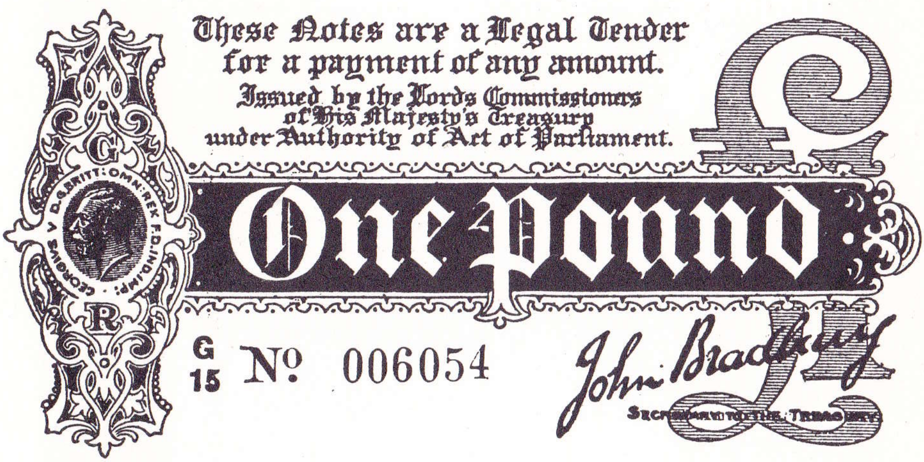
GOVERNMENT DEBT AND CREDIT CREATION

A study of the creation of credit & its effect on the British Economy.



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ECONOMIC RESEARCH COUNCIL

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To promote education in the science of economics, with particular reference to monetary practice.

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FOREWORD

The inspiration for this paper came from the feeling that there is something wrong with Government financing when as much is spent on paying interest on the National Debt as on Education or on Health.

With our slender resources we have only been able to draw together some of the relevant information which seems to point to startling conclusions.

We accept that these conclusions may not be wholeheartedly accepted, however we do strongly feel that the concept is worth more comprehensive study and discussion as the implications are profound. In any event, they should not be ignored.

I would like to especially acknowledge Edward Holloway's enthusiasm and guidance along with Malcolm MacDonald's research.

The paper has also greatly benefited from help with presentation and criticism from Sir Arthur Bryant, C.H., C.B.E., Harry Rutherford, Simon Phillips and M.A. Cameron, also M.H. Cadman, Simon Webley and Alan Hawkins, members of the E.R.C. Publications Committee to whom the E.R.C. is immensely grateful.

D.P. de Laszlo

CHAIRMAN

December 1981.

GOVERNMENT DEBT AND CREDIT CREATION

INTRODUCTION

The Economic Research Council has been well known over many years for its papers examining and explaining the course of inflation. The thesis it propounded in 'A Programme for National Recovery' and 'Excessive Taxes lead to Stagflation' is now generally accepted and has been acknowledged by at least two Chancellors of the Exchequer. However, the attempts by the present government to reduce public sector borrowing, bring down interest rates to acceptable levels and regulate money supply have not been satisfactory and the economy has suffered grievously as a result. Even the substantial income flowing to the Exchequer from North Sea Oil (estimated by the government at £5,880 million for 1981/82) has not enabled either the present government or the previous one, to reduce overall taxation. The government's share of the Gross Domestic Product rose from 34% in 1955 to 40% in 1980; and the central government estimate for taxation increased by about £10,000 million from £65,400 million for 1980/81 to £75,500 million for 1981/82. One fact which stands out is that the cost of servicing central Government Debt (mainly National Debt) has risen from £705 million per annum in 1955 to £8,661 million in 1980.

Recognising that the payment of interest at present high levels places an intolerable burden on the productive sector of the economy, the Economic Research Council decided to initiate an enquiry into the way in which money in all forms, comes into circulation. We have been led to the following main conclusions:

(1) That the State should create all the currency and credit needed to satisfy the spending power of the Government and the buying power of consumers:

(2) The power of the banks to increase the amount of credit money in circulation should revert to the State. Had

this been done since 1945 some £30,000 million could have been saved by the Government if they had maintained their historic privilege of themselves issuing all forms of money including credit.

It is right that the banks should be fully recompensed for the valuable services they perform, but if we examine these closely we would see that this is essentially book-keeping. It is misleading to describe the banks services in financing Government expenditure out of newly created credit money as "lending". The word should not have been used in this connection as it creates a false picture of what really happens. As a result we have allowed private institutions to usurp the right to issue our money and to make very handsome profits thereby.

