WHERE MONEY COMES FROM !

Being two scripts on the creation of money and credit, written for broadcasting—

by

EDWARD HOLLOWAY

ONE SHILLING

"For land produces naturally something new and profitable, and of value to mankind; but money is a barren thing, and produces nothing . . . "

[LOCKE: *Considerations of the Lowering of Interest*]

"*We have learnt to worship money, and in so doing we worship, ignorantly and harmfully, a man-made idol . . .* "

[SIR REGINALD ROWE: *The Root of all Evil*]

" The objective of the Government is to achieve stable prices, but these cannot be attained unless increased incomes are matched by increased output . . . "

RT. HON. PETER THORNEYCROFT.
[*House of Commons Official Report, 16th July, 1957*]

For graph showing changes in the purchasing power of the £ sterling, see page 11.

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INTRODUCTION

Continued inflation and the consequent ever-rising cost of living are matters which are causing the nation grave concern. These evils arise through the failure of our financial and monetary system to reflect reality. It does not provide an efficient means of promoting stability in the economy, and is clearly in need of an overhaul. Recognition of this fact was givin by the Chancellor of the Exchequer in March last, when he appointed the Radcliffe Committee to examine the whole question of monetary and credit policy. It is becoming increasingly clear that there is need for much greater knowledge on these questions in all walks of life.

On 21st October, 1957, "The Times" published the following letter:—

Sir,

Mr. E. H. D. Skinner is absolutely right when he stresses, in his letter of October 17th, the need to explain to people our present and potential financial difficulties free from political prejudice or slogans. As one who spends a fair amount of time attempting to do this, I am convinced that not only trade unionists, but also the business and professional community are confused and anxious, and welcome any sincere attempt to clarify the economic issues confronting us.

The trouble is that there is so much ignorance on basic facts; for example, the creation of money and credit is one of the hidden mysteries so far as many people are concerned. In these circumstances is it any wonder that misconceptions abound?

Sir Winston Churchill put his finger on the spot when he wrote in his last war memoirs: "The multitudes remained plunged in ignorance of the simplest economic facts, and their leaders seeking their votes did not dare undeceive them."

Yours faithfully,

EDWARD HOLLOWAY.

Following the publication of this letter, it was suggested by a Talks producer at the B.B.C. that the subject of the "creation of money and credit" would make a very good subject for two broadcast talks. Shortly after this, two scripts were submitted, and after a delay of one week a reply came which said that the scripts could not be used, the inference being that the subject was too complex to reduce to understandable terms.

As the scripts had been written specifically so that anyone of reasonable intelligence could understand, I took the opportunity of reading them over to several audiences composed of different types of people and age-groups. On each occasion I was assured that the talks were perfectly understandable, and that they supplied the kind of information which those present were glad to have.

This encouraged me to consider publishing the text of these two talks exactly as submitted to the B.B.C., believing that the information contained is of considerable interest and importance to the people of this country, particularly at this present time when the whole question of monetary policy is under review. If our economic and financial problems are to be solved, it is vital that basic facts about money should be known and understood. It is difficult to appreciate why they should be considered to be more complex than many other technical subjects which are dealt with at great length, both in the press and on the radio.

It is in the hope that this pamphlet will, to some small extent, assist in dispelling the fog which surrounds the whole question of money and monetary policy that this is now published.

EDWARD HOLLOWAY.

2nd December, 1957.

THE CREATION OF MONEY AND CREDIT (I)

by EDWARD HOLLOWAY

We all hear a lot about inflation, which has been described as too much money chasing too few goods. If there is too much money in circulation, surely its important to know where it comes from and how it is created. First of all, let's see what has actually happened in the past few years. Since 1938, the amount of money in circulation has been increased 3½ times, while gross national production has only increased by about one-third. Look at it this way. If you were manager of a theatre and you increased the seating capacity of your theatre by one-third, and at the same time let the box office issue 3½ times as many tickets, would you be surprised if the patrons found that they had to obtain three tickets to ensure they could get one seat?

That is, in fact, what has happened. As a result we now require three £1 notes to buy the quantity of goods and services that one £1 note did in 1938. Compared with 1938, £1 now buys only 6/6d. worth of goods.

Now the question is, where did all this additional money come from? To answer this we'll have to take a look at money as it exists to-day. Possibly you think of money as the coins and notes you use every day to buy your groceries, pay your fare, and so on. Well, coins and notes are, in fact, only the nation's small change. By far the largest proportion of money is in the form of credit; that is, it has no physical existence except as entries in the ledgers of the banks. The method of transferring this credit money from one person to another is by means of the cheque, that very useful aid to our economic life.

