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Master's of Applied Ethics

**Just Money. Sovereign Money System and the Ethics of
Banking**

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Abstract

One of the monetary reform proposals put forward after the financial crisis of 2008 is Sovereign Money System (SMS). The purpose of this thesis is to discuss its normative aspects. Firstly, several theories of banking are presented, and it is analyzed how the pro-cyclical functioning of banks leads toward the emergence of economic crises. Secondly, the role of Sovereign Money System is discussed as a possible institutional remedy. Then, the proposal is divided into two constitutive elements: access to safe digital money and full state provision of money. The main claim of the thesis is that the former is desirable, while the latter is not. In defense of the former claim, it is asserted that the payment system, on which safe digital money accounts depend, is a public good, and thus needs to be provided to each citizen. Accordingly, it is defended that this access will increase aggregate social welfare. In defense of the latter claim, several episodes where public institutions have acted undemocratically and as bad managers of money supply are recounted. These examples purport to show the hastiness of equating democracy with institutions genuinely acting in the public interest. Lastly, a more moderate alternative to SMS is proposed.

Key words: *monetary policy, central bank, banking sector, CBDC, safe money*

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Introduction

Market economies are blemished by crises, and each new one brings with it a set of explanations on the causes and the potential remedies. The economic crisis of 2008 was no different. Much has been written on the conditions that led to its emergence and many policies were advanced to mitigate the consequences.¹ The role of this thesis is not to survey all of these proposals, for they are too many.² Therefore, I will focus only on the one: the Sovereign Money proposal (henceforth SM or SMS, for Sovereign Money *System*). Even so, I will shy away as much as possible from the economic technicalities and try to tease out ethical, political, and conceptual issues at stake.

The purpose of this thesis is two-fold. Firstly, it is my intention to get the philosophical crowd more familiar with the nature and the problems in finance, banking, and monetary policy. These issues have long been neglected in academic philosophy.³ On the one hand, it is understandable, given the technical baggage these fields carry. On the other, it is surely a pity, since they are immensely important for our everyday lives – a fact starkly exemplified with the economic crises beginning in 2007/2008. Aside from that quotidian relevance, it is my view that these fields suffer from serious conceptual confusions, and would gain considerably by further philosophical work. For instance, the question on the relation between money and debt – Is money divisible from debt or are they inherently coupled? – borders on metaphysical. It is at the very least curious to see that lack of clarity exists on such a basic token of our lives. The similar could be said for banks, which will be discussed shortly.

Secondly, I intend this to be an essay in applied philosophy and as a useful guide to future students of policy in the area it discusses. I would like it to be an example of how conceptual and ethical skills can be applied to specific practical, ‘real-world’ issues. This is not going to be an easy task, since most of the practitioners economic theory – and especially monetary policy – are infamously resistant to drawing normative conclusions from their work or even taking such matters into consideration as a part of their thinking. That is surely a regretful state of affairs. However,

¹ See for example (Turner, 2016; Wolf, 2015).

² For a subset of these, see (van Dixhoorn, 2013). Some other proposals will be mentioned in Section 2.

³ For a recent summary of the literature on this topic, see (de Bruin, Herzog, O’Neill, & Sandberg, 2018).

the areas mentioned are brimming with normative assumptions and are ripe for picking once set out to.

To their credit, the writings of Sovereign Money advocates are a step in the right direction in this manner. They set out to untangle and bring to light such ethical issues as inequalities in standard operation of the banking sector and undemocratic functioning of monetary policy in developed countries, among others. Furthermore, their reasoning is quite explicit on this, as they appeal to a notion of justice. For example, they suggest that the implementation of their proposal would lead to a desirable tax reduction for the worst off or increased public investment into socially necessary areas (as will be shown in Section 2).

I find this direction commendable and my goal is to push this value-laden argumentation further in my thesis. However, due to the constraints of space, my goal will not be as far-reaching as that of the proponents of SM. I will try to confine myself to a thin sliver of their proposal and try to critically examine it. In order to do that, I will have to set some theoretical foundation first.

In Section 1, I will start by examining banking. This section is relevant, first, in its own right, since it tries to clarify the much discussed issue of how banks even operate. It is a matter of much curiosity, if not outright shame, that this matter has not been fully settled by now. Secondly, it is relevant to discuss the different proposed models of bank functioning, and see how they are related to economic crises. With that goal in mind, I will present the three most dominant theories of banking. I will demonstrate what the distinguishing characteristics of each are, and how they relate to each other. Lastly, I will select one of them as the working theory of the thesis.

This selection is not coincidental nor *ad hoc*. I will opt for it for the following three reasons. Firstly, even though experimental methodology in banking is rare, there are at least two experiments that point to the direction of the empirical adequacy of accepted model. Secondly, in the last several years, and especially since the financial crisis, many central banks have started speaking up about the empirical adequacy of this model, more so than about the competing ones. But lastly, I will pick the model because it is accepted as a starting point by the proponents of Sovereign Money. Only by understanding it can we understand the emergence of the 2008 crisis, and only in that context can we understand what it is that Sovereign Money seeks to remedy.

In Section 2 I introduce the Sovereign Money proposal. There, I will present the core of the idea: money creation should be taken away from the banks and be nationalized. Then, I will mention several of the main arguments advanced for this policy reform. Lastly, I will note some

of the desirable social and economic outcomes it allegedly entails. It should be noted that, I do not strive to offer a thorough investigation of the proposal and the rebuttals to it. That work has already been done elsewhere and to a greater degree of rigor than I can offer here. Nevertheless, it will be sufficient for supporting my arguments. The crux of the thesis is contained in Sections 3 and 4. Section 3 begins by dividing SMS in two separate proposals. One is the state provisioning of safe bank deposits called ‘Transaction Accounts’ (which I will sometimes call simply ‘Safe Accounts’). The second is the full state creation of all money in the economy. In this Section I will defend the first proposal.

Sovereign Money advocates are surely right to favor the safety of people’s assets. However, they never offer any normative support for the claim, possibly believing it is obviously true and not in need of further support. While regrettable, I too stay silent on this matter, because some work in this area has already been undertaken (van ’t Klooster, 2017, Chapter V). Instead, I take another, more institutional approach in this thesis. In other words, I do not defend the claim that *having safe digital money is good*, but rather *why the state should provide the service of safely storing citizens’ electronic cash*.

The first claim is that already existing public payment system (of which Safe Accounts are an interface with the users) is a *public good*. In this section I discuss the role of the payment system and its importance in modern economies. Then, I draw the outlines of what the public provision of Safe Accounts would look like in practice. Lastly, I argue that this provision conforms to the standard definition of public goods as non-rivalry and non-exclusionary goods.

In the second part of Section 3, I introduce the reader to some elements of Joseph Heath’s Paretianism and his views on the welfare state. I rely on it in order to claim that payment systems are an example of natural monopolies in the hands of the public. This has two desirable results. Firstly, moving to a fully integrated public payment system increases efficiency, thus increasing aggregate welfare. Secondly, this integration will with much ease (due to economies of scale that monopolies deliver) address the injustice of many ‘unbanked’ and ‘underbanked’ citizens not having first class access to the economy. Lastly, I show that the relationship between bank money and state money is a form of parasitism that needs to be addressed.

In Section 4, I address the second element of SMS: the remedy to the present financial woes is giving to the state the full power of money creation. This, I claim, is the weakest spot of

the whole proposal. Where it is very well thought out *economically*, the proposed reform is weak and underspecified *politically*. I argue for this in two ways.

Firstly, I show that just by making money supply public and democratic, does not follow that it will be used to the public advantage. To support this, I cite numerous examples for the public institutions acting actively against the interests of the public. Among others are the data showing low responsiveness of the political elites to the demands of the lower classes and the anti-democratic track record of some public institutions, i.e. the central banks.

Secondly, I go on to argue that public institutions have historically had a sub-optimal money supply management results. Here I cite only three of those, taking place the most recently: Margaret Thatcher's short and unsuccessful flirtation with monetarist doctrine; Bundesbank's aggregate money targeting failure; and the dubious performance of the ECB's Quantitative Easing program.

The general purpose of this Section is to show, through several historical episodes, that just because an institution is public and democratically elected, it does not necessarily follow that it will either act in public interest *or* do a good job of money supply management.

In the last part of the thesis, Section 5, I offer sketches of concrete policy proposals to implement the ideas discussed in previous sections. Here I assess what the possible modalities for implementing safe Transaction Accounts are. Similarly, I submit some possible alternatives for banking reform and increased state investment. These reforms are, I claim, less radical and tried-and-tested, compared to the SMS. This renders them, in my view, more probable and politically desirable.

Section 1: How banks operate

Banking is pervasive in the economy and is a part and parcel of everyday life, at least in the developed countries. It is surprising, then, that so little is known about how banks precisely operate. While many ‘lay people’ have an instinctive animosity towards banks (Bennett & Kottasz, 2012), few of them can usually substantiate the rationale for that hunch. This vague gut feeling may be justified in the case of non-experts, given the veneer of complexity that surrounds the banking system. On the other hand, and what is less expected and justified is the economists’ disagreement over the nature of the functioning of these institutions.

This disagreement has stretched from at least the late 19th century until the 1950’s, when interest in the nature of banking subsided, until it re-emerged again after the economic crisis of 2008 (Jakab & Kumhof, 2015, p. 3). This cessation of debate is peculiar, given the crucial role that banks play.

This section will rely heavily on the work of Richard Werner (Werner, 2014a, 2014b, 2016) and Jakab and Kumhof (henceforth J&K) (Jakab & Kumhof, 2015). These papers present, to the best of my knowledge, the most accessible and comprehensive review of the banking debate throughout the 19th, 20th and the first decades of the 21st century. Moreover, aside from laying out the history of the field, they also offer adjudication on the debate and provide evidence for their claims.

1.1 Three theories of banking

The three competing theories that have appeared in the literature are *credit creation* theory, *fractional reserve* theory, and *financial intermediation* theory.⁴ Credit creation theory of banking describes banks as essentially money creators; banks create new money when they issue new loans (Werner, 2014a, p. 3). To take an everyday example, imagine a person entering a bank and requesting a mortgage for a house. After opening a bank account with the bank, doing the legally mandated background checks, and performing risk assessment, the bank teller decides to approve

⁴ Jakab and Kumhof call these models ‘Financing Through Money Creation (FMC)’, ‘Deposit Multiplier (DM)’, and ‘Intermediation of Loanable Funds (ILF)’, respectively. Furthermore, J&K intentionally call them ‘models’ instead of ‘theories’ for the reasons discussed later in the Section. I will use both terms interchangeably until that discussion.

this person's request. According to the credit creation theory, what happens next is that the bank teller simply types the requested amount into the newly created account and that is it. This bank deposit⁵, as it is technically called, is now able to be used for the required purpose of buying a home. The converse is also true: when the loan is repaid, the money is literally destroyed.⁶ This is often, although inaccurately, called creating money *ex nihilo*. A more accurate description is 'at the stroke of the pen' (although, in order to stay updated with the times, 'at the stroke of the keyboard' would be even more valid (Mellor, 2016, p. 109)).

It does not follow that banks can create new money infinitely. There are formal and informal rules that prevent them from doing so (McLeay & Radia, 2014a, p. 14; Werner, 2016, p. 373). However, what this view asserts is that banks' lending practices are not limited by their pre-existing assets. While banks, at the end of the day, do need reserves to back their loans, they are not limited by the amount of reserves they have in advance of issuing a loan. This consequence differentiates credit creation view from the other two.

