A New Financial Architechture: An Outline Arrived at through a Consideration of the Relationship Between Concepts of Money and Systems of Finance

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5/23/18

Introduction

In my view, the best definition of the term "money" that can be given is a broad one. The broad definition which I find to be most appropriate is as follows: That which is accepted by the individuals in a society to serve as a medium of exchange for the things which those individuals find desirable. To the extent that something corresponds to this definition, that is the extent to which it can be considered money. Some things, like paper dollars, or electronic number registrations on a computer screen which says "my account", may be very widely accepted by the individuals in a society as a medium of exchange for desirable things, while other things, like checks, shiny metals, or debt certificates may not be as widely accepted as a medium of exchange. Thus, paper dollars and electronic number registrations in an individual's online bank statement are "money" to a greater degree than are metals, debt certificates, or checks.

Throughout history, the things which human beings have accepted as money have changed. At times, certain societies only accepted as money things which were themselves desirable, such as lustrous metals, seashells, or food products like corn. At other times, certain societies have accepted as money things which were of practically no desirability in themselves, like bits of leather, or pieces of paper or clay. Today, for example, paper and electronic US dollars are very widely accepted as money- so much so that an electronic US dollar might be said to be the thing which best corresponds to the definition of money out of all things currently in existence. But, this was not always the case. Gold used to be the more widely accepted for payments than paper dollars. In fact, at one time, US dollars were only accepted as money at all because they represented claims to a certain amount of gold somewhere. Thus, we see how one thing becomes money to a greater degree than another thing over time: US dollars used to be considered money because they could be exchanged for gold, while, today, most people only consider gold to be money because it can be exchanged for US dollars.

These changes in the things which society generally accepts as money occur because the foundation of the acceptance of a thing as money in society is psychological, or subjective. There is no rule in the universe which dictates to man what he must accept as money and what he must not accept as money. This is not to say that certain things do not fulfill the role of a common

medium of exchange better than do other things; the changes in what mankind has accepted as money throughout history generally follow a course of improvement in how the practical questions of establishing a medium of exchange are addressed.

Naturally, the systems which human beings put in place for distributing money are determined by what it is which the society accepts as money. As the things which are accepted as money change over time, so too change the structures which society makes use of for the distribution of money. Old systems are replaced with new ones- hopefully to the improvement of the society. The birth and evolution of banking, for example, reflect such changes. For example, the clearinghouse system developed in the 19th century immensely improved the convenience by which society produced the immense number of transfers and exchanges of money needed to take place to facilitate trade. In those old days, when paper or metallic moneys were used, the clearinghouse system allowed banks to conveniently cancel out the checks drawn on each other, rendering only the remaining balance to be physically transferred from one bank to another at a convenient time. This was a very sensible innovation at the time, for it saved the societies which used it the great labor of constantly moving large amounts of silver, gold or paper money back and forth between banks which regularly had financial dealings with each other. However, the clearinghouse system is now obsolete. Why? Because of the development of electronic money which is transferable from one account to another account at light speed and involving no more effort than a mouse click (or even less given that much of money movement today is automated).[1]

Today, it seems that the systems which are in place for the distribution, regulation and control of money are those which the current concept of money which society operates upon does not necessitate. That is, it seems to me, that there are certain aspects of the financial system which are not necessary, based upon the way in which the idea of money has changed into what it is, from what it formerly had been. The concept of money currently accepted by the people of the most nations of the world is what is called “fiat currency”. The holder of such money has no legal right to claim a portion of something like gold or silver somewhere (as had formerly been the case, in times long past, with US dollars). Further, this currency is largely electronic, and the possibility of moving the US to a fully electronic-currency based money is a relatively immediate one. Based on this, as well as other considerations, it can be demonstrated that certain aspects of the modern financial system are unnecessary, and that, actually, they can be considered as but archaic vestiges of systems designed around a concept of money which has passed from the mind of society some time ago.

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[1] I understand that today there probably exist electronic analogs of the old clearing house system. However, of what benefit these would provide over direct electronic transfers between the accounts of banks I am unaware.

Below, I intend to convey my thoughts respecting the systems of money distribution in modern society. It is my opinion that some of the structures and practices currently in place are unnecessary given the current concept of money upon which society now operates.