When you write out a cheque to pay your bills, etc., the amount you write on the face of the cheque is debited to your account, and is credited to the account of the person to whom it is made payable. No actual transfer of coins or notes takes place, it is done by means of a book entry. It is this credit money that is of really vital importance.

But let's first take a look at coins and notes. Most people know that coins, the pennies, sixpences, shillings, two bobs and half crowns are made and issued by the Mint. These coins bear the head of the Sovereign, and were once the only kind of money. At one time they contained their actual face value in metal, copper, silver or gold, but now they are virtually metal tokens, and no longer carry actual value in themselves.

Coins are, however, less important than paper money. The story of the development of bank-notes is really a very fascinating one, and well worth studying. We have only time to note that the modern bank-note had its origin as a form of receipt for gold or silver deposited with the goldsmiths, the forerunners of our present bankers.

The bank-note to-day, the familiar 10/-, £1 and £5 note is issued by the Bank of England, and bear the signature of the Chief Cashier, Mr. L. K. O'Brien. As you will see if you look at one, they promise to pay the bearer on demand the sum of one pound, a relic of the days when the holder could take one of these notes to the bank and obtain in exchange the actual face value in precious metal—gold or silver.

But as I said previously, notes and coins are no more than the nation's small change. If it had not been for the invention of another form of money—credit money—it would not have been possible for us to have developed our economy as tremendously as we have in the past two hundred years. This credit money, which exists only as figures in the ledgers of the banks is by far the larger proportion of money in existence in our modern "managed currency" system. Its importance to the life of the nation can hardly be exaggerated. In my next talk I shall try and deal with the way in which this credit money is created and comes into circulation, and to explain how it comes to be universally acceptable, although it has, in fact, no physical existence beyond the book entries in the ledgers of the Joint Stock Banks.

THE CREATION OF MONEY AND CREDIT (II)

We now come to the very important question of the creation of credit. To understand this, it is essential to realise that the development of money in its various forms has been the result of a gradual growth over the years. At one time coins were used, then came the invention of paper money to supplement coins, and finally money of account, credit money, to supplement both notes and coins.

As distinct from coins issued by the Mint, and bank-notes issued by the Bank of England, credit is created by the Joint Stock Banks in carrying out their ordinary business. Let's take a hypothetical case. Suppose Mr. Smith has a scheme to start a new business, and he needs additional money for capital. He makes an appointment with his bank manager, and asks him if he can arrange a loan or an overdraft for say one thousand pounds. The manager knows Mr. Smith, and is confident of his ablity to earn the interest as well as to repay the capital sum in due course. The manager says: "Alright Mr. Smith, we are satisfied that you are a man who keeps his word, that your proposed business is sound, and we will make you a loan of £1,000."

Now most people seem to think that what happens then is that the £1,000 is transferred from the amount lodged by some other client of the bank, but in fact this is not so. The bank manager does not take £1,000 out of the account of someone else and transfer the amount to the new borrower. On the contrary, he either arranges to credit the account of the borrower with the £1,000, or, what amounts to the same thing, authorises him to overdraw his account to the amount of the agreed sum, in our hypothetical case, £1,000. When he came into the bank Mr. Smith did not have this £1,000, when he left he did, and he could at once proceed to use it to develop his business. No-one was deprived of the £1,000, it was new money created by the action of the Joint Stock Bank in making a loan or, in the case of an overdraft, comes into existence as soon as the customer draws on the overdraft by cheque and the payee pays that cheque into his account. Thus, £1,000 of new money comes into existence, created by the bank by the entry of the appropriate figures in the banks books.

Once this money is created it is called a deposit, and in terms of use it is no different from any other kind of money. So that banks can, and do, create credit, and thus they bring new money into circulation which did not exist before.

It's necessary to add, however, that before the loan is granted, our Mr. Smith must usually have had something of value to act as a guarantee for the loan, some shares, a house, something or other of value that the bank holds as collateral, though this is not always necessary. But this does not alter the basic fact that credit money is created by the Joint Stock Banks in making loans and granting overdrafts to customers. In doing this the Joint Stock Banks may be said to be monetising the nations resources, a job they do with great skill, which is a valuable service to the community.

The question now arises, what controls the Joint Stock Banks in their operation of creating credit? The answer is that they are limited in their ability to create credit by three main factors. One is the amount of cash they hold in their tills, or are held by them at the Bank of England. In fact by custom and agreement, the Joint Stock Banks now hold about eight per cent. of their total deposits in cash, that is notes and coins. They also maintain a ratio of thirty per cent. of their deposits in liquid assets, that is Treasury bills and sterling bills. The third factor is the existence of credit-worthy borrowers.