The fractional reserve⁷ theory resists this implication. Its advocates claim that banks need reserves in advance in order to be able to extend loans (Werner, 2014a, p. 6). According to their theory, the functioning of the banks begins with the injection of the reserves from a central bank. Importantly, each state proscribes the reserve ratio that each bank has to hold at every time. To simplify, let us assume that central bank issues one hundred dollars (\$100) to Bank A. That bank keeps the necessary reserve ratio of one percent (equalling \$1), and loans the extra reserves (\$99) to Bank B. Bank B, in turn, keeps the one percent required by law (equalling \$0.99) and lends out the rest (\$98.01) to Bank C. Bank C keeps its mandated one percent and lends the surplus on. (See Figure 1 for a visual representation of the process). Ultimately, the amount of money in the system will be an inverse of the deposit requirement multiplied⁸ by the original injection.⁹

⁵ Here we take it for granted that bank deposit and money are one and the same. We will discuss this equivalence in Section 3.

⁶ More accurately, the money presented by loan principal is destroyed; the interest earned is an asset of the bank.

⁷ This is a somewhat unfortunate choice of a name. On the one hand, as will be shown shortly, it accurately describes the view it labels. On the other hand, almost all of the banks currently in existence are by nature fractional reserve banks, regardless of which of the three theories is true. The opposite of a fractional reserve is a *full* reserve bank, meaning that it has all of its deposits fully 'backed up' by assets.

⁸ Hence the Jakab and Kumhof's terminology when speaking of the 'money *multiplier* model'.

⁹ One hundred dollars multiplied by the inverse of 1% (a hundred), equals ten thousand dollars. (or: $100 \times 1/0.01 = 100 \times 100 = 10.000$)

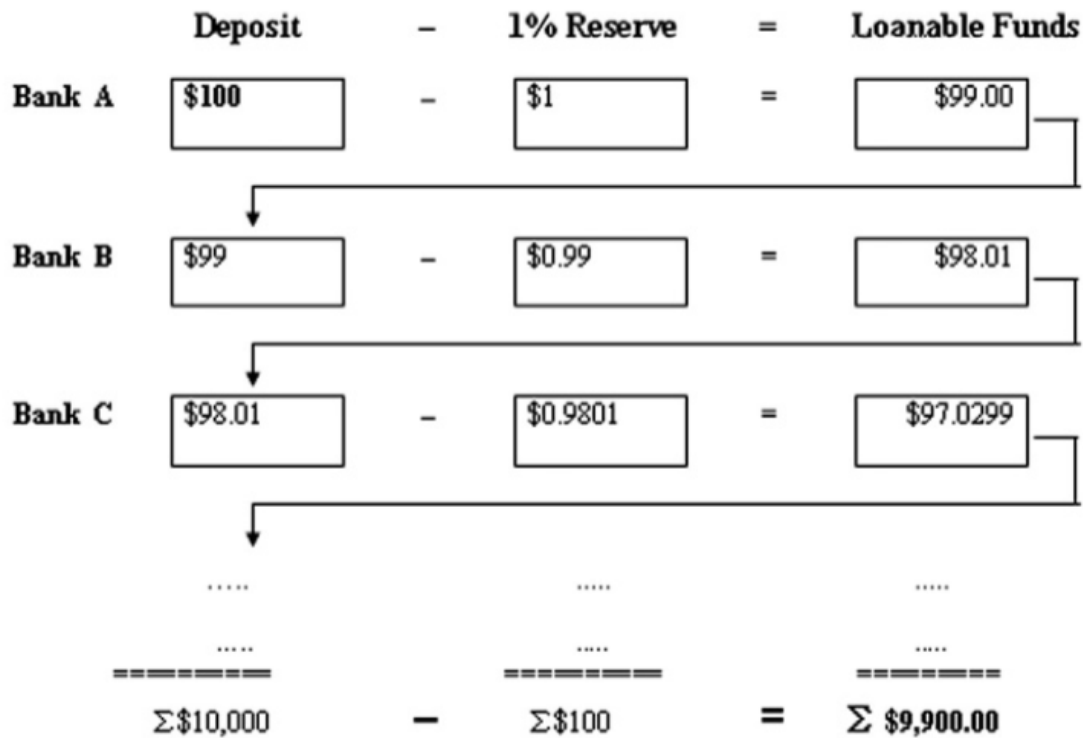


Figure 1. Visual representation of the fractional reserve model (Werner, 2014a, p. 8)

Another notable difference between this theory and the credit creation view is that here each *singular bank* does not create new money, but *the system as a whole* does. If one sums up the total amount that all banks possess as deposits (the left-most column in Figure 1), one notices that the amount of money is multiplied in total. The single bank has not created new money, but merely acted as an intermediary. This apparently magical property of global money creation led some authors to conclude that it is overly convoluted, and is the fact that ultimately contributed to its rejection (Werner, 2014a, p. 9).

What it was replaced with is what Werner calls the financial intermediation theory. What this theory has in common with the fractional reserve view is that it considers banks as pure intermediaries; they only loan the funds that they had acquired (Werner, 2014a, p. 9). Therefore, no new money creation, whether at the individual or at the systemic level, takes place. Banks, described by this theory, merely connect the savers and borrowers. Savers, who have surplus funds, put money in the bank counting on interest payments in the future. Borrowers, who lack funds for their projects, borrow from the savers in the present and return the amount, with interest, in the

future. This process is, according to the financial intermediation theory, merely facilitated by banks, who profit off interests paid by the borrowers.

1.2 Evidence and adjudication of the three theories

Before we present which theory Jakab and Kumhof and Werner defend, it should be noted that their respective methodologies are quite interesting. Werner, for his part, adopts a two-fold approach. The first is empirical, focused on the micro-plan, so to speak. In two of his papers, he sets out to visit a small, local bank in Germany, where he diligently and rigorously follows every step of the actual loan extension process. In advance, had formulated what each theory empirically predicts in terms of the balance sheet changes in the process. Then, he compares to results to analyse which fit best with the theoretical predictions (Werner, 2014a, 2016). Secondly methodology, presented in the third paper, is legalist. Since the banks can create new money, the assumption goes, what is it that enables that power *by law*? (Werner, 2014b).

Jakab and Kumhof, on the other hand, approach the issue from a more traditional economic perspective by building models. They take a standard model widely used in economics (Dynamic Stochastic General Equilibrium, DSGE), clarify that it is usually formulated based on the financial intermediation theory, and then build an alternative one based on the credit creation theory. Lastly, they run the models and compare which of the two better fit the data (Jakab & Kumhof, 2015, Chapter IV). But, curiously enough, they do not see the results as a way of falsifying the theory. They do not believe that any of the three views is a theory in the proper sense. Instead, they believe that one of them *just is* how banks work, and that model building using it will simply yield more empirically adequate result. To quote them at some length: “In the present context this would amount to asking whether we can provide empirical evidence for the “theory” that banks create money through loans, rather than intermediating pre-existing savings. But this is not a theory that needs to be proved, it is a simple fact, it is part of the elementary design of any modern economy’s financial system. The empirical evidence in Section VI is therefore not critical for justifying our modelling of banks. But it is critical for demonstrating that these insights have quantitatively important consequences” (Jakab & Kumhof, 2015, p. 4).

As suggested, J&K and Werner accept the credit creation theory of banking. The reasons they do so are different, however. Werner, for instance, comes to this conclusion as a result of his

‘field experiment’. For him, the crucial fact that distinguishes the credit creation theory from the other two is that it is an *empirical fact* that extending loans requires no reduction in funds elsewhere in the bank’s balance sheet. Having conducted interviews and analyzed the balance sheets of the bank before and after loan issue, he notices that the balance sheets only extended (increased in value), without shortening (decreasing in value) elsewhere in the bank beforehand. This, he concludes, fits only the credit creation model (Werner, 2014a, pp. 14–16, 2016, pp. 370–373).

The second, legalistic approach that he discusses, focuses on what are called the Client Money rules. Werner shows that banks and non-bank financial intermediaries (NBFIs) are governed by two disparate sets of laws. The NBFIs are obliged to keep their accounts separate from their clients’. Therefore, should the company collapse, the clients’ money is safe. On the other hand, banks are covered with another set of rules, which enables them to classify their clients’ fund as their own, aggregated ‘under one roof’. This aggregation allows them to (mis)label the newly created bank deposits as clients’, while they are in effect the property of the bank.¹⁰ Therefore, Werner concludes, banks are not only empirically different from pure intermediaries as a result of their lending practices, but this difference also has a basis in legal regulation (Werner, 2014b, p. 75).

Jakab and Kumhof also defend the credit creation view, although on somewhat different grounds. First, they offer a critique of the pure intermediation view. Namely, they take issue with the basic assumption that depositing money in a bank increases the lending powers of that bank. To explain this, they assume two banks, Bank A and Bank B. While removing a deposit from Bank A does reduce the amount of funds in it and adding the deposit to Bank B does decrease it, due to the closed nature of the banking system, *no new funding* emerges and the amount of funds remain the same (Jakab & Kumhof, 2015, p. 6). Interbank operations are a zero sum game: what one bank gains, another must lose. Therefore, no extra funds are created that could further be lent. (For the clearer visual explanation of this, please refer to the Figure 2 in the Addendum of the thesis).

Jakab and Kumhof are similarly disparaging towards the fractional reserve view. Firstly, they recognize that even the first step of the model – central banks injecting reserves in the banking

¹⁰ Incidentally, this leads to many popular confusions about banking. First off, bank deposits (‘the money in the bank’) actually belongs to the bank instead of the customer. Secondly, bank customers are not savers, since their money is not deposited safely and put to the side. Rather, they are lenders to the bank (Werner, 2014b, p. 77).

system and banks lending them on – is strictly speaking impossible, since banks cannot lend central bank reserves (Jakab & Kumhof, 2015, pp. 13–14). Namely, these reserves are only used to settle accounts on the interbank market, that is, between the banks themselves or between the banks and the central bank. When bank customers borrow from the bank, they can only receive bank deposits, or can alternatively convert those deposits to cash and withdraw it. It is literally impossible to lend bank reserve to citizens.

Secondly, Jakab and Kumhof claim that the fractional reserve model reverses the order of bank lending and central bank reserve funding. Central banks have long stopped performing monetary policy by controlling the gross amount of money in the economy. Instead, their main monetary policy tool is what is called ‘interest rate targeting’. In principle, that means that the central bank sets the interest rate that they think is optimal for the functioning of the economy, and banks are, in turn, obliged to lend guided by that rate. This requires that central banks lend to the banks upon request, in order for them to achieve this goal (Jakab & Kumhof, 2015, p. 13). This shows, according to Kumhof, that the fractional reserve model has it exactly wrong; it is the central bank that will provide banks with the necessary reserves when they need it to maintain the interest rate target, and not the banks requiring central bank reserves beforehand in order to be able to lend at all (Jakab & Kumhof, 2015, p. 14).

It is not only the academic economists who defend the credit creation view. Even central banks’ official research, and the statements of central bankers speaking publicly, support this view. Two very prominent research papers originating from the Bank of England (United Kingdom’s central bank) have been widely quoted in advancing the credit creation theory. McLeay and colleagues (2014a, p. 14), for example, state that: “Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower’s bank account, thereby creating new money” and “Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits” (McLeay & Radia, 2014a, p. 14). At another place, the same authors state that: “Far more important for the creation of bank deposits is the act of making new loans by banks. When a bank makes a loan to one of its customers it simply credits the customer’s account with a higher deposit balance. At that instant, new money is created” (McLeay & Radia, 2014b, p. 11). Similarly, according to Claudio Borio, the head of the Monetary and Economic

Department at the Bank of International Settlements¹¹: “This [bank] money is created as a counterpart to the loans banks extend or assets they buy” (Borio, 2018, p. 8). Criticizing the fractional reserve view he states: “As has become increasingly recognised, the money multiplier – the ratio of money to the monetary base – is not a useful concept. In fact, in systems without reserve requirements the multiplier is, practically, infinite; and nothing calamitous has ever happened” (Borio, 2018, p. 7, reference omitted).

