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Summary.

There are two main forms of money: state issued money (so called “base money”) and money created by private banks. It is perfectly feasible to have either type of money predominate and in most economies nowadays, private money predominates.

Introducing private money to an economy which uses only base money increases demand. To counter that extra demand, it is necessary to confiscate base money from households, which drives some people into debt. Conversely, if in 2017 real world economies private money were banned (as advocated by several Nobel laureate economists), that would be deflationary, which in turn would require government to create and distribute significant amounts of base money to households which would reduce their need to borrow.

There are two basic forms of money. First there is state or central bank issued money (base money). Second, there is money issued by private banks. As the opening sentences of an article published by the Bank of England explains (McLeay (2014), the large majority of money nowadays is privately created.

An economy where private money predominates involves relatively high levels of debt. The reasons for that are illustrated below by considering an economy which switches from a "base money only" system to a privately issued money system. Then a switch in the opposite direction is considered.

The former is rather hypothetical: i.e. the latter switch is more realistic because it involves switching from the EXISTING SYSTEM to a base money only system, a switch advocated by several leading economists including at least four Nobel laureate economists.

Costs.

Base money has a big advantage over privately issued money, namely that it is inherently cheaper to create and distribute. Reason is that when a private or commercial bank supplies money to customers, the bank normally has to obtain collateral, and doing that, plus checking up on the value of collateral involves very real costs. Plus the bank must allow for bad debts: another cost.

In contrast, all the state needs to do to supply the economy with money is create and spend that money into the economy. Job done. There is no need to check up on the value of collateral or allow for bad debts. Indeed, several governments have fed astronomic and unprecedented amounts of base money into their economies in recent years via QE.

As Milton Friedman put it in chapter 3 of his book, “A Program for Monetary Stability” and in reference to base money, “It need cost society essentially nothing in real resources to provide the individual with the current services of an additional dollar in cash balances” (Friedman, 1960).

As to the best or optimum amount of base money to create, that’s easy in principle: whatever amount induces the private sector to spend at a rate that brings full employment. After all, the more money a household has, the greater its weekly spending, all else equal. So there must be some stock of base money (in private sector hands) that results in a level of demand that keeps the economy working at capacity.

Note that that is not the same as the idea often attributed to Milton Friedman, namely that all we have to is control the money supply and all will be well. Reason is that the simple fact of increasing the money supply constitutes fiscal stimulus, and that has a stimulatory effect over and above the money supply increasing effect. To illustrate, if aggregate demand is deficient, the cure advocated here (and indeed by Dyson (2011) is to have the state print and spend more money, which increases the stock of money in private hands. But of course, THE MERE FACT of spending additional money (e.g. on infrastructure) creates additional employment.

Incidentally Bernanke (2016) expressed approval of stimulus in that form (while not actually advocating a total ban on private money) – see his para starting "So, how could the legislature…"

Borrowing.

The exact way in which borrowing is done in our hypothetical economy is crucial. Assuming the only borrowing is direct, person to person, in a "base money only" system, then that does not change any of the above points. In particular where one person abstains from consumption and saves up money and then lends it to someone else, the latter saving will reduce demand, while the deflationary effect of that will (roughly speaking) be counterbalanced by the borrower spending the money.

Alternatively, if borrowing is done via private banks, then (again) nothing changes as long as those banks only lend out money which has previously been deposited (either by depositors or shareholders or bond-holders). That system equals full reserve banking (advocated by at least four Nobel laureate economists: Milton Friedman (1948), James Tobin, Merton Miller and Maurice Allais – for Allais, see Phillips (1999). And “full reserve” is a system under which privately created money is banned, or at least thwarted. (See under Friedman’s heading “I. The Proposal”).

The alternative is the system we actually have in 2017, sometimes called “fractional reserve” banking. Under that system, as the above Bank of England article explains, private banks can create and lend out money IN EXCESS of the amount of base money they have. However, letting private banks do that clearly raises demand.

But if (as per the above assumption) the economy is already at capacity, that additional demand is not allowable: it would cause excess inflation. Ergo on introducing private money, government would have to implement some sort of deflationary measure to compensate, like raising taxes and confiscating some of the population’s stock of base money.

But that would drive a significant proportion of households and businesses into debt: exactly what “money printing” private banks want.

Hopefully that establishes the point made in the title of this article, namely that to enable private banks to create and lend out money, it is necessary to drive a proportion of households and firms into debt.

Incidentally Selgin (2012) also considered the above hypothetical scenario where privately issued money is introduced to a base money only economy – start at his third paragraph if you like. His conclusion is similar to the conclusion here, namely that existing holders of base money are robbed. The only difference is that because of Selgin’s different starting assumptions, the robbery takes place via inflation rather than via tax.

The real world.

Having considered a very hypothetical scenario above, namely an economy which switches from “base money only” to “mainly private money”, a more realistic scenario is to start with real world 2017 economies and consider what needs to be done to switch to a “base money only” set up. Well the answer is hopefully obvious: the opposite of the procedure set out above!

That is, banning private money has a deflationary effect, but that is easily countered by having the state print and spend more base money into the economy. The net result is that a significant proportion of households and firms instead of having to borrow from private banks in order to come by money would have a stock of money big enough to relieve them of the need to borrow.

Milton Friedman and other leading economists who advocated banning private money had a point. Moreover, bank failure under the latter “ban private money” system, i.e. full reserve banking, is virtually impossible.

Or as Diamond (1999) put it in the abstract of his paper, and in reference to a private bank’s money creation activities, “the bank has to have a fragile capital structure, subject to bank runs, in order to perform these functions.” In short one of the basic causes of the 2008 bank crisis and indeed all bank failures thru history is the simple fact of private banks trying to create money!

As to why, if banning private money is so beneficial, that idea hasn’t been implemented, one answer is that such a ban is not in the interests of private bankers, as suggested above. Or as Friedman put it in the preface of the above mentioned book of his, “The vested political interests opposing it are too strong….”.

What private bankers like doing is taking big risks, keeping the profits when that pays off, and relying on taxpayers to pick up the pieces when it doesn't.

Conclusion.

Assuming the above arguments are correct, then the conclusion is obviously that a system where privately created money is allowed will involve larger household debts that a system where such money is suppressed. However, while that is a weakness in a private money system, it is not necessarily a fatal weakness.

Proof that a "base money only" system is overall superior involves showing that GDP is higher under that system, and there is actually a good reason for supposing that to be the case, namely that under such a system the rate of interest is the genuine free market rate, as distinct from a private money system, where the rate is artificially low. That idea is clearly counter-intuitive, as you might think that a system where private banks can do what they want equals a genuine free market. And indeed the arguments there are a bit complicated and involve two or three times the number of words that make up this present article, so there is not room for that argument here. However I set out the argument in Musgrave (2017).

That article also explains another anomaly which some readers may have spotted, namely that if privately money costs more to create than base money (as claimed above), how come private money manages to drive base money to near extinction, given the chance? The answer is that as explained by Huber (2000), most lenders have to either work or borrow money in order to be able to lend money. Not so private banks: they can just print the stuff! Thus they can undercut normal lenders. (See Huber's p.31, para starting "Allowing banks to create…".)

So to summarise, this article has set out part of the picture. Hopefully has aroused the interest of some readers enough to induce them to study this subject in more detail.

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