Bringing money back from “the underworld”.

By Douglas Coe and Ann Pettifor
20th March 2014
Bringing money back from “the underworld”.

Douglas Coe and Ann Pettifor

The Bank of England has performed a vital service with two articles on the nature of money in their latest Quarterly Bulletin. Its economists have confirmed that most of the money in the modern economy is created by private banks making loans. Rather than banks lending out deposits that are placed with them, the act of lending itself creates deposits. Banks, it turns out, are not simply intermediaries lending out money that savers deposit with them. The money multiplier process is an incorrect account of the lending process; and bank lending is not constrained by reserves.

Moreover the Bank emphasises that this is “the reverse of the sequence typically described in textbooks”. Let us be clear here: this is not a failure of some textbooks; it is a failure of virtually all textbooks.

As a result students are taught a fallacious theory of money. And this failure of teaching is symptomatic of an even greater failure, the failure of the academic economics profession itself, of its learned discussions, conferences, published papers and contributions to policy. And let us not beat about the bush: as the liberal John Hobson observed over 100 years ago:

“…the selection and rejection of ideas, hypothesis, and formulae, the moulding of them into schools or tendencies of thought, and the propagation of them in the intellectual world, have been plainly directed by the pressure of class interests. In political economy, as we might well suspect, from its close bearing upon business and politics, we find the most incontestable example.”

But thankfully the triumph of class interests is not universal. The Bank credits just a handful of scholars that have railed against ‘mainstream’ academia’s understanding of money. Those few economists argued their positions at great expense to their academic careers. They have not been permitted to participate in learned discussions, nor have their views been sought on policy. Professor Charles Goodhart describes how

“…the suggestion that Prof. X took an institutional approach to monetary analysis was sufficient to cast his/her reputation into outer darkness. Only small groups of mainly heterodox (and of various hues of post-Keynesian views) economists have bothered much to relate theory to reality. Why this has been so, I do not know… [it] is not a good advertisement for this sub-sector of our profession.”
To an impartial outsider or observer of the economics profession, this beggars belief. How can economists analyse the economy without an understanding of money - the cornerstone and raison d’être of all economic activity? And how can those who do grasp these processes be cast into ‘outer darkness’?

And while the Bank of England is shining light on this darkness, some distinguished economists are still obscured from view.

**The Bank of England’s omission**

The most glaring omission in the Bank’s articles is any positive mention of John Maynard Keynes. A great part of his career was spent in debate over the proper conduct of monetary policy. His election to the Court of the Bank of England in 1941 was recognition of the remarkable contributions he had made in the course of those discussions.

His ideas evolved from a profound understanding of the nature of money. The opening chapters of his *Treatise on Money* (1930) were widely understood at the time as the fullest exposition of these matters, and subsequently commended as such by Josef Schumpeter:

“... it proved extraordinarily difficult for economists to recognize that bank loans and bank investments do create deposits … And even in 1930, when the large majority had been converted and accepted that doctrine as a matter of course, Keynes rightly felt it necessary to re-expound and to defend the doctrine at some length, …”

In fact, as anthropologist David Graeber’s work has shown, an understanding of credit can be traced back to the dawn of civilisation in Ancient Mesopotamia.

In a speech delivered earlier this week, Mark Carney reflected the conventional wisdom about money when he cited an author that defined the motive behind the establishment of the Bank of England in 1694 as raising money “to carry on the war” with France.

We disagree. While financing the war was important, the authorities were more concerned at the time to instigate a bank money system like that already established by the Dutch and along the lines of that described by the Bank of England staff today. Their goal was to mimic the Dutch in reducing the rate of interest facing commercial interests; to bring interest rates down and into line with those that prevailed in the financially more advanced Netherlands.

But this understanding of bank money driving low rates of interest was lost by the classical economics of David Ricardo (a financier). As a result the theories and
policies lived on only (as Keynes put it) in “an underworld” of scholars and activists, such as Henry Thornton, Thomas Malthus and Henry Dunning McLeod; and of the sociologists Knapp and Georg Simmel, who were not content to leave the question of the nature of money to the economists.

Keynes’s great achievement was to retrieve this understanding from its burial by economic scholars. He understood that basing a theory of the economy on a fallacious theory of money would lead to profound misjudgements in economic policy, and to financial and economic crises. The task he set himself in his General Theory of Employment, Interest and Money (1936) was to devise a theory of an economy based on a correct understanding of money. Its conclusions about practical policy were vastly different from those of his contemporaries, and from their successors in today’s economic establishment.

Keynes recognised that the monetary system should be steered away from serving vested or class interests, and repositioned to serve the needs of society as a whole. This understanding led to policies for permanently low interest rates, near full employment, a thriving private and public sector, financial stability and the unprecedented narrowing of income distribution. With no disrespect intended, Keynes’s reforms went far beyond the anthropologist, David Graeber’s rejection of austerity in a recent Guardian article.

Predictably perhaps, his policies did not endure. And with his policies, went his theory and once more the understanding of money, lost to a revival of classical economics. The understanding of those in the “underworld” lived on only through Keynes’s closest colleagues in Cambridge, who were cast out of the profession.

His theory was revived as post-Keynesian economics in the US under Sidney Weintraub, Hyman Minsky and Paul Davidson; and in the UK by Victoria Chick, among others. Geoffrey Ingham has revived the tradition within sociology. This revival has been echoed by the accessible and popular new economics foundation account Where does money come from? and Ann Pettifor’s book Just Money: How Society Can Break the Despotic Power of Finance (2014).

Now the economic establishment in the form of the Bank of England has encouraged more economists to emerge from out of the “underworld”.

Conclusion

Today’s ignorance of the nature of money avoids a return to Keynes’s theoretical conclusions, and protects the same class or vested interests so badly served by his policies.

While the Bank of England’s intellectual excavation is welcome, it is not enough.
Bringing money back from “the underworld”.

The whole shaky superstructure on which the flawed classical theory is based should now be dismantled.

A deeper understanding of Keynes’s theory and policy conclusions will provide economists and society with tools for recreating an economy that can once again restore balance and stability; an economy that will serve the interests of society as a whole.

__________________________