We maintain it would be possible to stop this compounding debt interest without affecting inflation if the Government extended control of its fiduciary responsibility to all forms of credit creation.

The present system of banking began when Goldsmiths first made loans or advances for which they did not have full backing by issuing receipts that were negotiable. This evolved into the Provincial banking system of the 18th and early 19th Centuries. Provincial Banks issued their own bank notes which were backed by unlimited liability of the Bank's Partners - the issue invariably exceeded the liquid assets and often the total assets of the Partners with the consequential periodic banking crises typical of the period.

Before 1844, banks issuing notes could use those notes to make commercial loans on which they earned interest and even, on occasions, lend money to the Government.

The creation of credit and liquidity by this method was a major source of capital for the industrial revolutions. In order to regain the control of fiduciary instruments and to

raise money Parliament passed the Bank Charter Act of 1844 which gave the monopoly of bank note issues to the Bank of England in England and Wales. Certain Scottish and Northern Ireland Banks still have the right to issue notes. The Act was later updated by the Currency and Bank Notes Act of 1954.

The Government at various times during this period tried to tax the Bank's fiduciary ability by Stamp Tax on individual notes (1783) and other methods. The 1844 Act recovered for the Government its control of the note issue, which was a major source of credit creation, and the profit accruing to it. Since 1844 the creation of credit has slipped out of the Government's hands, as other forms of credit have been developed and expanded.

The Bank of England's note issue was originally fully backed by holdings of gold. Today, the note issue is backed by Government and other Securities. The interest earned on the securities held by the Bank of England Issue Department against the issue of notes is refunded to the Treasury since the Bank of England is itself a Government Agent and profit on its operations is payable to the Treasury.

This paper proposes that the method by which credit is created should be re-examined and suggests that the creation of credit should once again become the sole prerogative of the Government. Abraham Lincoln summed up the principle very succinctly:

> "Government possessing the power to create and issue currency and credit as money and enjoying the right to withdraw both currency and credit from circulation by taxation and otherwise, need not and should not borrow capital at interest as a means of financing Governmental work and public enterprise. The Government should create, issue and circulate all the currency and credit needed to satisfy the spending power of the Government and the buying power of the consumers. The privilege of creating and issuing money is not only the supreme prerogative of Government, but it is the Government's greatest creative opportunity."
>
> (U.S. Senate Document No. 23)

Major proposals along these lines were put forward by the American economist, Irving Fisher, during the Depressions of the 1930's.

A quote from the Economic Reform Club's (now part of the E.R.C.) series of papers 'The Banks and the War', IIIrd Paper, published in 1943, put the position clearly, describing the situation where Government does not have full control of credit:

> "...it is apparent that no new (credit) money can be created except through the banking system, which issues it as an interest-bearing debt owed to them by the Nation.
>
> The result of this has been the piling up of an enormous burden of debt on which succeeding generations of our people will have to pay huge sums each year in the form of interest and Sinking Fund.
>
> As the banking system in creating this money is merely using the Nation's credit by liquifying it, the right of the Banks to treat such created credits as a loan and to receive payment of interest thereon is unjustifiable, and it is therefore submitted most strongly that they are not entitled to anything more than an agreed fee based on the extra work devolving upon them by the handling of these funds, in a manner similar to that in which the Bank of England is compensated for the management of the National Debt and of the Fiduciary Issue."

SUMMARY

The power to issue bank notes has provided for the Government, since 1945, about £19,000 million of revenue, of which £9,300 million arises from the increase in notes issued, and £9,800 million from the interest saved on government securities held as backing for the issue.

In 1980, the Government borrowed £11,154 million and spent £8,661 million paying interest on previous debts. The interest payments represented 10.6% of Central Government current expenditure.

The power of the banks to increase credit has meant that the Government has foregone revenue, since 1945, of <u>over £30,000 million</u>, of which £14,000 million arises from the increase in credit, and £17,000 million from the interest the Government could have earned if the credit had been issued as notes.

Under the present system the Government could have sold direct to the Bank of England Issue Department government stock and received notes in exchange. Interest paid on this stock would have gone to the Issue Department and in turn been credited back to the Treasury. The effect on total money supply and consequently on inflation would have been nil.

CONCLUSION

If the Government had followed a policy of extensive fiduciary control and had itself issued credit, rather than allowing the banks to do so, it could, for example, have made a net reduction over the period 1970-80 in the need for Government borrowing from the £48,578 million securities issued to about £22,000 million, a saving of about £27,000 million on the national debt over the period.