The Two Kinds of Money, Banking and US Dollars

A distinction to be made before proceeding is as follows: There are two kinds of money: "representative money", and "base-money". Both correspond to the definition of money which we have adopted above, but there is a difference between them. The difference lies in the subjective basis for acceptance of each as a medium of exchange. A thing is "base money" if the individuals in a society accept it as a medium of exchange by convention or faith in convention, and do not question whether there are any legal claims to something associated with the possession of such money. Things which are "representative money", on the other hand, are accepted as a medium of exchange because of the judgement of the individuals in a society that the legal claim which the representative money makes to "base money" is reliable. Obviously, representative money can become base-money for most of the members of a society over time. Today, what used to be representative money, US dollars, is now base-money. As mentioned above, gold used to be considered base-money, and US dollars representative money; but, today, US dollars are base-money, and gold too is base-money, but it is less widely and commonly accepted than dollars, and, in fact, most people only think gold to be valuable because they can exchange it for US dollars.

The recognition of the fact that "representative money" has the potential to serve the same purposes as the money which it represents was important. The idea is this: If a certain amount of what a society generally accepts to be money, such as, in old times, gold or silver, be put away somewhere like a vault, that money could still be used, in a certain way, by the society as a medium of exchange. This is accomplished by the creation of notes, usually on pieces of paper, which give their holder a legal right to claim a certain amount of the money so vaulted up. Thus, these notes, to the extent that the truth of the obligation associated with them is believed, can serve as a medium of exchange just as well as the money in the vault would if it were used- and often with more convenience, as when light paper replaces cumbersome metal.

Further, it was discovered that, on account of the fact that the notes put into the hands of people in this way were never returned to redeem the money in the vault which they represented immediately, an amount of notes, the total claim to money in the vault of which was greater than the actual amount of money in the vault, could be created and put into society. The most rational way of thus putting these excess notes into society was seen to be in the form of loans. The idea

was that, as long as the loan was paid back either in notes, or in money,[2] the ability to satisfy the redemption of all of the notes issued would eventually be restored, and no great danger of someone bearing a note yet unable to redeem the money which it represented would develop. The "vault money" used in such schemes was usually gold and/or silver.

Banks in the US were established which operated in this way- notes would be issued by banks which bore claims to base-money in the banks' vaults which were in excess of the base-money actually possessed by those banks. Eventually, the notes issued by banks became US dollars uniformly.

As mentioned, changes have also occurred in the status of US dollars as representative money. First, US dollars represented claims to gold. Then, they represented claims to US government treasuries, which were, in turn, to be paid in gold. Then, US treasuries ceased to be fulfilled in payments of gold, and, thus, the dollars no longer had any claims to gold, direct or indirect. Dollars were to be issued "backed" by US Treasuries, while US Treasuries were to be backed by dollars. Thus, US dollars assumed the position, not just within the minds of the population, but in legal status, as base-money as opposed to representative money.

Questions of Money, and their Implications for the Structure of Financial Systems

As we shall see, the following questions about money are of some importance: Is the base-money which is most commonly accepted by a society created by the government, or created by private entities? Is the creation of the base-money of a society solely in the hands of the government or private interests- or is it shared between them? How easily and quickly can the base-money be created? Is the thing most commonly accepted as base-money of a society a certain kind of physical object, such as a piece of gold or a paper dollar, which can be possessed and used by anyone just as any other physical object could be? Or, is the base-money simply an abstract unit of account?

These questions are related to each other in important ways.

If the base-money of a society is a physical object like gold, then it can only be created by those who have the ability to create pieces of gold- which is not easily or quickly created. Therefore, in such a situation, the base-money supply is not easily or quickly increased. (Representative money, however, can be used to rapidly increase the money supply in such a situation, as with the issuance of notes seen in the early banks of the US). If the base-money of a society is paper

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[2](At least base-money of the same type as in the vault- or of a type easily exchanged for the kind of base-money in the vault.)

notes, the money can be very easily and quickly created. A government cannot have a monopoly over the base-money supply if the thing accepted as base-money is a certain kind of desirable object like gold- for the ability to produce such desirable objects cannot be monopolized by the government. Thus, the control by a government over money, and those processes in society involving money, would be less if the predominant base-money were a desirable commodity like gold. The government can monopolize the creation of certain kinds of pieces of paper -passing laws which ensure punishment of anyone caught producing pieces of paper like them- and establish, by law, the "legal tender" status of such paper. In such a situation, the paper will likely become base-money, and, thus, the government will have greater control over the base-money supply.