To quote these authors is not to blatantly appeal to authority. While the central banks do play an important role in the financial sector in every country and should be taken as authoritative on the matter, it is always possible that they are wrong. For example, Werner shows that the very same Bank of England has supported different views throughout the years (Werner, 2014a, p. 12). Nevertheless, all of these pronouncements seem to independently point to the emerging consensus that supports the credit creation view.

1.3 Conclusion

It is not easy to assess the claims made here, because it is not clear what the status of all three competing theories is and to what extent their methodology supports their claims. Are they scientific theories in the field of economics, amenable to empirical falsification?; Or are they rather *a priori* views, which are ‘simply’ true or untrue in Jakab and Kumhof’s sense? Werner seems to believe it is the former, having devised an experiment, to show support for his favored theory. Jakab and Kumhof, even though they assume the latter view, ultimately creates a mathematical model using credit creation theory that appears to make better empirical predictions than the one based on the pure intermediary view (Jakab & Kumhof, 2015 especially sections IV. and VI.). Until we have a better understanding of the nature of these theories, and how to go about testing them, we should be very cautious with our final conclusions. Nevertheless, for the purposes of this thesis, it is sufficient to stay agnostic on the methodological questions and tentatively accept the credit creation view.

¹¹ An institution owned by sixty central banks that coordinates monetary policy between them; often called the ‘Central bank of central banks’ (See: <https://www.bis.org/about/>)

Section 2: What is wrong with banking and how does Sovereign Money address the issue?

What was presented so far is merely descriptive of the debate; we have only learned how banks create new money, without any kind of value judgement attached to it. However, a wide group of monetary reformers perceive the credit creation as a failure of the system, and strive to transform it. The proposals for reform are numerous: return to the gold standard (Forbes & Ames, 2014), abolishing the central bank (Paul, 2009), introducing full reserve banking (Kumhof & Benes, 2012), etc. These alternatives will not be discussed. Instead, we will focus only on the one: the Sovereign Money System (SMS). For the purposes of this thesis, we will be referring to (Dyson, Hodgson, & van Lerven, 2016)¹² and (Huber, 2017)¹³. The former are the members of Positive Money, the think-tank that most visibly argues for the Sovereign Money System. The latter is the most prominent academic economist working on the issue.

SMS is on the face of it fairly simple. It recognizes that the banks' power to create money leads to intermittent market failures at best, and large scale financial crises at worst. Because the advocates of this reform do not believe that reform is a successful potential solution (Dyson et al., 2016, p. 11), they propose that the money making power should be stripped from the banks and given to the state (Dyson et al., 2016, pp. 4–5).

This deceptively simple statement hides a lot of complexities underneath: How would banks work in this system?; How would the state conduct monetary policy?; Which state institution would create money?; Who would decide how much money is created?; Where would the newly created money be spent or lent? All of these questions are legitimate, and have been a subject of a lively intellectual debate. However, not all of them are relevant for my purposes here. What I intend to do is present the criticisms that the SM advocates have of the current banking system and how they claim their proposal will fix it.

2.1 What is wrong with the current system?

¹² Dyson and colleagues' new booklet supersedes, by their own admission, their previous book on the matter (Jackson, Dyson, & Daly, 2014) (see: <https://positivemoney.org/modernising-money/>).

¹³ Similarly to the previous note, this book is an updated version of (Huber & Robertson, 2000). For more literature on the topic, the reader is referred to (Mellor, 2016; Robertson, 2012; Zarlenga, 2002).

First off, according to the SMS advocates, the current financial system is inherently unstable and unsafe (Dyson et al., 2016, p. 12). As discussed, banks create money (bank deposits)¹⁴ when they issue new loans. These loans are, in accounting terms, assets of the bank. They are what the bank *is owed*. On the other hand, the newly created money are the liabilities of the bank: it is what the bank *owes* to the customer. Therefore, the money in the system is always heavily dependent on the banks' assets. These assets can be of various quality and in the times of the financial upswing in the economy, they are usually of stable value. However, if the assets quickly start losing their value, or enough customers default on their loans for various reasons, the bank's survival is put into question (Dyson et al., 2016, p. 12).

This is usually not a problem, since the central bank usually smoothes out smaller issues in bank's liquidity. However, if the crisis is systemic, like it was in 2008, the banks could be brought to the brink of failure. This leads to two possible outcomes. The bank is either let to fail, which freezes the customer's bank deposits, so that they are unusable. Then state then has to liquidate the bank and pay off the depositors itself. In the second case, the state decides to save ('bail out', as it is popularly called) the bank with taxpayers' money. This keeps the banks afloat, but also at the cost of the taxpayers (Dyson et al., 2016, p. 12). The former role is being the deposit guarantor. By the virtue of it, the state guarantees to compensate the banks' customers with the pre-agreed maximal sum in the case of collapse. The latter role is being the lender of last resort (often abbreviated to LOLR). This entails the central bank lending to the failing bank in case that other financial institutions can or will not. To be sure, more often than not, the latter scenario takes place. But in either case, the government is responsible for underwriting banks' liabilities.

Intuitively, there is something wrong with this situation. It is one of the fundamental tenets of market economy that any private enterprise can succeed or fail on its own terms. Furthermore, in that view, that the government's only role is to set the rules of the market, so to speak, without disturbing the functioning of the market itself. However, in the case at hand, it seems like that the

¹⁴ The question whether bank deposits are money should be addressed here. To grossly oversimplify, we should not consider money as a specific token, thus delineating whether one object is or is not money. Instead, we should think about the *liquidity* of various objects. 'Liquidity' here means to what extent can an object be exchanged for a good or service. Thus banknotes are considered money because they are highly liquid: under normal circumstances, any person or company will accept it. However, in a hyperinflation, banknotes are worthless; they have low liquidity. Conversely, cigarettes have low liquidity in most of society; therefore, they are not considered money. However, in some prisons, they are the main role of exchange – are highly liquid – so they assume a form of money. Therefore, bank deposits are money in as much as they are liquid – as long as the people are ready to accept them (Lonergan, 2014, Chapter Introduction). This is usually true in times of stability. On the other hand, in times of crises and distrust towards a bank, or the whole banking sector, bank deposits lose their liquidity.

government is committed to fully supporting the banking private enterprise. This state of affairs only increases the incentive for banks to take risks, knowing that they will be caught with the public safety net – a typical example of a moral hazard.

The second issue with the banks having the power to create money, according to Dyson et al., is that bank lending is pro-cyclical – meaning that it leads to the new economic crises emerging (Dyson et al., 2016, p. 13). Therefore, it is not only the issue that banks are prone to collapse in the case of crises; it is actually that their default functioning leads to said crises and prevents the recovery of the financial system. To explain, start from the beginning of the business cycle. At first, banks are optimistic and willing to lend. This increases the demand for credit (money) and more people are willing to take on a loan (usually a mortgage). However, as more and more people lend, they are burdened with repaying the debts. If they cannot, they default on their loans. This reduces the total amount of assets of banks, which leads to collapse. This is the downswing of the cycle. Little new credit is issued, the economy is stagnant, people lose their jobs, and are thus reluctant to take on new debt. It is the new influx of liquidity that is needed at this point. However, banks are reticent to issue new loans and thus prolong the downswing. This is what pro-cyclicality means: boosting the upswing when the economy booms and prolonging the slump when it slows down.

Ironically, what is needed in the downturn is the injection of credit, which leads potentially to new crises – hence the name ‘business *cycle*’. Because most of the money in the economy is issued in the form of credit (when new loans are extended), the cycle is bound to continue. The one entity that could ultimately prevent the cycle, the state, is actually complacent in the problem. This is the third issue that SMS advocates underscore. Namely, the central banks do have instruments to counter the business cycle, main of which is the *bank policy interest rate*, or just ‘bank rate’. This is the target rate that the banks follow (Dyson et al., 2016, p. 4). Colloquially, it could be explained as the ‘price of money’. The lower the bank rate is, the money is cheaper, the banks have more incentive to lend at lower interest rates which, in turn, incentivizes citizens to take on debt. This is done in the state of the downswing in order to boost lending and improve the economy. Contrariwise, having a high policy rate makes money more expensive, thus disincentivizing citizens from further borrowing in the upswing (Dyson et al., 2016, p. 13). This policy lever is obviously quite indirect, and its efficiency has been disputed (Dyson et al., 2016, pp. 14–15).

This aforementioned first set of issues might conceivably be called economic. But, Dyson et al. continue, the current financial system causes various social and environmental adverse effects (Dyson et al., 2016, pp. 15–17). For instance, consider asset prices in general, and the price of homes in particular. Since banks act as a kind of economic planners, loosely speaking, the areas they decide to invest in are valued higher. In the current system, the largest single target of lending are mortgages (Jorda, Schularick, & M. Taylor, 2016, p. 8). Because the home ownership is highly valued (Ryan-Collins, 2019, sections 2.2 and 2.3), citizens are highly motivated to take out mortgages for their private homes. Following the law of supply and demand, this increases the price of those homes. This is one of the reasons the home prices are so high in developed countries.

This is a social issue on its own, but it gets compounded by the demographic distribution of asset ownership, since assets, and specifically homes, are predominantly owned by older generations (Ryan-Collins, 2019, sec. Introduction). This entails an increase in asset prices that disproportionately benefits the older members of society, further increasing rift between them and the increasingly impoverished youth.¹⁵ Asset inflation is damaging along another axis: Existing wealth disparity. Namely, groups who own assets, regardless of age, are more well off than the groups who do not. Booming asset prices just add towards the wealth inequality in society.

Investing in mortgages means creating new money for the purposes of speculation and artificially rising prices of existing assets. That necessarily further means that less money is invested in what is called the real economy: starting new businesses, creating new jobs, building social housing, etc. This stifles the economic growth and reduces the welfare of the society.

2.2 How does Sovereign Money purport to solve these issues?

As stated, SMS entails, on the surface of it, a very simple proposal: take the money-creating powers from the banks and give them to the state. The transition would, it is assumed by the proponents, lend more credence to the money creating process, making it more transparent, democratic, and more amenable to public interest.

¹⁵ This development is, once again, compounded by the demographic trends of ageing of the population. Therefore, the already impoverished youth is, due to the nature of the welfare state, coerced into further reducing their income in order to contribute to the welfare of the retired.

The first advantage of the SMS, according to the advocates, is increased stability of the economic system. As discussed, the current system is heavily reliant on bank-originated credit money: money is created in the form of credit, which at a later point needs to be repaid. Since banks are influenced by the market forces, it is in their interest to issue as many loans as possible. And, as shown, this leads to crises.

Sovereign Money System strives to undercut this system not by introducing more counter-cyclical reforms, but by changing the nature of money. Under this system, all money would not be predominantly credit-based, but all of it would be solely *fiat* money. That means that it would not have any kind of backing based on various assets, but would fundamentally depend on the trust of the institution that issues it (Huber, 2017, p. 26). To explain; Credit bank money (bank deposits) are only as good as the assets (loans) that ‘back’ them. Similarly, historically currencies were dependent on various assets, but typically, on precious metals like gold or silver. This means that one unit of a given currency was exchangeable for a certain unit of gold. However, in the twentieth century, all currencies were ‘unpegged’ from gold, thus becoming *fiat* – ultimately not dependent on any single asset. So, one gets no asset if one tries to exchange an amount of fiat money.¹⁶ To reiterate, under the SMS, all the money would be *fiat* – depending on the stability of the state; not needing to be repaid – and none would be credit-based – depending on bank’s assets; needing to be repaid to the bank.

Therefore, according to the advocates of SMS, the safety of citizens’ money would not depend on the whims of the market, and the willingness and capacity of the state to ‘bail out’ the failing banks. Furthermore, the state would not have to act as a safety net (deposit guarantor and LOLR) in case the banks do fail. That not only reduces the moral hazard in the banking sector, but is more in ideological accordance with the idea of the market economy.