The effect of implementing the proposed move now would be that a net amount of £20,000 million of national debt could be cancelled. The consequent reduction of interest payments on the national debt and, therefore, of taxation or further borrowing required to meet these payments, would help to bring about reflation without inflation.

1. The creation of cash

A. *The total amount of cash*

Money in the form of cash is created in the United Kingdom mainly by the Bank of England, the amount being fixed in agreement with the Treasury, and formally subject to a degree of Parliamentary control.

The note-issuing monopoly for England and Wales was first given to the Bank of England under the Bank Charter Act 1844, and is at present governed by the Currency and Bank Notes Act 1954. Certain Scottish and Northern Ireland banks also have the right to issue notes, but these amounts, of which some details are given later, are small. Coin is issued by the Royal Mint, the Bank of England buying any coin it needs at its face value. Profits of the Royal Mint belong to the Government.

The note issue is handled by the Issue Department of the Bank of England. That department was separated by the Bank Charter Act of 1844 from the Banking Department, which controls all other banking business. The issue of notes was at first fully backed by holdings of gold, but now the Issue Department holds securities as a balance against the liability arising from the issue of notes. These are normally Government securities, as shown in the following balance sheet of the Issue Department for 10 December 1980:

TABLE 1

Bank of England Issue Department

Position as at 10 December 1980

Liabilities	£ million	**Assets**	£ million
Notes in circulation	10,611	Government securities	8,430
Notes in Banking Department	14	Other securities[a]	2,195
Total notes in issue	10,625	Total securities held	10,625

Source: CSO Financial Statistics

[a]Includes commercial and local authority bills and bonds, and company and other securities, etc.

This shows that the Bank has issued over the years £10,625 million in notes, and holds as security backing for the issue £10,625 million in securities. The amount of the note issue and of the securities held for December in each of the years 1945 to 1980 is shown in Table 2 on page 10.

The amount of notes in the Banking Department has not been of any significance, and it may be noted that notes in circulation here includes notes held by all other banks and by the public. The term public is used in monetary information to refer to the total of all sectors other than the banking sector. The notes referred to in Table 2 are only those issued by the Bank of England. The rest of the cash in circulation, consisting of notes issued by Scottish and Northern Ireland banks, mentioned on page 7, and a certain amount of coin, is comparatively small, as can be seen from Appendix Table 17 (page 45).

The amount of notes and coin held by the banks in the form of 'till money' is shown in Table 3 (page 11), along with the amount in circulation with the public. These figures are for yearly averages, and differ from those in Table 2 (page 10) which refer to 'banking' December of each year; throughout this analysis it will be noted that there are many banking statistics referring to bankers' make-up dates rather than dates such as end of month and year normally used in other forms of information.

Table 3 shows the figures for each fifth year 1945 to 1980, and figures for the years 1919 to 1944, and 1945 to 1980 are included in Appendix Table 18 (page 46) and Appendix Table 18a (page 47). Also included in Table 3 are figures for the total amount of notes and coin held by the public at the end of each calendar year; both the annual averages and the amounts at the year end for 'circulation with the public' show the cash part of what is usually called the 'money stock'.

TABLE 2

Bank of England Issue Department

(amounts in £ million at December of year[a])

	Liabilities: Notes in circulation	Notes in banking department	Total notes in issue	Assets: Government securities	Other securities[b]	Total securities
1945	1,380	20	1,400	1,399	1	1,400
1946	1,428	22	1,450	1,449	1	1,450
1947	1,350	100	1,450	1,449	1	1,450
1948	1,293	32	1,325	1,324	1	1,325
1949	1,322	28	1,350	1,349	1	1,350
1950	1,358	18	1,375	1,370	5	1,375
1951	1,438	12	1,450	1,447	4	1,450
1952	1,525	50	1,575	1,571	4	1,575
1953	1,620	55	1,675	1 672	4	1,675
1954	1,752	24	1,775	1,771	4	1,775
1955	1,890	11	1,900	1,896	4	1,900
1956	1,998	28	2,025	2,021	4	2,025
1957	2,128	22	2,150	2,146	4	2,150
1958	2,135	65	2,200	2,196	4	2,200
1959	2,237	63	2,300	2,297	3	2,300
1960	2,374	26	2,400	2,398	2	2,400
1961	2,458	17	2,475	2,474	1	2,475
1962	2,453	47	2,500	2,499	1	2,500
1963[a]	2,598	53	2,650	2,649	1	2,650
1963[a]	2,556	44	2,600	2,599	1	2,600
1964	2,696	54	2,750	2,749	1	2,750
1965	2,876	24	2,900	2,899	1	2,900
1966	3,036	14	3,050	3,049	1	3,050
1967	3,160	40	3,200	3,199	1	3,200
1968	3,282	18	3,300	3,299	1	3,300
1969	3,370	30	3,400	3,375	25	3,400
1970	3,592	58	3,650	3,477	173	3,650
1971	3,785	40	3,825	3,380	445	3,825
1972	4,379	21	4,400	3,878	522	4,400
1973	4,788	12	4,800	4,027	773	4,800
1974	5,520	5	5,525	5,284	241	5,525
1975	6,138	12	6,150	5,430	720	6,150
1976	6,858	17	6,875	5,952	923	6,875
1977	8,019	6	8,025	7,095	930	8,025
1978	9,122	28	9,150	8,085	1,065	9,150
1979	10,089	11	10,100	8,635	1,465	10,100
1980	10,611	14	10,625	8,430	2,195	10,625