The question respecting whether the government has the sole monopoly over the creation of the base-money of society is pertinent to whether or not the money will need to be treated like an object or not. Assuming that the base-money of society were easily created, and that the government had a monopoly over this creation, if all banks were to be authorized by the government to create money, then the connection between deposit-taking and lending would be completely destroyed. I explain: If the base-money of a society were paper notes like US dollars, the creation of which were monopolized by the government, banks would need to lend out the actual dollars which they received as deposits, because those would be the only dollars (besides interest and other profit etc.) which the bank would have access to for lending. Because of the requirement of the bank to always be able to disburse actual paper dollars to whomever has a deposit account with the bank, the lending of the bank is constrained in various ways, as by capital and reserve requirements, other kinds of regulations, and the bank's own policies of discretion respecting lending operations. However, if the government of such a society were to authorize the banks to print the paper base-money and use it for lending, then there would no longer be any logical reason to keep in place the measures which were intended to ensure the ability of the bank to fulfill the obligation to pay paper notes to any depositor that might demand them.[3] Why? Because all of the deposits could be kept in the vault by the bank and not used for lending at all, while all lending could be done with paper base-money printed by the bank itself. In such a situation, there would be the possibility of banks not taking any deposits at all, but only making loans of printed money, while, at the same time, new businesses would spring up which would be nothing more than places which people could put their money for safekeeping; providing also such services as banks usually would provide, like money transfers by check or debit card- all while making no loans whatsoever. Again, the distinct functions of holding money for the public and providing certain related services would be completely disconnected from the function of loan making. In fact, a law might even be passed which would mandate that a loan

[3]Or do things roughly equivalent, like crediting debtors accounts with the right to draw dollars, and fulfilling the draw demands with actual dollars should they take place- perhaps after clearinghouse operations with another bank for example.

making bank cannot also provide money holding and related services. In such a situation, the banks would only be able to make profits off of the loans which they made, and not from the off-balance sheet operations made possible from the holding of the funds of society. This should illustrate that, under conditions of easily creatable base-money the legal right to create which is governed by a single authority like the government[4], there is no necessary reason as to why deposit taking and loan making should be in any way dependant upon each other. This has many implications respecting the characteristics of the financial system. For example, if the above outlined system were to be put in place, the economy would save the expense of paying deposit interest since no deposits would provide the basis for the making of loans. More implications will be discussed later.

It should be noted that the above situation would be identical in effect to one in which the banks were not allowed to create base-money, but were allowed to issue loans only with borrowed newly created base-money from the government authority controlling base-money creation. For example, in the US, the banks could be set up such that they took no deposits, and only lent out money which they borrowed from the Fed, which, in turn, would only ever lend newly generated base-money (as is currently done by the Fed with the discount window).

Obviously, the ability to enable banks to create base-money in the way just described depends upon the ease and speed with which base-money can be created. If gold or some other commodity were to be the predominant base-money of a society, the scenario just outlined would not be possible since gold cannot be immediately created. In addition, the procedure would not be applicable. For, as mentioned, the government cannot reasonably establish a monopoly over the production of a certain desirable commodity like gold. Therefore, if the base-money of the society were a desirable commodity, like gold, then the government would have no capability to authorize anyone to create it, since anyone could already do it.

The questions respecting whether the base-money of a society is a physical object or an abstract unit of account is also to be considered in this connection. If the base-money of a society is a physical object, then the speed and ease of its creation will be determined by what kind of physical object it is. If the base-money of a society is merely a unit of account on someone's bank statement, then there is virtually no cost, effort, or time involved in the creation of new base-money by whomever is legally authorized to do so in the society.

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[4] It will be noted that we the clause “the legal right to create which is governed by a single authority like a government” needed to be inserted. If the base-money of a society were easily creatable, yet had no legal restrictions on its creation, whatever were considered to be that base-money would rapidly lose its status as base-money, since everyone in the society would create vast amounts of it for themselves and use it for purchases of goods. This would cause immediate and massive hyperinflation of that base-money- driving it to the point of absolute worthlessness.

This points toward one of the major problems with the acceptance by society that the predominant base-money is a desirable commodity. Under such a condition, the quantity of base-money, and, thus, "sound" representative money, and, thus, the total supply of money and credit, will be limited by the presence of the desirable commodity which constitutes the base-money of the society. Thus, a situation might arise in which there were economic potentialities of investment readily available to a society which were unable to be actualized due to a shortage of money required to make the exchanges of goods involved in that actualization possible.