The second problem of the pro-cyclicality is similarly alleviated in the Sovereign Money System. If we accept the received view that the market is inherently prone to periods of exuberance followed by panic and resignation and that the role of the state is remedial, then, it is assumed, giving the governments full control over money supply will inherently lead to a smoothed-out business cycle (Dyson et al., 2016, p. 13).

¹⁶ An interesting curiosity is that if one attempted to ask for an asset, presenting a bank note at the central bank, one would get the same bank note (or another, newly printed one) in return. <https://www.bankofengland.co.uk/knowledgebank/how-much-is-a-banknote-worth>, paragraph 3 and (Jackson et al., 2014, Appendix III, para. 8)

This transformation also tackles the stated issue of indirect and often inefficient central bank monetary policy. In the current system, central banks indirectly incentivize banks to lend by tweaking the bank rate. However, especially since the economic crisis of 2008, this has increasingly been seen as insufficient (Dyson et al., 2016, pp. 14–15). Furthermore, the so called unconventional measure that is the Qualitative Easing, that literally entails creating new money in order to boost the economy (although, again, indirectly), has proved to be an ineffectual tool (Jackson & Dyson, 2013, pp. 12–13).

Proponents of the SMS claim that their reform gives the government more direct instruments of control over the economy than the bank rate can offer. Namely, governments would no longer have to act from a distance, when they could instead decide directly where the investments are made. This change would solve not only the problem of indirectness of influence, but also the lack of diversity in investment (Dyson et al., 2016, p. 15); Under the SMS, it is assumed, the citizens and the economy would no longer depend on the decision of the small circle of investors as to where the money in the economy would be directed to. Instead, democratically elected and accountable governments would decide on optimally allocating investments for socially desirable interests. For instance, instead of spending on mortgages, the state could invest in building new housing stock. Similarly, instead of financing new and environmentally harmful coal powered plants, the state could take climate change into account, and build new facilities that use renewable sources, or even nuclear and hydroelectric power plants.

This change would not only help mitigating climate change, but also conceivably reduce unemployment. But this is not the only social improvement that the SMS would allegedly bring. Since the state would, it is assumed, divest from assets, it would also relieve some of the social inequality already discussed (Dyson et al., 2016, p. 16). But more to the point, under this system the line between monetary and fiscal policy would be considerably blurred. Therefore, many previously socially favorable programs could be financed. For instance, tax reductions could be availed to the poorest and the middle classes. Similarly, citizens' income could be paid out to the citizens of the state (Dyson et al., 2016, pp. 44–45). Lastly, more funding could be provided to all of the social services that were targeted by cuts in the austerity regime of the last decade.

2.3 How would the Sovereign Money System work in practice

The description given in the last subsection is a bird's eye view of the SMS. It laid out the supposed advantages on a very large social, political and economic scale. What was not spelled out is what that system would look like in practice. Spelling out the technical details would spoil the narrative of the thesis. Therefore, I will only focus on one key idea and two key elements of the proposal.

As discussed in Section 1, bank deposits are created when new loans are issued. Furthermore, it is also shown that the sustainability of those deposits is highly dependent on the quality of the assets that back them and the liquidity of the banks. What was left unstated, however, is that bank deposits are a means of payment – and a dominant one, at that. In the UK economy, around ninety-seven percent of all money in the economy are bank deposits (McLeay & Radia, 2014a, p. 15). (The other three percent are cash money in the form of bank notes and coins). Moreover, bank money is the *de facto* the only way of transferring money electronically.¹⁷

This fact is increasingly more important as fewer transactions are being performed by cash and people are relying on payment cards (credit and debit) more and more. In some countries, like Sweden, more than 85% of transactions are performed by cash (Sveriges Riksbank, 2017, p. 4). Thus, it is clear that by increasing the reliance on electronic money society further increases its reliance on the banking system.

This would not be an issue, in principle, if the banking system operated sustainably. But, as discussed, its failure may lead to its customers' funds being made inaccessible. That is because the banks have a monopoly on the *payment system*. This term has been hidden in the discussion so far, but is actually crucial for the debate. Payment system is essential for the proper functioning of the economy. Without it, no transactions could take place: businesses could not operate because their customers could not transfer their funds to them; citizens could not settle their accounts between each other; banks could not perform interbank settlements; central bank could not inject reserves to assist the illiquid banks; etc. Needless to say, these systems are crucial for the everyday functioning of modern market economies.¹⁸

¹⁷ Not counting electronic transactions in cryptocurrencies and various e-cash schemes that, at least for now, take up a small overall percent of the traffic (World Payments Report, 2018, p. 12).

¹⁸ For more information on payment systems of, for example, the European Central Bank, Swedish Riksbank, and the Bank of England: <https://www.ecb.europa.eu/explainers/tell-me/html/target2.en.html>, <https://www.riksbank.se/en-gb/payments--cash/the-payment-system---rix/>, <https://www.bankofengland.co.uk/payment-and-settlement>

However, in the current system, access to payment system is inextricably tied to the credit creation and allocative roles of banks. In other words, banks are the institutions where these two roles converge. This state of affairs is not necessary, but is actually a result of historical contingency. In the 17th century, goldsmiths often had the roles of the proto-bankers. They would keep their customers' gold specie, and give them receipts (IOUs) as a marker of confirmation for the amount stored. The customers soon realized that these receipts could be used as a means of exchange, instead of using the cumbersome gold specie kept at the goldsmith's. Soon, however, the goldsmiths realized that the customers arrived more often to deposit their gold than to pick it up. Shrewdly, they further realized that they could just write the receipts without there existing a corresponding amount of gold. Hence, it is assumed, the fractional reserve banking was born (Davies, 2002, pp. 248–252).

As the world started getting more globalized, with Europeans venturing outside of their native continent, long-haul, intercontinental trade increased in importance. With it, the new need for a simplified payment system arose. As in the case with the goldsmiths, traders were reluctant to carry around large amounts of precious metals due to its large volume and weight, but also due to high risks of robbery. The problem was, once again, solved by the cunning use of paper receipts. Important bankers, who were often rich, reputable men, would have their businesses closely follow newly emerging trade routes. Their role was not only financing this trade, but keeping the accounts of the tradesmen performing it. These bankers, due to their widely famous reputation, performed the roles of the goldsmiths before them, with a crucial difference. Their receipts were not valid only in a village or a town, but also across states and continents. This global acceptance of their notes turned them into providers of a first reliable long-distance payment system.¹⁹

Banks are also hailed not only as facilitators of trade, but also as the kickstarters of early capitalism. Many resource heavy investments were required in this period – machines, new factories – and the bankers were the only ones who could provide such capital. However, times have changed since then, and with it the nature of money and the paper-based payment systems. Since our transaction accounts do not depend on gold specie anymore, it is not at all clear why our payment systems need to be tied to the money creation role of old.

¹⁹ For an extensive history of banking in the early modern period, see (Davies, 2002, Chapter 6) and (Graeber, 2014, Chapter 12).

This is the key insight that the Sovereign Money puts on the table: *separating the payment system and money creation and allocation*. So what would that system look like in practice?

Interestingly, it would not look much differently than what the majority of people think that the current system looks like. That is, banks would be reduced to pure intermediaries (one of the models discussed in Section 1). Since they would be stripped of powers to create new money when they issue credit, they would first need to attract loans before they could lend. This would put them on the same level as the other actors in the economy and would dispose of the requirement for the government's preferential treatment of being a guarantee depositor and lender of last resort.

Of course, lending entails risk of loss as much as potential for gain. Therefore, banks' customers' funds would be at risk as in the current system. There are two differences from the current system, however. Firstly, in the new system, banks' customers would be aware of the fact that they are investors and that they can lose their money. Compare that to the current system where most bank customers believe that the money in the bank is theirs and that it is safe and merely saved for the future (Motivaction, 2016).

But secondly, and crucially, having risky accounts is not an issue, since there would be a second type of accounts, Transaction Accounts (or as I will simply call them Safe Accounts) where the citizens' money would be completely safe²⁰. These accounts would hold deposits at the central banks, and would therefore not depend on private bank lending. These deposits would be 'as good as cash' or could be considered a digital equivalent to cash. Or in other words, they would present an electronic form of government-back printed or minted physical currency. These Transaction Accounts need not necessarily be managed by the central bank or the state. Its administration could also be given to the hands of the market (Dyson et al., 2016, p. 19). They would provide the most important basic services, provide innovative payment possibilities, etc., but they would not be allowed to further lend out those funds. These companies would be fully exposed to all market forces and would fight for profit, without government assistance. But what is important to note that even if a company bankrupt, the money is safe with the central bank. They are merely fiduciaries of their customers to the deposits in the Transaction Accounts.

²⁰ We should not overplay the safety here. It is safe only insofar as it is not exposed to risk. It is conceivable that money could somehow be lost due to a malicious attack, massive power outage, natural disaster, etc. Therefore, 'safe' here means 'not exposed to risk' and not 'completely indestructible'. This should not be taken as a disappointment, since the other kind of safe money – cash – is equally, if not more vulnerable to damage, and yet it is the most liquid form of money in the economy.

That is the payment system side of the reform. But what does the credit creation by the state aspect look like? Proposals on this differ. Some proponents argue that new money should be created by the Ministry of Finance or the Treasury (that is, by the state proper) (Werner, 2012), while others argue that it should be in the hands of central banks, since they are somewhat independent from governments in most developed countries (Huber, 2017, pp. 144, 149). Some proponents even go so far as to appeal to transforming the central bank into a new institution called a Monetary Authority, which would not even be a bank by its nature (Wortmann, 2016, p. 9).

The second point of agreement is that the decision on how much money to be printed should be brought about democratically and with a strong separation of powers by design. It would rather defeat the purpose of the reform if a group of privately appointed, unelected bankers were replaced by another, but quite similar group of unelected technocrats. It is not controversial to claim that the budgetary decision on how the state should provision money – fiscal policy – is political. But a lot of politicians and economists believe that monetary policy is a technocratic, apolitical endeavor. Nothing could be further from the truth (Dietsch, Claveau, & Fontan, 2018). As discussed, money creation power entails outsized political, social, and economic consequences. Therefore, the choice on the volume of newly created money should be democratically deliberated. Again, it does not mean that it should be used on a whim by an ideologically driven politician. But it does mean that it should be used responsibly, with the input of both the experts in the field and partisans from various parts of the spectrum.

2.4 Conclusion

Sovereign Money system is an immensely radical reform. It intends to upend the banking system, the state monetary policy, as well as the configuration of the relationship between the executive power (Ministry of Finance), Treasury, and the central bank. While the idea has gained a following by some reputable economists and journalists (Turner, 2016; Wolf, 2015), it has not gained too much political traction. Only the government of the small nation of Iceland, strongly hit by the crisis, was interested (Sigurjónsson, 2015), but that enthusiasm quickly waned. Similarly, there was a Swiss initiative to implement a similar program, but was ultimately

rejected.²¹ There is little doubt that the perceived extremeness of the proposal was one of the reasons for resistance to change. By the end of the thesis, I will offer a more moderate, and hopefully more palatable alternative. Before that, the merits and demerits of SMS need to be discussed.

²¹ For more information on the initiative, see <https://www.vollgeld-initiative.ch/english/>

Section 3. Critique of the SMS: Payment systems

In the following two sections I will offer my critique of the SMS. It will largely follow the division line already hinted at: separation between the safe payment system, and the public creation and allocation of credit. In this Section I will normatively underpin the former, and in Section 4 I will criticize the latter. Thereby, I will offer a more moderate proposal that could be a middle way between the status quo and the full SMS implementation. This would, I hope, make it more politically appealing and economically and socially less radical.

To reiterate, payment systems are immensely important for the smooth working of modern market economies. Unfortunately, in the current economic system, the citizens' access to the payment system is heavily reliant on the inherently unstable workings of commercial banks. Sovereign Money proposal argues for regulating away the banks money creation powers, and giving the citizens public access to the payment system. Furthermore, it would give the states full power of all money creation in the economy.