Sources: Bank of England, Statistical Abstracts 1 & 2; CSO, Financial Statistics

[a]For 1945 - 63, the last Wednesday in December (or, if a holiday, on the nearest working day); from 1963, bankers' make-up date, generally the 2nd Wednesday in December. Figures are shown both ways for 1963.
[b]Increased investment in other securities followed changes brought in with the National Loans Act 1968.

TABLE 3

Notes and coin outside the Bank of England (£ million)

(full table for each year see appendix - Table 18a)

	Annual averages[a]: Held by banks (till money)[d]	In circulation with the public[c]	Total outside the Bank of England	At end year[b]: In circulation with the public[c]
1945	153	1,263	1,416	1,287*
1950	199	1,244	1,443	1,268*
1955	268	1,657	1,925	1,688*
1960	339	2,062	2,401	2,101*
1965	515	2,426	2,941	2,636
1970	682	3,067	3,749	3,320
1975	791	5,341	6,132	5,904
1980	945	9,763	10,708	10,411

Sources: Bank of England Quarterly Bulletin, March 1981; Annual Abstract of Statistics; Bank of England Statistical Abstract Number 2, 1975.

[a]Average of weekly figures 1945-61; average of monthly figures 1961-80

[b]Estimated before 1963 on the basis of annual averages increased by 1.9% (the actual difference for 1963)

[c]These amounts form the basic quantity for 'money stock'.

[d]Excludes Bank of England notes held as backing for issues of Scottish and Northern Ireland notes in excess of their fiduciary issue

*Estimate

B. *The amount of new cash*

The amount of new cash issued 'is a source of finance for the central government' (quotation from 'National Accounts Statistics, Sources and Methods', CSO, 1968, page 420). That is, the amount of increase in the total amount of notes issued, and in the total of coins issued, is a pure source of interest-free finance for the Government.

The Note issue results from the monopoly given to the Bank of England by the Government; the Bank has created the cash at the cost only of printing and management. The profit arising from any increase in note issue belongs to the Government. Since this may be an unfamiliar idea it is worthwhile to dwell on it for a moment. If a private individual were to succeed in printing a five pound note so effectively that he could buy five pounds worth of goods with it in a shop, it would be clear to everyone that he had got something for nothing - or at least for no more than the cost to him of printing the five pound note. The illegality, as well as the immorality, of this action would consist in the fact that he was using the credit of the community, as represented by the five pound note, for his own personal gain. The Government equally, when it issues a five pound note, gets five pounds worth of goods or services for no more than the cost of printing and issuing the note. But it is perfectly legal, and considered quite legitimate, for the Government to use the credit of the community in this way, because the purposes for which they are using it are supposed to be for the benefit of the community as a whole. And in any case they have the right to raise that money by taxation.

The total increase in note and coin in issue over the period from 1946 to 1980 was £9,800 million on the basis of the banking year figures shown in Table 4 (page 14); this includes about £500 million increase in the issue of coin. The cost of producing and managing the note and coin issue over the period

would have been about £500 million (for details see below), leaving a net gain for the Government from their monopoly to issue cash of about £9,300 million for 1946 to 1980.