The Situation Today

Today in the US, although paper dollars are widely accepted as base-money, the great majority of payments made in the US economy are by non-cash means, with electronic payments increasing as a percentage of total non-cash payments all the time. The units of account on bank statements have come to be accepted as the base-money of the US economy. That is, whatever action results in a registration of an increase in the number on a bank statement -whether it be the swiping of a card or the scanning of a phone- is viewed as a legitimate payment of money; as is made clear by the preponderance of non-cash payment in the US- the preponderance of which is growing.

Further, it should be recognized that this money is created by the government- or at least a government agency: the Fed. Or, formulated more accurately: The basis for the proliferation of these units of account is created by the Fed.

Thus, respecting the questions put forward above, the US base-money system is thus: Is the base-money which is most commonly accepted by a society created by the government, or created by private entities? It is created by the government. Is the creation of the base-money of a society solely in the hands of the government or private interests- or is it shared between them? It is shared, in the above indicated way, by the Fed and the private banks. How easily and quickly can the base-money be created? Very easily and immediately. Is the thing most commonly accepted as base-money of a society a certain kind of physical object, such as a piece of gold or a paper dollar, which can be possessed and used by anyone just as any other physical object could be? Or, is the base-money simply an abstract unit of account? The base-money of the US is, primarily, the unit of account on financial statements. Use of paper dollars is diminishing all the time, and it would not be difficult to transfer to an entirely cashless society soon.

As was demonstrated in the previous section, a society with the base-money characteristics just identified as belonging to the US is one in which there is no longer a necessary connection

between deposit taking and loan making by banks. Certain of the aspects of our current financial system -like the connection between deposit taking and lending- were developed when society held base-money to be a physical object, like paper dollars or gold. As these things were not capable of being readily produced, they had to be procured. Deposit taking became the method by which such base-money was principally procured. The use of this base-money for loans had to be done such that the owners of the money would have no trouble accessing it when desired- which implies certain aspects of a corresponding financial system. As was mentioned, a society's base-money can be changed from gold to paper notes. If this is done, the possibility of authorizing the private creation of money arises, and the connection between loans making and deposit taking is rendered unnecessary. The change of a society's base-money from physical paper notes to abstract units of account simply reduces the time and effort required to create base-money- thus, it is a change which further reduces the obstacles of totally dissolving the connection between deposits and loan making.

In order to further illustrate how it is that some of the aspects of the US financial system are not necessarily based upon the concept of base-money now prevalent in the US, consider the following hypothetical financial architecture which could now be established in the US without violating the concept of base-money currently prevalent in the US.

Another Hypothetical System

Besides granting money creation capability to the banks in the way described above, it were possible to completely do away with the private banking system and replace it with a federal credit authority. For instance, the federal government could open offices all over the country in which the activities of the credit authority (CA) would be carried out. At each office, a number of authorized employees of the CA would perform essentially the same function as a typical bank-loan officer: the agent would distribute loans to entities that requested loans for the purpose of making economically sound investments. Upon authorization of the loan, the CA would credit the account of the entity with the amount of the loan. The debtor would be under an obligation to repay the loan as specified in the loan contract.

This all sounds precisely identical to what already takes place in the banking system at present. What would be the difference? The difference would be that the money loaned to the debtor by the CA would not need to be deposited at the CA by some other entity beforehand because the CA would be using its power of money creation to issue the loan. This would be as if the Federal Reserve were to decide to shut down all the banks in the country, and replace the lending which those banks had engaged in with direct lending of its own. This would eliminate the need for a number of practices currently tied to the lending of money by modern banks.