These two proposals are bundled together, but it would be better to consider them analytically apart first, and then discuss which of the parts holds under scrutiny.

3.1 Payment system as a public good

We have seen in the short presentation on the history of banking that the two roles mentioned have converged as a matter of historical contingency. Goldsmiths and bankers provided much necessary liquidity in their respective economic niches, and as a matter of facilitation, they used their power to provide a robust payment system. While this function is commendable and was necessary at the time, it is arguably no longer the case now.

Technology has progressed to such an extent that there are many non-bank companies that provide a more or less robust and prevalent payment possibilities. For instance, payment with cryptocurrencies, as capricious as it is at the point of writing, enables its users to perform remote payment without relying on banks, nor on centralized payment systems. Similarly, the rise of many

smartphone applications²² enable instant transfers between users and many other innovative options, not usually provided by banks.

However, cryptocurrencies are ridden with uncertainties and failures (Borio, 2018, p. 10), while the aforementioned applications are ultimately reliant on their users' bank accounts. This points to two facts: traditional payment systems are robust, reliable, and immensely useful; and banks ultimately have a monopoly on the access to them.

Payment systems are immensely complicated. Some of them are public, while others are private. Some are small scale, used for particular niches, while others span states and continents, used between governments and large market players. Some work in real time and support large amounts of transactions, while others perform clearance daily and thus net out smaller amounts. I will not focus on these particularities, although that does not mean that I do not find them pertinent. I will assume a bird's eye view of the technology and hope not to lose finer points by over-generalizing.

This is only half of the story. After all, not all money is electronic money. While the use of cash dwindles, at least in some parts of the world and in certain demographics, it is still a crucial instrument for large swathes of people worldwide (Access to Cash, 2019). Maintaining a stable cash system is, therefore, equally important as the electronic one. That entails various obligations. Money notes and coins need to be designed and printed or minted according to various stringent standards. Then, they need to be supplied to the banks and other financial actors safely. Also, the amount of cash money needs to be tracked and put into circulation at different time periods, depending on the amount of cash money already in circulation, the amount of 'hogging' money, the amount of physical damage that notes and coins sustained, etc. Lastly, it needs to be put out of circulation for replacement and security upgrades.²³

It should be clear that maintaining both cash and electronic payment systems requires considerable amount of funds and effort. Most of this effort is provided by the state. While private actors can be subcontracted to perform some parts of the work, it is ultimately the responsibility of the state to maintain the stability of the system. This is rightfully so, because, I assert, *payment systems should be perceived as public goods*.

²² Such as Swish in Sweden, WeChat Pay and Alipay in China, Venmo and PayPal globally.

²³ For more details on this process, see <https://www.bankofengland.co.uk/banknotes/lifecycle-of-a-banknote>.

Public goods have traditionally been defined as goods that are *non-rivalrous* and *non-exclusionary*. The former means that the enjoyment of the good on the part of one person does not impede another person from enjoying it. The latter means that no single person can be excluded from enjoying the good, or at least that their exclusion from the good is more expensive than keeping them included.

Let us assume that the government founds a new institution that is mandated with providing access to the payment system. (In effect, this would mean providing the Transaction Accounts to all of its citizens, since these would be the safe accounts, not exposed to lending risk). Further assume that the government has reliable information on all of its citizens and the IT infrastructure to build such a system. It is relatively easy to see that such a system would be non-rivalrous: one person having more money on their account, or accessing their account at a given time, would not impede other users from having money on their account or accessing the system at the same time. Similarly, with the aforementioned provisos, it would be relatively easy to create accounts in bulk, for each citizen, so that none of them are excluded. Before continuing to demonstrate why it is beneficial to see payment systems as public goods, we should first spend a few words on Joseph Heath's view on the welfare state.

3.2 Money relationship as parasitism and injustice

If my claim that access to payment system is a public good, then the functioning of the current banking system is not only inefficient, but also unjust. As discussed, there are two kinds of money in the economy today: credit and fiat money. Credit money is provided by the banks when they issue loans, thus it needs to be repaid. Fiat money, on the other hand, is provided by the state – in the form of notes, coins, and central bank reserves – and is an asset of the holder, which means that it does not need to be repaid.

What has not been discussed is a relationship between these two types of money. While it would be straightforward to assume that the public has free access to state money, it is not the case. To the contrary, all forms of state money have to go through the banking system in order to reach the citizens. First off, take the central bank reserves. This money is the only form of digital money provided by the state, but it does not interface with the public directly. Rather, it is only used as a mode of interbank settlement. However, the situation is true of bank notes and coins. The only

way for these forms of fiat money to enter into circulation is through banks. It is up to the banks to order enough cash money from the central banks in order to satisfy their everyday needs and restock the ATM machines.²⁴

This interdependence goes beyond what we called the safety net for failing banks. This is a system where private money creation is not only supported by the public, fiat money; it parasites upon it. Banking sector simply could not function without the guarantees of the government and its backing the credit system with fiat money. But perversely, the state's fiat money is not freely available to the citizens – it needs to be first converted from the credit money. In modern economies, the only way to obtain cash is to go to a bank or an ATM and first reduce the amount of money on the bank account before being able to withdraw cash. In essence, there is no way to access a public, state form of money than through a private party.

Even if there were historical reasons why public money was inaccessible to citizens, it is no longer true. This is another angle from which we can look at the introduction of 100% safe money in transaction accounts. It is an interface between central bank reserves – the digital fiat state money – and the citizens, without the necessity of banks as intermediaries. The similar is true of cash; states can provide the citizens with the free-of-charge usage of ATM machines (even the private ones), in order to circumvent banks as middlemen.

Public highways are often taken to be a paradigmatic example of public goods. They are non-excludable and non-rivalrous. To reiterate, the former means that no citizens can be excluded from their use (barring the practicalities, like citizens not owning cars or a driver's licence.). The latter means that the enjoyment of the good of one person does not diminish the enjoyment of use of another. Just because I use the highway does not mean that you cannot drive on it at the same time, too. (Again, barring the practical circumstances that are congestions).

However, building the highways is often a hugely expensive endeavour for the state to take up on itself alone. Therefore, sometimes it contracts a private company to build the highway, with the promise of later repay. Sometimes the repayment method is agreed through the partial remittance of the pay toll transactions. Thereby, states partially or fully waiver the income from

²⁴ One curious exception are the employees at the Bank of England, who, until recently, had bank accounts at the central bank and direct access to the cash using the two ATM machines in the building of the Bank. Source: <https://www.theguardian.com/business/2016/jul/17/bank-of-england-closing-personal-banking-service-employees>.

the pay tolls and divert them to private company as a way of repaying the costs for building the highway.

It seems to me that the current situation with regards to banks and the payment systems are akin to the highway one. The states own the public systems – ‘the highways of money’ – but the banks monopolize access to it. Therefore, citizens are paying pay toll surcharge to the *private* entities (banks) in order to use a *public* good (the payment systems). But this ‘debt’ that the state has owned the banking sector has expired. The states now can provide a relatively cheap access to the highways without the private tolls needed.

My opponent might disagree, claiming that many such public-private partnerships are already in place, without any issues. For example, in some countries pipelines and sewer lines, electrical and internet cables are laid down by the government, but are managed by private entities. Not to mention public goods and services – railways, post offices, etc. – that are completely privatized. They could claim that there is nothing wrong with the arrangement.

There are three ways to respond. The first is practical: in at least some of these cases, privatization has had underwhelming results. One famous example is privatized British railways, where after privatization the price tickets rose steadily and the service continuously worsened (Bowman, 2015).

But that is a less interesting response. More importantly, it seems to me that the role of a payment system is relevantly different than that of utilities. While utilities are merely the services that the governments (or private entities) supply, payment systems are fundamental to the economy. Payment systems are built into a ‘tissue’ of the economy; it is one of the prerequisites for the market to work in the first place. Utilities, it seems to me, come only as a corollary of a well functioning market. Therefore, there is more reason to keep the payment systems fully public.

Lastly, and most interestingly, is the status of the agreement between the public and private entities on this matter. First off, many members of the public simply do not know how the banking system works. More worryingly, even the members of some Parliaments misidentify the role of banks in the money creation process.²⁵ Secondly, the question about the legality of the private

²⁵ Two surveys performed in 2014 and 2017 asked British MPs on their knowledge of money creation, with disheartening results. See: <https://positivemoney.org/2014/08/7-10-mps-dont-know-creates-money-uk/> and <https://positivemoney.org/2017/10/poll-shows-85-mps-dont-know-money-comes/>.

money creation is very much open. Officially, only the state money is legal tender, meaning that it is the only means by which debts could be settled, while the bank deposits are not legally regulated; they are in a ‘grey zone’. Thus, the current situation wherein bank deposits are made for widespread payments is more of a result of an outdated legal framework, rather than conscious design (Huber, 2017, sec. 5.14). Thus we return to the question on the difference between the standard public-private partnerships and the one regarding the banking sector. If I am right, the relevant difference is that in the case of the former, all parties, *ex hypothesi*, enter the *lawful* contract *voluntarily* and with *adequate knowledge* as to what the contract entails; in the latter, that is not the case.

The second criticism that my opponent might offer is that even though maybe the role of banks is not *consensual*, it may be *justified*. As already acknowledged, credit allocation is the lifeline of the economy. The institutions that provide such important service surely deserve proportional rewards, which could be keeping a monopoly on the payment system, my critics could conclude.

While not untrue that banks have a crucial role to play, left to their own devices their track record has been less than admirable. Since the liberalization of that sector in the seventies, the world has evidenced conglomeration, oversized influence of finance, and an increased number of banking crises (Reinhart & Rogoff, 2011, p. 74). This is surely not an outcome to be celebrated.

But more importantly, the debate is not led only about access, but also about the nature of the service. Banks offer an *inherently unreliable* product prone to failure. If the government can provide the same service at better quality and lower cost, why would it not? There is no way for banks to ‘sanitize’ the bank account so that it is not risky.²⁶

3.3 Joseph Heath on ‘Paretianism’ and the role of the welfare state

Heath’s view of the market is ‘Paretian’ in nature. This, very roughly, means that increasing the efficiency of the market increases social welfare. Increasing efficiency, used thusly, means

²⁶ That might not be completely true. It is possible that banks open separate ‘full reserve’ wings of their companies, where the money would not be lent out, only administered for basic services. However, that effort has, at least in the Netherlands run into legal issues. (For the history of the debate in the Netherlands, see (WRR, 2019). But even if true, it is still not clear why a private company should be a gatekeeper to a public good that is the payment system

increasing *Pareto*-efficiency – meaning leaving someone better off without leaving anyone worse off. Another important element in the story is the price system. All the changes in the market are indicated by changing market prices. Any state or process of the market that deviates from the state of perfectly efficient market (called the market *equilibrium*) results from the mispricing of resources. This deviation is called a *market failure*. A classic example of a market failure is pollution. Since the value of clean air is mispriced (polluting does not cost anything, its price is zero), the producers have an incentive to pollute. This mispricing keeps the market out of equilibrium, that is, keeps it less-than-perfectly-efficient. This further results in having reduced total social welfare by having air polluted by smog and dust particles.

This standard narrative often gives the (welfare) state only a residual role: its only purpose should be correcting market failures. In the case of air pollution, it should put the price on (i.e. tax) emitting polluting gasses. This price increase would disincentivize the producers from polluting, thus allowing the market to reach a state of equilibrium. Thus leaves the air cleaner and increases total social welfare. Later, we will see how Heath takes issue with this standard narrative.

Secondly, Heath famously claims that the erstwhile thinking on the way the market functions has been dominated by one value: the gains from trade. This has ignored four other mechanisms that could better describe the market functioning: economies of scale, risk pooling, self-binding, and information transmission. Investing is a type of self-binding, for instance: one reduces and ‘locks up’ one’s income in the present in order to gain more in the future.