The increase in cash is shown in Table 4 in two ways: from the Bank of England statistics, relating generally to 'banking' years from December to December, and from 'national income' statistics, which adjust the total issue to a calendar year basis. In Table 4 are shown the increase in the total note issue by the Bank of England, and the estimated increase in coin in use. The figures in the first column of Table 4 are calculated from the increase each year of the figures in the third column of Table 2 (page 10). Those in the second column of Table 4 are calculated from the increase each year of the figures in the fourth column of Appendix Table 17 (page 45). The total of these in the third column of Table 4 gives a crude estimate of the benefit to the Government for 'banking' years. The national income figures in the fourth column of Table 4 show for calendar years the total issue of notes and coin, less the increase in holdings of notes and coin by the Bank of England Banking Department. These holdings are deducted because they are treated separately in the national income statistics as part of the general indebtedness to the Banking Department. On a national income basis, the total increase over 1946 to 1980 was a gross £10,100 million or net £9,600 million after the estimated cost of production and management.

The figure of £500 million given above as the cost of producing and managing the note and coin issue from 1946 to 1980 is calculated from figures in the Bank of England Accounts. The average cost for the period 1971-81 of producing notes was about 1.9% and the cost of managing the issue about 0.1% per year; this gives about £200 million as the cost of production from 1946 to 1980 and £300 million as the cost of management.

TABLE 4

New cash created (£ million)

	Estimates for 'banking' years: Note issue of Bank of England[a]	Coin issue of Royal Mint[b]	Total note and coin creation[c]	National income statistics (calendar years): Increase in notes and coin in circulation outside the central government[d]
1946	50	8	58*	50*
1947	0	5	5*	0*
1948	-125	21	-104*	-120*
1949	25	0	25*	30*
1950	25	-7	18*	30*
1951	75	0	75*	80*
1952	125	-1	124*	100
1953	100	7	107*	87
1954	100	3	103*	126
1955	125	5	103*	136
1956	125	7	132*	124
1957	125	7	132*	126
1958	50	2	52*	42
1959	100	3	103*	85
1960	100	6	106*	123
1961	75	13	88*	97
1962	25	9	34*	6
1963	150	1	151*	154
1964	150	2	152*	157
1965	150	4	154*	193
1966	150	9	159*	148
1967	150	4	154*	152
1968	100	13	113*	186
1969	100	96	196*	197
1970	250	15	265*	231
1971	175	-4	171*	243
1972	575	14	589*	578
1973	400	24	424*	544
1974	725	32	757*	788
1975	625	35	660*	673
1976	725	33	758*	837
1977	1,150	26	1,176*	1,044
1978	1,125	51*	1,176*	1,286
1979	950	40*	990*	1,199
1980	525	50*	575*	392
Total[e]	9,275	533*	9,808*	10,124*

Sources: Tables 2 and 17; National Income & Expenditure ('Blue Books')
[a]Increase in notes in issue from December to December (see Table 2 for dates in December [b]Increase in coin in circulation from average December to average December (this is not exactly the increase in issue, but an approximation to it) [c]Approximate increase [d]Excludes holdings by Bank of England Banking Department [e]1946–80
*Estimate

C. *Earnings from the cash issue*

The other source of finance for the Central Government, arising from the note issue, is the interest received on securities held by the Issue Department of the Bank of England (although this funding is mainly obtained by reducing the net interest paid out on government securities). The exact amount of this interest is not published, but the estimated net payment to the Treasury from 1946 to 1980, as calculated below, was about £9,800 million.

Hence, the power to issue cash has provided finance for the Government, over the period since 1945, totalling about £19,000 million, of which £9,300 million arises from the increase in cash, and £9,800 million from the interest on securities held as backing for the note issue. That is, the government borrowing requirement was £9,300 million less than it would otherwise have been; interest saved has been £9,800 million, although by the mechanics of the operation, the Treasury pays most of the interest to the Issue Department and then receives it back again.

The rest of this section is concerned with the calculation of the estimated £9,800 million net payment to the Treasury of interest on securities held against the note issue.

The Bank of England has published since 1971 in its Annual Report and Accounts the amount of income and profits arising from its holding of government and other securities.

Figures were as follows, <u>for the Bank Accounting year ending 28 February 1981</u>:

Total securities held:	beginning of year	£9,775 million
	end of year	£10,325 million
Income and profits for the year:	gross	£1,780 million
	expenses	£ 40 million
	net payable to Treasury	£1,740 million

Income and profits for the year include the effects of any revaluation of securities to market value; expenses are mainly costs of production, issue, custody and payment of bank notes. Figures for the net amount payable to the Treasury are shown in Table 5 (page 18) for the period for which they are available.

If the average securities held for the Bank of England accounting year are estimated at £10,050 million (average of beginning and year end figures), then the average rate of return was 17.3%. This includes profit other than interest payments. Separate information for interest only is not available.