To summarise the position then:

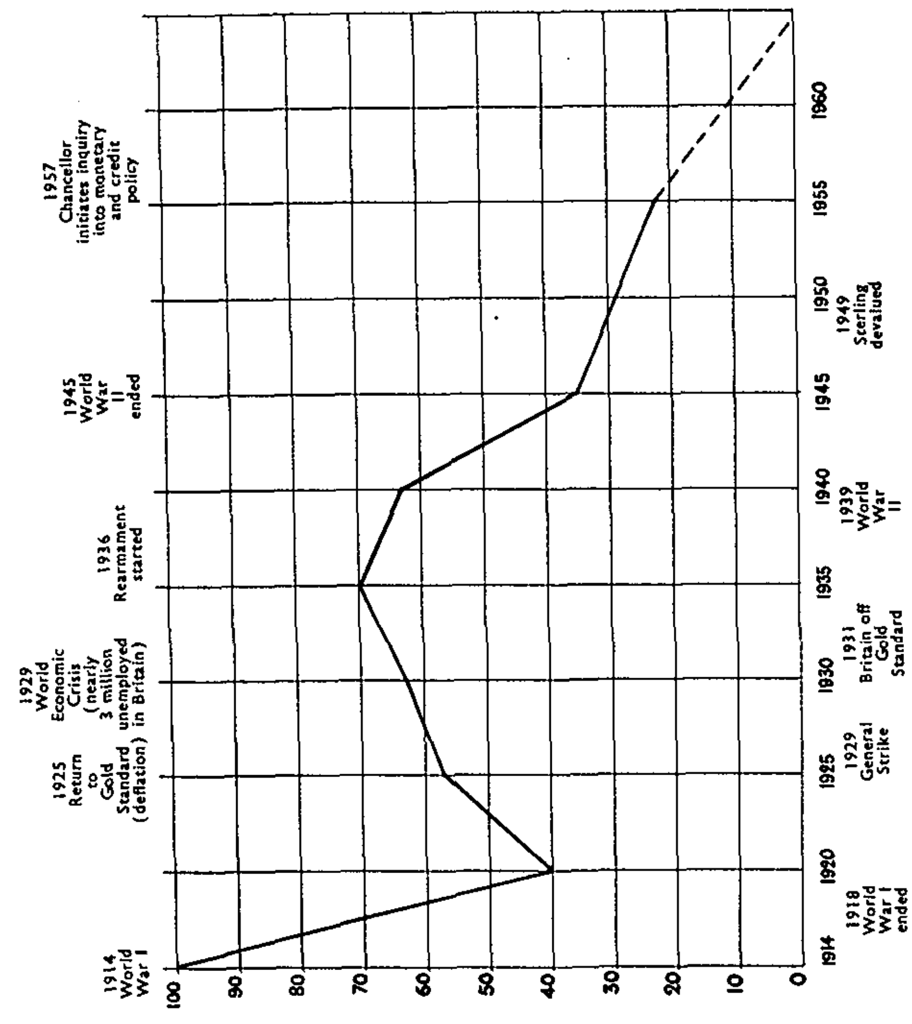
Coins are issued by the Mint. Bank-notes are issued by the Bank of England. These form the basis of the creation of credit which comes into existence by the action of the Joint Stock Banks in making loans, granting overdrafts, and also in the purchase of securities.

These are rather technical matters, and perhaps difficult for the layman to understand at first hearing. But it seems to me to be absolutely essential that they should be understood and their real significance appreciated, for the whole system is one of confidence. Without this confidence which has been built up over the years as a result of the co-operation between banks and their customers, the system could not have endured. Confidence should be based on understanding.

A final word. Under our present "managed currency" system, it is not gold or silver, but real wealth—goods and services of all kinds that gives value to money, whether coins, notes or credit. Unless the people of the country produced real wealth to give backing to money, it would become valueless. This sobering thought should be more clearly recognised at all levels. If it were properly understood, then perhaps we would hear less about such brakes on production as restrictive practices, go-slows, strikes and so on, for it would be clear that in acting in this manner we were undermining the value of our money, and bringing down our standard of living.

ESTIMATED changes in the purchasing power of the £ sterling for the years since 1914, taking the index as 100 in 1914.

Dotted line indicates decline over next ten years assuming a trend based on average of years 1935-55.



RECOMMENDED READING

EXPANSION OR EXPLOSION by ANTONY VICKERS.
A solution to the vital problem of inflation in the machine age.
The Bodley Head 6/-

OUTLINE OF MONEY by GEOFFREY CROWTHER.
Revised edition *Nelson* 15/-

ECONOMIC TRIBULATION by VINCENT C. VICKERS.
The Bodley Head 5/-

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