Sometimes, some of these forces come into collision with each other. Take enclosure laws. On the one hand, they have increased the yield of the land that was previously common, thus boosting the efficiency, i.e. increasing the gains from trade. On the other hand, it was an “unpooling” of risk for the commoners, who as a group used to be able to use the whole of the land freely. In case a patch of land would be blighted, they could all freely use the rest of the land without restrictions. This reduced the collective risk of famine, because everyone could depend on the free group access to the whole of the land. Enclosure, however, meant that they were forbidden from moving freely to other parts of the lands. Thus in the case of blight one patch, the risk of famine is increased, because the access to the healthy parts is limited by enclosures.

Sometimes these mechanisms are mistaken for one another. For instance, social security systems are often perceived as egalitarian programs that redistribute from the better off to the

worse off. The retirement systems are often presented as the young supporting the poor or reducing the poverty of the older and more vulnerable population. However, Heath suggests, these systems should rather be understood as self-binding and risk-pooling arrangements; self-binding, because they mandate that people save (give up on their income) in their youth, in order to gain in their elderly years. But they are also risk-pooling, in the sense that each saver can decrease their rate of savings, since many savers are doing the same at the same time.

Heath's claim is that if one accepts the gains from trade as the only market mechanism, then one necessarily sees the welfare state as having merely residual activities by fixing the errors of the market. However, Heath concludes, it is much better to perceive the welfare state as offering the five mechanisms present in the market on its own. For instance, economies of scale in the public sector are natural monopolies. When the state had already laid down the water pipes, it costs just a fraction more to connect the next house in the neighbourhood. Furthermore, it would make no sense for the private sector to install a parallel set of piping since it would incur massive costs.

Heath's views on the welfare state are related to our topic in two following ways. Firstly, I suggest that we should perceive the payment system as a natural, public monopoly, and the welfare state as providing access to that system. The payment system is a network of 'money piping' that has already been laid down by the government. While the parallel private payment systems have been set up, this has been costly and redundant, increasing maintenance and transaction costs, rendering the market inefficient. On the other hand, providing each citizen with access to the payment system is, firstly, relatively inexpensive, owing to economies of scale. As discussed, opening one bank account after several millions is almost cost-free. But moving to a single payment system is also massively beneficial for the companies. Firstly, that would reduce the transaction costs, since they would not have to worry about interoperability issues. Secondly, after the initial price of transitioning to the unified public system, that would reduce the multiplied maintenance costs of each of them, since only one system would have to be taken care of. The advantage of this transition is massive increase in efficiency, and thus, according to Paretianism, general increase in social welfare. Furthermore, this transition is, I think, another way of looking at what Sovereign Money advocates call 'levelling the playing field' (Wortmann, 2016, pp. 4, 6). The state has provided the same basic market rules for everyone and where they can compete on their own merit.

The second connection between our topic and Heath's view is the collision between the two market mechanisms. On the one hand are economies of scale, as exemplified in the public, monopolized payment system, and on the other are gains from trade, enjoyed by a fractured market of predatory payment institutions. In developed economies, commercial banks are many. Each of them offers basic bank accounts with many strings attached. Some, for example, require paying expensive account maintenance fees. These fees multiply the more in debt its owners are. That, of course, disproportionately targets poorer bank customers. One of the consequences of this is that in some developed countries, like the U.S., many of the poorest citizens do not bother opening a bank account, but use the payment services of various predatory check cashers and payday loan service providers. Secondly, opening a bank account usually requires documents that some members of society, like refugees and (illegal) immigrants, may not have. This leaves them cut off from the payment system and needing to rely on more expensive alternatives (Baradaran, 2018).

This system nothing if not wasteful and unjust. Many different private market actors are offering their services at different rates, catering to different demographic profiles of citizens, often with predatory practices. At the same time, these actors offer basically the one same thing: access to the (digital) payment system. All of these citizens could be given access to the public monopoly that is the payment system, and essentially for free – given the design of economies of scale. Each citizen could be given a Safe Account, which they could use to access the basic payment services. This solution would both increase the efficiency of the market, thus increasing total welfare, and reduce the vulnerable population from the predatory businesses.

This account of the welfare state provides a solid normative foundation for the technical arguments offered by the Sovereign Money advocated. Firstly, it shows why the project is politically justified: if the payment system is a public good, then all citizens *should* have access to it, akin to popular access public education, public electricity network, or public parks. Secondly, and relatedly, my claim is that the payment system should further be seen as a public, natural monopoly. Giving everyone access to this system, firstly, reduces the transaction costs from having parallel systems, thus increasing the efficiency and, arguably, welfare for all market participants. Secondly, it also reduces the injustice of relying on the predatory market players.

3.4 Conclusion

Sovereign Money system can be seen as two separate proposals: having access to the public system via a 100% safe bank deposits with the central bank, and state provision of all money in the economy. The goal of the present section was discussing, and ultimately accepting the former. In order to do that, I have shown that the access to the payment system should be considered a public good and that it is more efficient and more just for the state to provide access to it.

Section 4: Critique of the SMS: the danger and uncertainty of the state provision of money

In the previous section, I have broadly concurred with the first element of the SM proposal: Safe Accounts should be introduced because they are an entry point to the payment system, which is a public good. But what about the second element of SMS, that the state should issue all of the money in the economy? That part of the proposal is, I claim, more problematic.

4.1 The democratic deficit

On the face of it, the Sovereign Money proposal can be perceived purely technically: their preferred reforms lead to an economic system that would be more stable, more resilient, amenable to simpler and more efficient monetary policy. However, one need not dig too deep to discover that these authors are also interested in remedying social and political injustices. Some of these have already been mentioned previously. These authors claim that SM would lead to reduced social inequality, would increase investment in socially constructive areas of the economy, could help the poorest members of society by issuing citizens' dividend. All of these questions are, of course, deeply normative. However, I will not address them here. Instead, I will discuss another claim that SM proponents make: SMS would automatically lead to more just and socially desirable outcomes just by giving the state the power to issue all the money in the economy.

As discussed, the bodies that issue money in an economy have enormous power and privilege. Ideally, that power should be used for productive and socially beneficial goals. However, as SM advocates rightfully point out, that is not the case in the current system. Data show that more than eighty percent of bank lending goes towards non-productive investments, while only around fifteen percent ends up contributing to the real economy (van Lerven, Hodgson, & Dyson, 2015, p. 27). In other words, most of the bank lending does not lead to the growing economy and increasing overall welfare, but merely boosts asset price inflation, supports the FIRE (Finance, Insurance, Real Estate) sector, thus increasing financial speculation.

This is surely suboptimal. But the bigger issue, according to the SM advocates, is that this planning role is performed by the free market. Free market merely responds to the price mechanisms and does not take into account the social desirability of its functioning. On the other

hand, SM advocates assume, putting this role in the hands of the state will rectify the situation. Questioning these assumptions will be the goal of the present subsection.

On the one hand, it is commendable that these authors recognize the democratic deficit in the current system. There is something unjust about having groups of unelected and unaccountable bankers deciding on the future of societies. Only the public should have this role. In democracies, the voice on these decisions is given to Parliaments through democratic elections. Ideally, the citizens' representatives will act in the best interests of their voters and be accountable to them.

Unfortunately, there is no reason why this will *automatically* be the case. There are several responses to this naive conception of democracy. First off, when the SM authors claim that the states will be more responsive to the interests of the public, they assume that the public is a homogenous monolith. In fact, the public is constituted of various overlapping groups with different, and often opposing interests. To put it cynically, even in the current system, as bad as it is, there are groups in the public who are benefitting from it. These groups will, *ex hypothesi*, be made worse off by the transition to SMS. Therefore, the SM authors should recognize that there will always be *some* parts of the public that will be worse off under a reformed system.

But this is not too interesting of a response. What is more problematic, however, is the faith which SM advocates put in the political elites and their responsiveness to the majority of the public. It is simply not at all clear that the elected governments will act in the best possible interest of their constituencies. For instance, notice the gradual ideological shift of the Democratic party in the United States from the poorer, working class constituency towards relatively young, rich and urban demographics.²⁷ More worryingly, the issue of the lack of accountability goes beyond the shifting of the voting bases. Some recent empirical research has demonstrated that the public opinion of the lower and middle classes is *almost completely disparate* from the actual policy of the government (Gilens, 2012; Gilens & Page, 2014; Page, Bartels, & Seawright, 2013). Similar results were arrived at in Germany, as well (Elsässer, Hense, & Schäfer, 2018).

If this research is plausible, then it seems to show that it is only the most well off members of society who have influence on policy making. Similarly, as discussed, in the current economic

²⁷ See, for example (Frank, 2017) for how the Democratic party in the United States has gradually shifted its voting base away from the working class and slowly turned to catering to the interests of the upper classes, thus hurting the interests of their previous constituency.

system it is also the richest that gain from the bank lending, through increasing asset and share prices. It seems like the only thing that was done in the transition is replacing an *unelected* group of people acting in the interests of the most well off with an *elected* group acting in the same interests. Therefore, it is not at all clear how moving towards Sovereign Money will be an improvement.

Maybe I have set myself too easy of a target. After all, these examples target only one current of the Sovereign Money club. Let us call this spending-happy wing the ‘Keynesians’. Their policy proposals favour large state investments and the blurred lines between the monetary and fiscal powers (Dyson et al., 2016, p. 30). But another camp, represented by Joseph Huber, is more sceptical of these ideas. Call his camp the ‘Ordoliberalists’. Their perception of the SMS is somewhat more minimalistic: public money creation is nothing more than government levelling the playing field. Banks are taken away the special privileges they had – singled out for access to central bank reserves, almost certain guarantee that they would be bailed out, money making powers – and will be just the same as any other company. The only difference is that money creation will not be a duopoly of state and banks, but only a monopoly of the state. However, and this is where Ordoliberalists differ from the Keynesians, the state will have no increased role in investments in the public. Central banks, independent and technocratic as they are, will only decide on the amount of money being created; the rest is left up to the usual, political fiscal powers of the executive branch (Huber, 2017, secs. 6.3-6.4, 6.15).

Huber’s solution, then, seems to aim at increased stability of the system. If politicians are inherently unreliable, they should not be given more powers. Instead, they should keep their current responsibilities and the money creation power should be put in the hands of experts. In Huber’s case, these experts are central bankers.

This solution is, at best, redundant. As discussed, the original problem that the SMS was trying to solve was the unelectability and the unaccountability of the private bankers. However, it is a fact that most central banks currently are very independent in their operations. That means that most of them decide on (the interpretation of) their own mandate and even personnel change. For the most independent ones the government cannot even replace the Board members or the Governor, save for the cases of gross misconduct. In some cases, members of central banks can be

summoned for hearing by government bodies, but in most cases their work cannot be influenced by them.

This should present a conundrum for the Ordoliberal current of Sovereign Money. If the original goal of the reform was to take away the unearned power of money creation from unelected and unaccountable bankers, it is scarcely an improvement to put it in the hands of unelected and unaccountable *central* bankers.

It is not only a worry that independent central banks will not act in accordance with the democratic principles. Indeed, as history has shown, some of them have acted in clearly anti-democratic and even illegal manner. Take for example the Bundesbank, the German central bank. Ever since its founding it has been one of the most independent central banks in the world. This enabled it to introduce and administer monetary policies independent, and often even contrary, to the ones of the elected governments. The starkest example of this took place in the 1970s.