The amount of interest is also not distinguished in national income statistics. This is because the Bank of England is regarded as the agent of the Central Government and its transactions are treated as those of the Government itself. Interest on Government securities held by the Bank of England Issue Department is excluded from both receipt and payment side of the Central Government accounts, although interest received from outside Central Government is included in receipts on current account.

In order to obtain estimates of the amount of return which the securities held by the Issue Department can be expected to have received over the full period from 1945, the following calculation has been done, the basis of which is set out in tabular form in Table 5 (page 18):

1. The first column gives the annual average of securities held each year by the Issue Department. It is obtained by taking the average of the securities held at the beginning and end of each year from the last column of Table 2 (page 10).
2. The second column gives the average redemption yield on Government securities for each year. This average yield is a straight average of the official gross redemption

yields for short, medium and long-dated British Government Securities (an official general average not being available). Also shown, in the third column, for comparison, is the official average annual Treasury Bill rate, which is applicable to short term investment (concerning which see later, page 32).
3. The fourth column gives an estimate for each year of the income value which could fairly be expected from the securities held against the note issue. It is obtained by applying the average yield on Government Securities in the second column to the annual average of securities held each year given in the first column.
4. The sum total of all the figures in the fourth column represents the total 'standardised' income from securities held over the period from the end of 1945 to the end of 1980, which was £11,100 million.
5. The fifth column gives for the years 1970 to 1980 (inclusive) the net amount actually paid to the Treasury each year, which adds up in total to £7,347 million. The corresponding 'standardised' income for those years, as estimated in the fourth column, adds up to about £8,300 million.
6. If the ratio of actual net payments for the years 1970-1980, namely 7,347/8,300, is applied to the full period 1946-1980, then the estimated net payment to the Treasury from 1946 to 1980 would be roughly £9,800 compared to the 'standardised' value of £11,100.

TABLE 5

Income from securities held by the Bank of England Issue Department

	Total securities held (annual average)[a] £ million	Yields: British Government securities[b] %	Yields: Treasury Bill rate %	Income from securities: Estimated from securities yield[c] £ million	Income from securities: Net payment to Treasury[d] £ million
1946	1,425	2.4*	0.5	34*	na
1947	1,450	2.5*	0.5	36*	na
1948	1,387	2.5*	0.5	35*	na
1949	1,337	2.8*	0.5	37*	na
1950	1,362	2.9*	0.5	39*	na
1951	1,412	3.1*	0.6	44*	na
1952	1,512	3.9*	2.2	59*	na
1953	1,625	3.8*	2.3	62*	na
1954	1,725	3.4*	1.8	59*	na
1955	1,837	4.1*	3.8	75*	na
1956	1,962	5.0*	4.9	98*	na
1957	2,087	5.2*	4.8	109*	na
1958	2,175	5.2*	4.6	113*	na
1959	2,250	4.9*	3.4	110*	na
1960	2,350	5.7*	4.9	134*	na
1961	2,437	6.2*	5.1	151*	na
1962	2,487	5.7*	4.2	142*	na
1963	2,575	5.1*	3.7	131*	na
1964	2,675	5.7*	4.6	152*	na
1965	2,825	6.6*	5.9	186*	na
1966	2,975	6.9*	6.1	205*	na
1967	3,125	6.7*	5.8	209*	na
1968	3,250	7.5*	7.0	244*	na
1969	3,350	8.9*	7.6	298*	na
1970	3,525	8.6*	7.0	303*	145
1971	3,737	7.9*	5.6	295*	170
1972	4,112	8.4*	5.5	345*	204
1973	4,600	10.6*	9.3	488*	371
1974	5,162	13.8*	11.4	712*	700
1975	5,837	13.0*	10.2	759*	583
1976	6,512	13.4*	11.2	873*	914
1977	7,450	11.6*	7.6	864*	464
1978	8,587	12.0*	8.5	1,030*	728
1979	9,625	12.9*	13.0	1,242*	1,328
1980	10,362	13.8*	15.1	1,430*	1,740

Sources: Table 2; CSO, Financial Statistics; Annual Abstract of Statistics; Bank of England, Annual Report
[a]Average of beginning and end of year figures from Table 2. [b]Straight (unweighted) average of official gross redemption yields for each of short, medium and long-dated British government securities. [c]Applying the government securities yield to the average holding. [d]Interest and profits from securities; year beginning March 1st.
*Estimate na = not available.