No reserve requirement would need to be maintained since the two currently purported reasons for the existence of the reserve requirement of banks- management of risk and control over the money supply- would no longer be applicable to the financial system. First, take risk management. The basic idea is that a bank must keep a certain amount of money on hand so that, in the case of a bank failure, a certain amount will be available to pay back those who have deposited money into the bank. But, in the case of the CA, since the money being created for the purpose of loaning did would not exist before it was created, there would be no risk of an original depositor of that money losing their money if a number of loans issued by the CA were to go bad. What about control over the money supply? Reserve requirements do provide some capability over the control over the money supply- but only under the banking system model currently in place. That is, because many private banks are authorized to loan out a portion of the deposits they receive, the amount of loans capable of being made by banks, and, hence, the "money multiplier," is dependant upon the reserve requirement. But, if all of the banks were to be eliminated, besides the CA, the supply of money would be effected solely by the amount of loans made by the CA over time, and no money multiplier would even exist. In such a case, every person in the economy could have an account at the CA in which their money would be deposited (electronically). Transfers of money from the account of one person (or business entity) to that of another could still take place. But, the total amount of money in the accounts at the CA would in no way determine the amount of loans which could be issued by the CA. The functions would be separate, since no reason for the functions to be connected were necessary (as in older phases of society and corresponding concepts of base-money). Another consequence of the fact that all of the money held by the public would be in accounts at the CA, and that the money held in these accounts would be in no way connected to the lending operations of the CA, would be that FDIC insurance, or other similar kinds of insurance expenditures, would be pointless. Again, since, nobody's money is being loaned out, there is no risk to anyone's money which is held in CA accounts. This would eliminate the basis of things like bank panics and bank runs which can cause so much economic damage by a disruption in the flow of credit to economically valuable activity. Thus, it would eliminate the need for all of the financial structures put in place to prevent or attenuate the adverse effects of banks panics/runs- like, for example, much of the aspects of the organization of the Federal Reserve System. In fact, one of the primary reasons for the creation of the Federal Reserve System was, supposedly, the establishment of a system by which bank panics/runs could be addressed in such a way as to prevent bank failures and corresponding economic damage.

Further, this would eliminate the need for the government to borrow any money from any entity other than itself. Taxes could still be levied (and much more efficiently than is done today), but the borrowing of the government could be done through the CA. This would save the government the economically unnecessary expense of interest. As discussed elsewhere, ideally, the government should not spend borrowings (including those of the CA) on things which do not

represent sound economic investments. The financing of government activities must be determined by weighing the nature of the activity with the consideration of the time scales involved in the activity and in its economic effects, while weighing the degree to which the activity should be financed by the public at the current time (by taxes), or by the public at a future time (by borrowing- from the CA). We will not delve into those complicated questions here, but to point out just a couple of examples: administrative activities would be best financed by taxes, while large-scale infrastructure construction could be financed by borrowing; medium-sized infrastructure might be financed with a combination of the two, and so on.

Money Supply and Inflation Control

Since, under such a hypothetical system, the government will not borrow from anyone other than itself, there will, eventually, be no government bonds. Thus, the CA will not be able to purchase any government bonds as is currently done by the Fed for the purpose of controlling the money supply and modifying the prevailing market rates of interest. This, however, would be of no concern under the CA system. For the alteration of the money supply by the Fed is ultimately rationalized by the intention to ensure adequate supplies of money available for lending by banks- lending upon which the economic process depends. However, under the CA system, there could never be a shortage of credit available for economically useful lending, since all of the lending would be done by the CA, which would have the ability to create as much money as would be needed.

It might be objected that this would limit the ability of government agencies, like the Fed, to curb inflation by selling government bonds which they had formerly purchased, thereby decreasing the money supply, increasing interest rates, and decreasing lending. However, those points of argument would be moot. Since all of the lending would be performed by the CA, the CA could adjust the amounts of its lending according to the needs of the economy, including the suppression of inflation. This would be a more direct way of modifying lending amounts than is currently done by the open market operations of the Fed. Because it would be more direct, it may prove more effective and precise than the method currently used by the Fed. Indeed, since the lending of the country would be made by a single agency, the management of that agency could combat inflation by selectively contracting credit to certain categories of investment which were judged to be of less productive economic return.

However, this is not the only financial means by which inflation could be curbed under the CA system. (We will not discuss the economic means by which inflation can be curbed- though that is a discussion which is of great importance, we are now focusing only on monetary tools of the government or government agencies here). I have produced a report in which it is described how a new system of taxation could be implemented based on a national federal sales tax. My

proposal is not the kind of national sales tax as is commonly referenced, but, rather, a non-homogenous national sales tax, in which the rate of taxation on every sale is dependant upon the total amount of purchases made by the purchasing individual in the sale over a given period of time. As was pointed out in that report, such a tax could be crafted, in various ways, to the effect of reducing inflation. Increasing the sales tax, as a basic example, would curb inflation (granted that the proceeds of the tax were not spent again shortly after collection).