4.2 A brief history of Bundesbank

Early seventies have been a turbulent period in the economic history. Firstly, the long period of post-War stability came to a halt when the United States broke off the gold standard. This ultimately destroyed the Bretton Woods system, which was an underpinning of a period of unprecedented development and social progress. The shockwaves of this event rippled through not only U.S. and Western Europe, but also the world. Secondly, the first Oil shock took place, when the OPEC countries – a cartel of large oil producers and exporters – decided to surge the prices of oil. This decision led to what is popularly known as ‘stagflation’: economic recession happening hand in hand with high inflation. Lastly, this period marked a disappointment with Keynesian policies, which considered stagflation as an impossibility. That gave rise to the ascendance of conservative currents in politics and monetarist thinking in economics.

Monetarism quickly took roots in the German political scene and especially in the Bundesbank. Coupled with its strong independence, this gave it large powers over German economy, but also its politics. Monetarist teaching had a strong focus on anti-inflationary policies. Thus, the decision on the part of Bundesbank whether to fight high inflation or high unemployment was easy. This choice was further facilitated by the Bundesbank’s strong and narrow mandate focussing on keeping the stability of the currency.

In practice, this meant that inflation should be fought with increasing the interest rates. However, for various reasons, Bundesbank decided to raise them too quickly and, after the inflation somewhat subsided, lowered them too slowly and gradually. This led to hurting of the smaller enterprises in the German economy (and ultimately, their workers), since they could not lend at such high interest rates. Furthermore, and more urgently, it disabled the proper functioning of the political system.

Then incumbent Prime Minister of Germany Helmut Schmidt was in a difficult position, being in an urgent need to finance the budget of his government. Since the Bundesbank kept the interest rates artificially high, he could not borrow from domestic banks. Luckily, he managed to arrange a loan from Saudi Arabia. However, the Bundesbank disobeyed and declined to issue government bonds in order to execute the transaction. This decision, although highly illegal and unconstitutional, came to pass. It resulted in the vote of no confidence and the ousting of the prime minister (Leaman, 2001, pp. 189–192).

The purpose of retelling this episode was to show two things. Firstly, it somewhat defeats the purpose of the Ordoliberalists' plan to remove the money creation decision making from unelected bankers to unelected *central* bankers. Now, Ordoliberalists might object, stating that while unelected, they are at least a public institution. Thus the second purpose of retelling the episode: it is now obvious that just because an institution is public, it does not mean that it will serve *in the interest of the public*.

A similar development took place in the US, where the then Governor of the Federal Reserve's (the U.S.'s central bank) approved of a sudden surge of interest rates. This, in turn, caused a recession, further increasing unemployment levels. This decision hurt the working class the hardest, and, under one interpretation, was intentionally issued in order to break the power of the unions, in accordance to desires and ideology of the then conservative government (Harvey, 2011, pp. 23–25).

To reiterate, these actions of Bundesbank and Fed are merely a result of *indirect* monetary policy. Without wishing to succumb to far fetched speculation and fear mongering, one has to wonder about what could conceivably be done by the state entities – even under good pretenses²⁸

²⁸ See the attempt of Indian PM to fight corruption by removing large banknote denominations out of circulation, thus causing chaos with the holders of these notes <https://www.nytimes.com/2016/11/09/business/india-bans-largest-currency-bills-for-now-n-bid-to-cut-corruption.html>.

– if they were given more direct levers of power. Huber mentions making central banks a Fourth pillar of power in democracies. This would, the assumption goes, make it sufficiently independent from all three others, so that it can function unimpeded and in the public interest. However, there is no reason why this would be so. To take an example of the U.S. justice system: even though the Judiciary is independent from other powers, the presidents have the power to elect judges of their own political persuasion. This does not mean that they directly decide on the judges' ruling, but it can influence political climate in the country. Similarly, it is conceivable that the executive could influence the decisions of central banks for their own gain. This has happened before: it is widely known that President Nixon pushed the Federal Reserve to loosen monetary policy in the wake of his re-election campaign (Eichengreen, 2018, p. 380). Therefore, it is not at all clear why democratic or public institutions would automatically action policies beneficial to the public. This concern is compounded by the fact that putting money creation in state's hands gives a considerable amount of power to a relatively centralized entity.

This leaves SMS with a dilemma: either keep the money creation power in the hands of unelected groups in society, thus risking dysfunctional social development; or keep it in the hands of elected politicians, but face the possibility that they are only responsive to the interests of the most well off. Either way, the result that money is created and invested for the benefit of the wider public is possibly a foregone conclusion.

All of this is not to say that money creation is *necessarily* harmful in the hands of the government. It would be quite silly to claim that the governments *never* act in the interests of the wider public. The purpose of the discussion in this subsection was to criticize the naive idea that just because something is in private hands that it will automatically be for the benefit of the majority of the population.

4.3 The bad track record of public money supply management

Let us now bracket the issue of democratic legitimacy and pose another question: How can we guarantee that any public body will do a good job at managing money supply? Fortunately, there is a track record of this, but it is not encouraging.

After the end of World War 2, central banks have had very important roles in their respective economies. However, these roles have diverged considerably and these roles were often

tioned to the level of independence that they boasted. Great Britain and France²⁹, on the one hand had very *dependent* central banks. They were summarily nationalized quickly after the War with the purpose of funding the rebuilding of the devastated infrastructure in these countries. On the other hand, as discussed, Germany had a very *independent* central bank. Due to the experiences of hyperinflation and the strong influence of the U.S. in its occupational zone, the new central bank (Bank deutscher Länder, later Bundesbank) was designed akin to the US Federal Reserve System.³⁰ It was ordained with a similar decentralized design and was given a mandate of strong independence. However, its role has never been that of rebuilding the broken country. Instead, it was given a strong anti-inflationary mandate, as already shown.

The nature and mandates of the central banks strongly predicted the response to the crisis. Take the case of the U.K. first. While the Bank of England has struggled to achieve some power since World War 2, it was ultimately unsuccessful. An important episode took place in the first government of Margaret Thatcher. As discussed, strong monetarist thinking took hold as a response to the crisis of the 1970s, and Thatcher was one of its most ardent followers, at least for awhile. Since monetarism entailed that inflations were always caused by increased money supply, the main policy lever was controlling the amount of money in the economy. Thatcher decided to target the so-called M3 monetary aggregate, while her Minister of Finance removed all foreign exchange controls. However, the government soon realised that shifts in M3 were hard to predict, especially with the exchange controls removed, since they naturally increase in the fluctuation of the currency (Elgie & Thompson, 1998, pp. 61–62). This led the disempowered and exasperated employees at the Bank of England to call politicians “inflation creating machines” (Elgie & Thompson, 1998, p. 65).

The Bundesbank has similarly had a poor record of keeping their money supply in check. “In the first four years of the operation of single figure targeting (1975-78), the targets were never met. [...] CBC [central bank council] stuck to the same target for the expansion of the central bank money stock of 8 per cent for four successive years; in each year there was an overshoot, in 1975 of 2 per cent, in 1976 and 1977 of 1 per cent and in 1978 of 3 per cent.” (Leaman, 2001, pp. 164–

²⁹ For the history of Bank of England and Banque de France, I rely on (Elgie & Thompson, 1998). For the history of Bundesbank, I use (Apel, 2003).

³⁰ Opposite to the usual interpretation, it is possible that the American influence played a stronger role here than the cultural preferences of the populace. For more details on this matter see (de Haan, 2018, pp. 393–394).

165). Therefore, the institution that had the foremost credentials in monetarist thinking has consistently failed to perform its primary task.

Bringing a point closer to home, central banks have shown a weak performance as a result of battling the last financial crises. The two most important central banks in the world, the European Central Bank and the US Fed, have been for several years following a policy called Quantitative Easing. While the details are complicated, this program essentially entails creating new money in order to support the failing economy. The results have been underwhelming, especially in the Eurozone. The inflation is barely positive and growth is still lacking. But most importantly, critics accuse the ECB of misdirecting the newly created funds, and thus boosting asset prices – exactly the thing that SMS advocates criticize banks of doing (van Lerven, 2016, Chapter 2).

Of course, there is something disingenuous about my criticism. Firstly, SMS is emphatically *not* a monetarist doctrine. Even though it entails targeting monetary supply, its advocates do not believe that the shifts in money supply are the only cause of inflation (Dyson et al., 2016, pp. 50–51). Secondly, in the new system banks would not be able to create new money, therefore the influence of the central bank on the economy would be more direct. That much is true.

However, none of it is to detract from the fact that both the politicians and the central banks have had bad episodes of conducting monetary policy. And since SMS would entail *more* responsibility for the state on the monetary front than previously, coupled with the fact that it has never been put into practice before, we have reason to be skeptical of its success on this front.

I may be accused of cherry picking, selecting only the most egregious examples of handling of monetary policy. One could find equally hugely successful stories. For instance, after World War 2, central banks of South East Asian countries performed the so called ‘window guidance’ policy, whereby they strictly controlled the targets of bank lending. Typically, these were large industrial and technology companies that helped employ the citizens, industrialize the countries and provide strong export revenues.

This is certainly true. Nevertheless, the purpose of this section was not to show that the state will certainly do a terrible job of managing the money supply. Rather, it was to show two things. Firstly, just because the state is democratically elected, does not mean that it is responsive

to its citizens. The situation is even worse when central banks are taken into account. Secondly, taking historical record into account, we should have low confidence that the government could perform this job well.

4.4 Conclusion

The goal of the current Section was to shed light on the second element of the SMS proposal. The intent was to show that its proponents have a naive vision of the competencies and the interests of government with regards to money creation and the interests of their citizens. This is not an *a priori* argument against the centralized money creation. Instead, it was merely to point out that the proposals that SMS advocates put to the table are underspecified and overly optimistic in this political system. It is possible that SMS would be more suitable to a potential future where the governing structures in Western countries are more politically egalitarian and the knowledge about economics is more advanced. But at present, with the current configuration of political institutions, it is hardly certain to be progress over the current economic system.

Section 5: Sovereign-Money-light

Let us take stock on what we have achieved so far. Section 1 discussed several theories of banking and singled out the credit creation theory: the one according to which banks create money when they issue loans. Section 2 analyzed the problems of the banking system through the lens of credit creation model, and demonstrated how the Sovereign Money System could be a remedy for these problems. Section 3 offers a critical stance. It delineates the SM proposal in two claims: safe money and full state creation of money. In that section the first element of the proposal is defended. Section 4 is the second critical section, and this time it offers criticism to the SM, specifically, on the latter part.

So where do we stand now? What would a world with a, to put it colloquially, Sovereign-Money-light look like? How does it differ from the current system and the full SMS?

On the one hand, there would be completely safe Transaction Accounts, holding deposits of what is essentially ‘electronic cash’. That sort of money is nothing else than the digital version of the state-issued physical fiat money that are coins and paper notes. Another way to look at it is that they are the central banks reserves, only now every citizen would have access to them, and not only the banks. This policy would, in a sense, democratize access to digital money.

It is a matter of some controversy in the SM community on where the Transaction Accounts should be held: whether at the central banks or Ministries of Finance or some newly created public institutions (Wortmann, 2019, p. 1). The camp that is more in favour of central bank’s independent status favors that the Accounts be put there; the other camp, proponents of more democratic Ministries of Finance, prefer the latter (Werner, 2012). Either way, the common core of the policy is preserved: these accounts must be ultimately kept in public hands.

That does not necessarily mean that they must be *administered* only by public institutions. One of the advantages of the new system, that the advocates of SM underscore, is that the safe money accounts would present a level playing field: they would be kept in public hands, but could be accessed through different private account administrators. For instance, traditional banks, different tech companies, and debit card companies could ‘plug-in’ the Safe accounts and innovate on the access to it. However, one thing would not be allowed: loaning the money out. The safe money always stays in the hands of the individual, even if a company goes bankrupt (Dyson et al., 2016, p. 4).