2. **The creation of credit**

A. *The total amount of credit*

Most of our money today is in the form of credit rather than cash and it is created through the operations of the banking system. It is the method by which this credit money comes into existence which is worth examination in some detail. Under our present system it comes into existence as an interest-bearing debt and most of the present problems in the monetary sphere arise from this fact. In his book 'Economics', Professor Paul Samuelson explains in detail how "the banking system as a whole can do what the small bank cannot do; it can expand its loans and investments many times the new reserves of cash created for it". Or, as the Radcliffe Committee on credit and currency put it "the credit creating capacity of the joint stock banks are today their effective credit base; an increase in the amount of liquid assets in the banking system may therefore make possible an increase in the bank's lending to the public". For many years the banks denied that the banking system could 'create credit', but today there is no shadow of doubt that they can do so as long as there are credit-worthy borrowers requiring loans.

In 1940, when surveying war-time finance, the Economic Reform Club, now part of the E.R.C., wrote in a letter to Sir John Simon, Chancellor of the Exchequer - "the creation of such additional money and credit as may be necessary for the prosecution of the war should be the function of the State, and the Banking System should be called upon to act in this matter as the Agents of Government and not as the lenders of money. It appears to my committee that this is a fundamental issue and that no satisfactory solution of our financial problem will be found until the Government ceases either directly or indirectly to play the role of borrowers and to put upon the nation a consequent burden of debt without any such justification as exists when money is borrowed from genuine savings. There is not in the creation of such additional money any question of savings and there ought not, we suggest, be any question of lending".

The position remains the same today. The Government has since the war had the benefit from issuing notes, but not the benefit from issuing the other forms of credit which make up the money stock. The Government has allowed the Banks to increase credit and to obtain the benefits deriving from that power. In this chapter the amounts of funding which the Government has foregone in allowing banks to create credit is estimated.

Until 1971, the monetary base for the issue of credit by commercial banks consisted of cash held by those banks, added to the amount of bankers deposits with the Banking Department of the Bank of England (the exact relationship has varied - see page 22 - and from 20 August, 1981, has formally ceased to exist, although it is still a useful measure).

Cash held by the banks has been shown in Table 3 of Chapter 1 (page 11); in the following Table 6 a summary of the balance sheet of the Banking Department shows the amount of bankers deposits for 10 December 1980, and the way in which total assets are invested:

TABLE 6

Bank of England Banking Department

Position as at 10 December 1980

Liabilities	£ million	**Assets**	£ million
Bankers deposits	487	Notes and coin	15
Other accounts and reserves	675	Government securities	446
		Advances and other accounts	175
		Premises, equipment and other securities	526
	1,162		1,162

Source: CSO Financial Statistics

The amounts for bankers deposits (and special deposits where applicable) and other liabilities, and for notes and coin, government securities and other assets, are shown in Table 7 below for each fifth year from 1945 to 1975 and for each year 1975 to 1980.

TABLE 7

Bank of England Banking Department

(amounts in £ million at December of year[a])

	Liabilities				**Assets**		
	Bankers deposits	Special deposits	Other accounts and reserves	Total	Notes and coin	Government securities	Other
1945	274	-	82	356	21	313	22
1950	313	-	119	432	19	364	49
1955	245	-	106	351	13	283	55
1960	226	151	97	474	27	403	44
1965	261	96	123	480	26	374	80
1970	167	388	189	744	60	605	79
1975	322	989	455	1,766	13	1,405	348
1976	325	1,806	516	2,647	18	1,905	724
1977	428	1,185	624	2,237	6	1,591	640
1978	423	1,099	729	2,251	28	1,848	375
1979	462	806	732	2,000	12	1,462	526
1980	487	-	675	1,162	15	446	701

Sources: Bank of England, Statistical Abstracts 1 & 2; CSO, Financial Statistics

[a] For 1945-1963, the last Wednesday in December (or, if a holiday, on the nearest working day); from 1963, bankers' make-up date, generally the 2nd Wednesday in December.

The item designated 'other accounts and reserves' in liabilities includes public accounts (Exchequer, National Loan Fund, etc), balances of overseas central banks and some private sector accounts, etc; the item 'other' in assets includes other securities, discounts and advances, etc.

From the point of view of the Bank of England, bankers deposits are effectively the same as notes issued; just as the Issue Department holds government securities against the note issue, so the Banking Department holds government securities against bankers deposits (for additional detail, see page 32). Further, when there are special deposits, these are in effect held in government securities, as can be seen from Table 7 (page 21). There are, however, some advances and discounts made in usual banking procedures.