Questions

Now that we have taken the time to illustrate, with the above hypothetical examples, the way in which the current concept of base-money held by the US society (and other countries) renders certain of the current aspects of the financial system unnecessary, let us see what might be said in opposition to the establishment of a financial system like the ones we have described above.

First, we will start with the question as to whether the action by the government to authorize the creation of money by lending institutions, like banks, which would nullify the connection between deposit taking and lending, presents any immediately identifiable problems.

Before proceeding, the following ought to be addressed: Based on the "official" definitions of "money," banks already are allowed to create money through the making of loans. That is, since all deposits are defined as "money," or "M1", the action of banks in making loans (which increase total deposits in the banking system) does, by this definition, create "money." In fact, based on our definition of "base-money," and our identification of units of account in bank statements as the base-money of the US at present, banks currently have the power to create base-money. However, the creation of base-money by banks in this way is not unconstrained in the way above. The amount of loans a bank can make is constrained by the amount of deposits which it receives. Thus, while the banks can create base-money, it can only do so in such a way as if it could not create base-money. Or, rather, the lending of money by banks today occurs as if those banks were lending physical objects which they could not willfully create. For example, the lending of electronic money by banks today occurs in just the same way as if the banks were lending pieces of gold. Because of this, the banking system is still susceptible to bank panics/runs (which have economic consequences). This is due to the way in which deposits and loans are connected in the banking system. Each loan made by a bank represents an allocation of the deposits put into it[5]- as if, to say it again, the loans were being made with some physical object as the money. That is, functionally, the banks do not create base-money, they only allocate

[5] It is understood that banks can create loans without any deposits on hand to "back it up" by crediting accounts. But such a situation, in which an account is open with no ability to draw on it, is only temporary, for a bank which created a loan in this way must eventually obtain deposits equal to the amount of the loan in order to cover withdraws from the account.

it, while claiming that base-money is created. Let me explain: If a bank were really "creating" base-money every time it made a loan (thereby increasing deposits in the banking system), then all of the depositors in that bank would be able to withdraw all of their money held on account in the bank without any effect on the bank or its loans. But, his cannot be done in our society today. If every single depositor in a particular bank in the US today were to attempt to withdraw all of their funds from their deposit accounts at once, only a few of the depositors would be able to do so, most would not get any money at all, and the bank would fail. Thus, it seems that we cannot really say that US banks actually create base-money at present, but only lend it while telling their depositors that they have base-money on account. In other words, banks today do not "create" base-money any more than could a bank in Alexander Hamilton's time.

What if, then, given the current concept of base-money, banks were allowed to create base-money in the way identified as a possibility above? What if deposit taking and loan making were no longer connected in the way they are now?

One objection to such a scheme might be that the lending activities of banks is made prudent by connecting it to the holding of deposits. That is, when a bank has only a certain amount which it can lend, then there will be greater surety that the lending of the bank will be sound.

This argument seems reasonable. But, in fact, the argument is easily countered: The government could simply limit the amount of loans which the banks could make. (In fact, it already does so, in a certain way, in the establishment of reserve requirements) It could establish this limitation in various ways- for example, with respect to individual banks, on the basis of various criteria, such as the population density or economic output density of the region within which a bank operates. Exemptions to the limit could be made for approved categories of investment. Further, what is ignored by the argument, is that the limitation of bank lending by deposit amounts might result in a situation in which there is not enough lending capability to ensure the most effective actualization of economic potential. This danger would be less in a system in which the banks could create money. It would be a danger if the government set the lending capability too low- but, this, of course, is already a danger under the current system, and, therefore, it would not be a new danger introduced by the adoption of the new system. Therefore, the banking system would gain an advantage in one respect while remaining as prone to failure in another- a net benefit. As mentioned above, this would also be an inflation management tool identical in effect to that which is currently used by the Fed, while more direct in mechanism.

