traders speculated on currencies and borrowed from low interest countries to invest in countries offering higher interest. Claiming that their industry was global they played off countries against each other demanding favourable tax status or lodging themselves in tax havens. However in doing so they were undermining the conditions of their own existence. The financialised money system was undermining its ultimate means of support, that is the public authority of money. At the same time public policy around money could not be separated from the operation of privatised finance. The financial system proved to be so interconnected that if some parts were to be saved, the whole system had to be stabilised. Private money was a public issue at both global and national levels.

## Conclusions

The approaches to money discussed here (state, circuit and monetary reform) both overlap and differ in their theories of money and the solutions they offer. The monetary reformers tend to take an historical approach and start from a critique of fractional reserve banking. This assumes two types of money 'real money' and bank credit. While the two groups of monetary reformers share a similar analysis their solution is different. The pro-market monetary reformers want to return to what they see as banking before the advent of state regulation, that is a totally privatised banking system without the power to create money limited by some kind of tangible base equivalent to the gold standard. Exactly how this will be done is not clear. The state/public group of monetary reformers start from a distinction between debt free state money and debt-based private money. They want the state to reclaim the issue of debt free money and tend also to favour local money initiatives. Where that leaves the current market system is less clear. However, they share with the state money theorists the desire to give priority to social (and environmental) expenditure.

The state and circuit theorists put forward a much more nuanced theoretical approach although they differ markedly in their analysis. The state theorists tend to be more universalist in their social approach to money whereas the circuitists seem to hover between an historical and a universalist approach. The productive money circuit would seem to be relevant mainly to capitalism, but the notion of all money as a system of credit-debt relations would seem to be more universal. While it is clear that state money theorists want to (re) establish the state as a monetary authority, the policy outcomes of circuit theory is more muted. Does the money system stand or fall with the capitalist productive system? Is there a role for public money? Given that the endogenous creation of money does not seem to operate as benignly as Rossi would seem to suggest, there would seem to be no case for the private ownership and control of money and banking. Capitalist control of the financial system has played a major trick on the public. Given that bank credit is created out of fresh air, like fresh air it should be a public resource not a private horn of plenty for capitalism. Far from having democratically controlled access to the process of credit issue, the public, as represented by the state, has itself to borrow from the capitalist owners and controllers of the nation's money supply or tax money for public expenditure as it circulates.

If the public is to be ultimately responsible for whatever money is issued in their name they should have a say about how this money is used. However, as capitalism has ideologically captured economic reasoning, if people demand to issue money themselves or demand that social and ecological priorities come first they will be told that 'this cannot be afforded'. The pretence is that the market puts some kind of brake on money creation and allocates it most efficiently. The recent economic crisis shows that neither of these claims is true. Given the public nature of money as evidenced by the financial crisis and the resulting public liability, the logic would be that all money should be seen as a public resource (Mellor 2010a). A crucial social

and political question would then be how money is issued and circulated and who has benefit of that resource. It may be that the public would vote to give the administration of money back to the private sector, but it would be much more likely that public and social expenditure would be prioritised. The private sector would then have to re-orient its activities to serving the needs of the public. This could form the basis of an economy where growth would only occur in response to social need. Money circulation could be focussed on the production of socially necessary goods and services in an economy run on the principle of sufficiency which would ensure enough for all, rather than surfeit for some.

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