Deposits in the commercial banking system have in the past mainly been related to the amount of 'cash' held, where cash is taken to mean the total of till money (notes and coin, which is effectively a deposit with the Issue Department) and deposits with the Banking Department. This 'cash ratio' was generally about 10% in the inter-war period, and 8% after the war up to 1971 when a new system was introduced for controlling the total amount of deposits in the commercial banking sector. The total amount of this 'monetary base' from the commercial banks point of view is shown in Table 8 (page 24) for the years 1919 to 1980. These figures are annual averages and not figures at year-end.

Very roughly, then, for the inter-war period, the total of commercial banking sector deposits was 10 times the total shown in Table 8, varying little over the years compared to the amount of change since World War II and being of the order of £2,000 million (average weekly deposits for London clearing banks and Scottish banks was £2,522 million in 1938).

The position for all United Kingdom banks for 1980 (December 10) is shown in Table 9 (page 25) for all sterling assets and liabilities. In this paper we are interested in the sterling position.

TABLE 8

The commercial banking sector 'monetary base'
(amounts in £ million; annual averages[a])

Year	Commercial banking sector 'monetary base': Till money	Deposits with Banking Department[b]	Total
1919	116	63	179
1920	110	84	194
1921	115	86	201
1922	111	80	191
1923	107	70	177
1924	107	70	177
1925	107	72	179
1926	106	69	175
1927	108	66	174
1928	108	66	174
1929	107	63	170
1930	106	66	172
1931	99	65	164
1932	95	81	176
1933	101	100	201
1934	102	100	202
1935	106	97	203
1936	112	96	208
1937	117	97	214
1938	121	106	227
1939	132	103	235
1940	141	110	251
1941	142	123	265
1942	147	137	284
1943	149	159	308
1944	155	184	339
1945	153	218	371
1946	159	255	414
1947	172	296	468
1948	177	305	482
1949	191	296	487
1950	199	292	491
1951	206	298	504
1952	220	277	497
1953	228	278	506
1954	240	281	521
1955	268	254	522
1956	281	228	509
1957	303	216	519
1958	315	218	533
1959	324	236	560
1960	339	248	587
1961[a]	358	250	608
1961[a]	385	254	639
1962	409	250	659
1963	433	250	683
1964	485	253	738
1965	515	269	784
1966	548	268	816
1967	561	285	846
1968	586	315	901
1969	640	288	928
1970	682	192	874
1971	705	231	936
1972	653	209	862
1973	703	246	949
1974	764	259	1,023
1975	791	281	1,072
1976	784	308	1,092
1977	812	338	1,150
1978	849	389	1,238
1979	914	460	1,374
1980	945	516	1,461

Source: Bank of England Quarterly Bulletin, March 1981.

[a]Average of weekly figures 1945–61; average of monthly figures 1961–80. Figures are shown both ways for 1961. [b]Excluding special deposits.

TABLE 9

Banks in the United Kingdom: sterling liabilities and assets
Position as at 10 December 1980

Liabilities	£ million	
Notes outstanding[a]		554
Deposits:		
UK private sector: sight[b]		21,000
UK private sector: time[c]		34,104
UK public sector: sight[c]		659
UK public sector: time[c]		303
Sub-total: UK private and public sector deposits[c]	56,066	
UK banking sector: sight		2,302
UK banking sector: time		15,375
Overseas: sight		2,946
Overseas: time		7,936
Certificates of deposit		5,727
Sub-total: Deposits other than UK private and public sector[d]	34,286	
Total deposits		90,352
Items in suspense and transmission		3,553
Capital and other funds		13,587
		108,046

Assets	£ million
Notes and coin[a]	1,591
Reserve assets:	
Balances with Bank of England	485
Money at call: discount market	4,601
other	295
Treasury bills[e]	1,168
Other bills	1,753
British government stocks (up to 1 year)	782
Total reserve assets[f]	9,084
Other market loans and bills[g]	29,348
Investments: British government	3,240
public sector	470
other	2,291
Total investments	6,001
Advances: UK public sector	1,885
other	51,047
Total advances	52,932
Items in suspense and collections	5,705
Other	3,359
Balance of 'other currency' assets	26
	108,046

[a]Notes outstanding are Scottish and Northern Ireland notes; part of notes and coin held as assets are held against this issue. [b]The main part of M_1 money stock. [c]Part of M_3 sterling money stock. [d]Not included in money stock (sterling). [e]UK and Northern Ireland. [f]Reserve assets required from 1971 to be held as a minimum 12½% of total deposits (up to August 1981). [g]Including loans to other banks, local authorities, etc.

Source: Bank of England, Quarterly Bulletin.