It should be pointed out that capital requirements of the banks could still be put in place. This would limit the amount of loans which the bank could make- the more capital, the more loans. Given the fact that loans would no longer be made with depositor money, what would be the rationale behind the establishment of a capital requirement, (besides that it would fulfill the

function of limiting loans- a limitation which a government law could establish just as easily)? The rationale is based on considerations of basic economic theory: Loans made correspond to consumed resources. That is, the money loaned will be used to consume some of the resources of society. An economically sound loan is one in which the consumption of resources produces other resources, or contributes to the production of resources in general, in such a way that the net effect upon the economic potential of the society is positive, or at least zero. Because the majority of resources and productive economic labor are procured through the exchange of money, loans which are made to productive purposes (or, "sound loans") are generally associated with a monetary return equal or greater to the original amount of the loan. Thus, repayment of an issued loan is an approximate indicator of whether the loan is economically sound (as opposed to merely financially sound- and there is a big difference!). If a loan of newly created money is made, and, then, fails to be paid back, this likely indicates that an amount of the resources of society corresponding to the amount of the loan have been wasted. This would represent an inflationary effect. Thus, in such a case, an amount of money equal to the loan would need to be extracted from the economy in order to offset the inflationary effect of the unpaid loan.

This serves to show how it is that the need to ensure depositor security in banking performed on the basis of loaning deposits is coincident with the needs of the economy respecting the consumption of resources. If a loan is made which is unsound, someone will have to pay for it. That is, the ability of someone to consume the resources of society will need to be reduced, whether it be the bank, the depositor who provided the original money, or the entity which defaulted on the loan. Laws have been established intended to provide equitable protection to these three parties involved in the making of loans. But the fact that the unpaid loan is eventually paid by someone corresponds to the above identified requirement of loans discerned by a consideration of basic principles of economics.

Thus, since it is sure that some of the loans which are made by the banks in society will fail, there must be some way that the banks can cover the unpaid loan- that is, repay it. This is true whether the banks are authorized to create base-money or not. Thus, in the case in which banks loan newly created base-money only, it is necessary that, in addition to other methods of ensuring repayment of the loan, they have a capital base which they can resort to for the purpose of covering any failed loan. Again, this would result in a reduction of the money (which is resource consumption capability) of the society to the effect of offsetting the inflationary effect of introducing new money into the economy in the form of a failed loan corresponding to non-productive consumption.

Another argument against the first system described would be that the effectively unlimited money creation capability of the banks would lead to economically damaging bubbles, inflation, and a loss of interest rate changes which constrain and encourage sound lending accordingly. All

of these arguments are answered in the same way as the first objection: limitations on lending could be put in place, most preferably by instituting capital requirements. The capital requirements could, of course, be adjusted as is deemed proper as economic conditions change. Beyond that, one thing to point out is the lack of force in the argument that changes in interest rates prevent unsound lending. Some have made the silly comparison of the effect of interest rate fluctuations to such biological control mechanisms as fluctuations in serum insulin levels. That is, some have said that just as serum insulin levels increase in response to increased blood sugar levels in order to facilitate absorption of the sugar into the cells, thereby bringing the level of circulating sugar into proper proportion, so too will interest rates increase when there is an increase in lending, in just such a perfectly calibrated way, as to constrain the amount of lending such that excessive lending does not occur. The argument, as can be seen, is based upon the assumption that the fluctuations of interest rates are calibrated with as fine a precision as are the insulin regulation mechanisms of the human body. This, of course, is not true. There have been plenty of bubbles and other negative results of unsound and excessive lending in history which have occurred while rates of interest were allowed to move freely.

The essential characteristics of a financial system as described in the second hypothetical case, in which the government controls all loan making, would be identical in how they differ from the characteristics of the current financial system. Of course, we do not need to choose between one or the other, a system in which both private banks and a central government credit agency issue loans of newly created base-money into the economy is easily conceived. To summarize, the three options are: 1.) Only private banks issue loans in the economy (of newly created base-money); 2.) Only the government issues loans in the economy (of newly created base-money); or, 3.) Both private banks and government agencies issue loans in the economy (with newly created base-money). In all three of these options, the financial system would differ from the current one in the same way. The primary difference, which many of the changes in financial structure would correspond to, is the separation of deposits and loans. As mentioned, this separation is made possible by the concept of base-money which society has come to adopt since the time during which the concept of base-money made the current connection between deposits and loans necessary.

I encourage others to explore more ways in which this kind of financial system could be an improvement over the one which is currently in place, or how it is that this kind of financial system would be worse than the one currently in place. This paper should be viewed as a foray into the subject, and not a final analysis. However, I can say that, at present, the potential benefits which I have judged would derive from the adoption of such a system -some of which are indicated above- warrant the serious consideration of adopting that kind of system.