This is where the SM flavor of Safe Accounts can come in friction with my defence of this proposal. I have struggled to defend the idea that public goods entail public access to those goods. Moving from unsafe to safe accounts, but keeping the access private scarcely remedies the issue. Thus, I stipulate that the government should provide at least basic access to the Transaction Accounts for the general population, but more specifically, the most hard to reach, isolated, or otherwise technologically passive demographics. For instance, the government should opt for the policy of opening physical offices or using postal service where applicable for the rural areas. Also, they should promote access to digital services to the previously ‘unbanked’ – the poorest, the homeless, etc. Lastly, free access to cash should be enabled to the ones who depend on it the most, through widely present and free to use ATM machines. In short, if access to the payment system is a public good, then it should serve as many citizens in the public as possible, and not only benefit one privileged, typically young and middle class, and technologically savvy demographics.

One policy proposals that has gained some steam in recent years is the Central Bank Digital Currency (CBDC). It is a program that entails that each citizen has an account opened at their respective central banks. The one bank that has gone furthest in this direction is the Swedish Riksbank. Namely, they have noted that year-on-year, the number of transactions performed with bank money has increased to a staggering 85% (Sveriges Riksbank, 2017, p. 4). Furthermore, they recognized that this development puts the power in the hands of the private banks, pushing aside the state money. They interpreted this state as threatening their mandate of maintaining the safe and efficient payment system, and therefore started deliberating on offering each citizen a bank account in their institution (Sveriges Riksbank, 2017, pp. 16, 34). Their rationale is remarkably similar to the justification offered in this paper and could be construed as offering further credence to the view from a legal perspective. In other words, it recognizes payment system as a key good (though maybe not a public good in a sense here defined) that needs to be protected and maintained by a public institution.

Introducing the Safe Accounts changes another aspect of the current banking system – elimination of the deposit guarantee. Since citizens would in a reformed system have access to the safe deposit to save their funds, there is no reason for the government to guarantee the funds in the traditional, unsafe bank accounts. This change is reasonable for two reasons. Firstly, it will

motivate the citizens to move towards the Safe accounts. Secondly, it will disincentivize banks' reckless lending behavior.

This introduces the differences between my proposal and the SMS. In Section 4 I addressed several criticisms towards the state-only issue of money. However, it does not follow that I believe that the current banking system is optimal. It seems to me that there are reasonable reforms that could be put into place that are less radical than what SMS entails, but still generating similar gains to the ones they promise.

One of the problems that the advocates of SM point out in the current system is that most of the bank lending goes towards funding mortgages. While regrettable, this state of affairs is only partially the banks' fault. As Josh Ryan-Collins convincingly shows (Ryan-Collins, 2019), focus on mortgage lending has only relatively recently become the focus of the banking business. But more importantly, it only came about as a result in changing government policies that increasingly promoted home ownership as the only desirable tenancy model. This has, not incidentally, been coupled with reduced state investment in social housing. The core of this criticism is not that government ought to introduce housing reform instead of moving to SMS. It is rather to show that governments were partly complacent in one of the regrettable consequences of the bank sector's lending practices.

Secondly, another problem with the Too Big To Fail banking sector is the monoculture of large, universal banks. These banks are usually transnational and offer large span of services: investing, wealth management, insurance, etc. The emergence of universal banking is comparatively recent phenomenon, coming about only from the 1980's. However, there are other models of banking that the states can encourage. Small scale, local savings and cooperative banks, prevalent in Germany, for example, are one possible alternative. These banks are shown to lend more towards the productive parts of the economy, instead of the financial speculation (Prieg & Greenham, 2012b, 2012a; Werner, 2014a, p. 18).

The downside to this proposal is, of course, strong political lobbying power that the banking sector possesses in general. It would be in their best interests for the high barriers to entry for new players to stay in place. Similarly, the weak protection against mergers and acquisitions that would harm smaller banks are also favoring big banks. About this much the advocates of SMS are right: reforms are slow, uncertain, and can always be rolled back. Nevertheless, each of these

reforms is less radical than what the SMS proposes, and more importantly, already has or had working examples in reality.

The Keynesian current of the SMS camp has put forward as one of the advantages of their reform that the government would have more power to invest in socially desirable goals. However, it is more likely that the lack of investments emerged more as a result of lack of political will than a lack of possibilities. There are currently many channels that governments can use to finance socially desirable and environmentally sustainable goals. State investment banks, such as *Kreditanstalt für Wiederaufbau* (KfW) in Germany are one possibility, as is funding smaller, local state banks. Another possibility, lately gaining traction in the media (at the time of writing) are the Green New Deal or the Green Quantitative Easing (Murphy & Hines, 2010). The former entails large state investment, through deficit (budgetary) financing, in environmentally sustainable technologies and research and development. Green QE, on the other hand, is a proposal that pushes for the money creation to be directed not towards bailing out large financial institutions, but rather ‘green’ investments. This increase in public state investments would mirror the desired increase in investment proposed by the Sovereign Money advocates, but without the cost of transitioning to a wholly new economic system.

What remains as a downside of the Sovereign Money-light system, as I have named it, is that banks will still have the power to create new money. However, the relevance of this practice would be strongly curbed by both their customers fleeing towards the Safe accounts; the lack of deposit guarantee; and the governments crowding in their investment space with its own investments and allowing the entry to newer, smaller banks on the market.

These reforms require strong political will and education and activation of many relevant actors. Furthermore, as stated, banks have a strong vested interest in maintaining the status quo, further slowing down the proposed reforms. However, all of these are, to my mind, advantageous to the full SMS due to their relative moderation and familiarity. Sovereign Money’s radicalism might prove to be too bitter pill to swallow.

Conclusion

The goal of this thesis was to critically and normatively assess the Sovereign Money proposal. The first two Sections were a theoretical foundation for this endeavor. Section 1

discussed three existing theories of banking: credit creation, fractional reserve, and financial intermediation. The first one was selected, due to increasing empirical results supporting its adequacy. Section 2 begins by discussing how the results of credit creation – banks being able to create new money when they extend loans – leads to instabilities in the financial system and various social inequalities. This section further offers an exposition of the Sovereign Money System, and how it purports to solve these issues.

Sections 3 and 4 offer a critical treatment of its proposal. Section 3 delineates two main elements of the proposal: separating the payment system from the money creation, and putting them in public hands. The main goal of that section was to defend the former element by giving it political underpinning. Three arguments were given for this. First, the public payment system should be perceived as a public good, free to access for all citizens. This would give them, *a fortiori*, access to Safe (Transaction) Accounts, not exposed to lending risk. Second argument is that the payment system should also be considered as a public monopoly. This perception delivers two benefits; First, simplifying the existing myriad of payment systems, thus reducing overall waste in transaction costs. Second, giving access to the less advantaged members of society who were either cut off from the payment system, or had to resort to various predatory schemes in order to participate in the economy proper. The third argument for the separation of the public payment system is that it will be a solution to the current money system – where private credit money owes its survival to the public, *fiat* money – which is, I claim, not a peaceful coexistence, but an example of unjustified and unjust parasitism.

Section 4 is more critical towards the Sovereign Money proposal. It puts into doubt whether it is desirable for the state to be the sole issuer of all money. This Section tries to problematize whether putting new power in public hands makes it automatically more democratic and more efficient than it was in the hands of the private sector. In order to corroborate that, I single out two sets of historical episodes. The first tries to show that governments and central banks have exhibited behaviors that were emphatically not in the public interest, or were expressly illegal. The second set goes to show that the track record of neither the government nor the central banks with regard to money aggregate targeting (i.e. money creation) was exemplary. Both of these episodes intend leave us wondering on whether the governments, or their central banks, should be the single locus of money creation.

The last Section demonstrates what the criticisms asserted in two previous Sections translate to, in terms of practical policy proposals. In that Section some modalities of implementing Safe Accounts are discussed, as well as the alternatives to full state money issue. Several more moderate proposals are offered, such as diversification of the banking sector and increased state investment through big public investment banks.

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Appendix

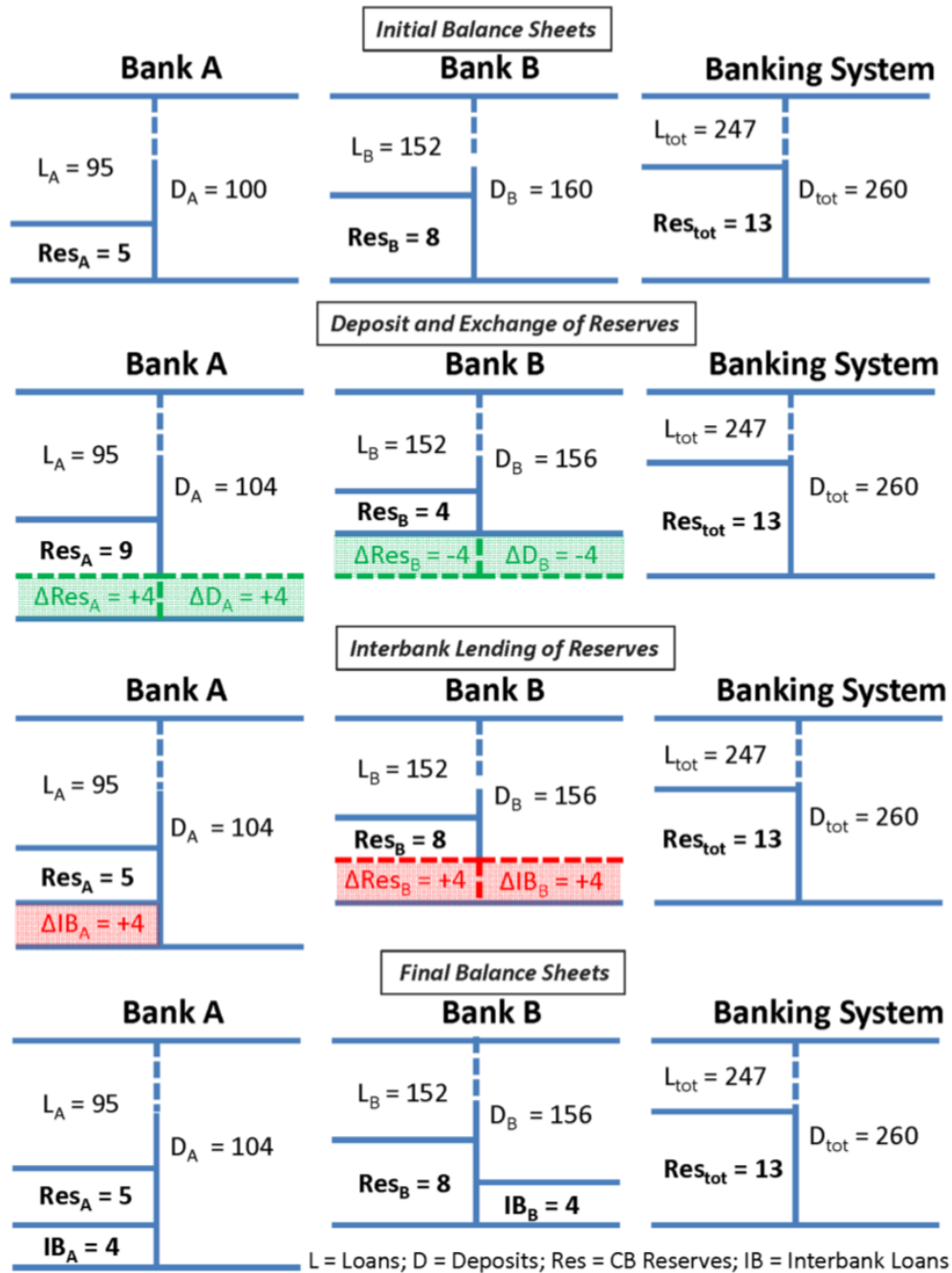


Figure 2. Visual representation of the interbank settlement practice. Step 1 (first row) is the original state. Step 2 (second row) represents moving deposits from one bank to another. Step 3 (third row) represents the settlement between the banks. Note that the total amount of funds in the banking system (right-most column) remains the same throughout all of the steps (Jakab & Kumhof, 2015, p. 46).