Money, Currency, Interest and Banking in a Georgist Economy

by David Spain BA, LL.B, LLM.

Synopsis:

It is impossible to understand the operation of Site Revenue, let alone of the existing economy, without comprehending the broader economic context in which rental is assessed and paid. The Site Revenue reform alone would not suffice to bring about economic harmony. Its introduction must take place in association with "Free Banking" reforms.

Money:

Since time immemorial, folk have used mutually-agreed **tokens** (e.g. shells, furs, coins) as a medium of exchange in order to facilitate trade. Only in recent centuries have paper or plastic notes served as such tokens. This new practice grew out of goldsmiths' receipts, being claims for precious metal deposited with them, becoming transferable from hand to hand. Central banks (especially the Bank of England) then issued notes entitling the holder to redeem their face value from gold reserves. Nowadays, with the abandonment of the gold standard, that nexus is destroyed.

Paper or plastic tokens have no intrinsic value and are not 'real' wealth (unlike buildings, cattle or gold). They are merely an **accounting device** for measuring, or obligating provision & transfer of, wealth: they command wealth, but are not wealth in the sense of possessing value in themselves. Money is useful as a "medium of exchange" or "accounting device", and is this regard is simply an agreed administrative score-keeping convenience, like playing poker using match-sticks. Currency may be light & handy as a token to exchange in transactions, but it is virtually worthless in itself (good maybe to light fires or as wallpaper). Other commodities do have intrinsic value as they are in economic demand. "Money" (when not relics out of circulation) is the same as currency (banknotes & coins – which together are "cash"). Economists term the total quantum of cash in circulation and instantly-callable deposits thereof "M1".

A range of instruments (such as cheques, promissory notes, IOUs, private bonds and credit card vouchers) are 'debt instruments' or 'transactional media' which may evidence monetary indebtedness or trigger money payments, but are not money in themselves. The creation of debt instruments does expand the money-supply, and is encouraged by land speculation since folk are more-ready to borrow for such 'investment' than to buy labour products which wear out before the debt is paid. Site Revenue will not cure the monetary problems, but it will stifle the continued expansion of bank credit.

Ultimately, any real utility of money is based on its exchangeability for some rock-solid commodity of true intrinsic worth. Tokens can only be accepted in a trading community because their convertibility to real wealth (goods and services) is trusted, or because governments dictate (and enforce if need be) that they shall be legal tender and can be used to pay taxes. The former basis (community trust) underpins free banking, but the latter (termed "fiat" value, because it rests on force) dominates the global economy. Modern governments dictate that their tokens shall constitute "legal tender" and shall alone be acceptable to pay tax, and they make no promises to exchange these tokens for anything except more "legal tender". Thus, no real backing exists save to the extent that the free market is willing to exchange real commodities for these tokens. If the only unit of account is a fiat one, redeemable only with more fiat currency, then it is a fictitious unit that can be exploited by inflation.

This is where the rot has set in. The power of government, or its delegated institutions[1], to introduce new 'money' into the game (thereby diluting others' holdings) is potentially the power to cheat. Since abandonment of the gold standard, the 'value' or 'real backing' behind currency has been insubstantial, a fleeting thing rising & falling relatively erratically in the marketplace reflecting whatever happens to be the status of citizens' goodwill & productivity amidst governmental manipulation at any given instant. That manipulation is no small thing as unscrupulous governments (and all of them are) ruthlessly position themselves for re-election. By allowing destruction of the fixed link between currency and a specific, truly valuable commodity (e.g. gold), the trusting democratic flock have allowed the 'political' wolves (in shepherds' clothing) to hijack the show. The rot has set in because the medium of exchange has ceased to be anchored to any specific commodity at a fixed price, but rather has been allowed to become a commodity in its own right. The existing supply of fiat currency should simply be left in circulation to find its own level against redeemable notes issued by free banks & business houses.

Supply Of Money

Money is 'supplied' by governments printing banknotes and injecting them, or 'credit' as their equivalent, into the economy. Governments do this by creating projects or buying goods & services which are paid for, not from taxes but crudely with 'hot air' – fiat currency. This fiat currency may be loaned by the Reserve Bank to the government or to trading banks so as to inject it into circulation. This creates an ever-increasing interest-debt which forces up the price of products.

In a sophisticated economy, the mechanism is rather more complex than this and is controlled by a central bank which is independent of political (governmental) control. The mechanism used by central banks to inject or reduce the money supply is the bond market. Bonds are certificates obliging the issuer (which need not be a bank or government) to pay a certain sum of money on a certain day. Bonds are invariably issued at a discount price and the difference between that price and the final payment gives the 'yield'. By issuing bonds at a large discount, central banks can make them more attractive than other investments and so soak up investment liquidity out of the community, driving up interest rates.

Conversely, central banks can inject money into the community by buying bonds (usually from retail banks and big institutions, but also new bonds issued by government) at an excessively generous price, thereby increasing liquidity and driving interest rates down. The central bank pays for these bonds with printed banknotes (which cost it virtually nothing) or by a cheque which the seller deposits at his private trading bank, and the bank presents it to the central bank which clears it by increasing that trading bank's money reserves.

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[1] In the USA and Canada the power to print banknotes or mint coin is held by private institutions (the Banks of America & Canada).

The extra reserves are money, which the private bank can loan out many times over (since only need a small fraction must be kept on reserve), thereby further increasing the money supply. Thus, without giving any true value (just paper IOU's claimable in the future and no doubt paid using monies raised from sale of fresh bonds), the government via the central bank can write cheques to support its expenditure and create money in the economy with no real asset backing. This abuse can be prevented by Free Banking because investors would then shun bonds backed only by fiat currency in favour of those backed by real commodities.

Inflation and Deflation

Responsible modern governments have to be careful about this monetary manipulation if the purchasing power of currency is to remain stable over time, enabling reliable planning for production and encouraging saving or lending. A hundred dollars in the year 2000 should be able to purchase the same equivalent of goods & services in the year 2003 or 2050. This means that there is no need for the hundred dollars to be lent out at interest just to keep up with inflation. The stability of the purchasing power of currency notes is tied to the demand for them relative to their supply. The more notes awash in the economy, the less folk demand them.

Accordingly (the theory runs), the total amount of currency in circulation should be flexible, increasing or decreasing in proportion to the quantum of goods & services in the community. If the money supply is not increased to match increased goods & services, then too little money will be chasing too much goods & services: the demand for loans will increase driving up interest rates, thereby dampening investment & consumption leading to recession. If the money supply is increased excessively then folk will have plenty of money, prices of goods will soar, workers will strike for higher pay and speculative activity will increase. It is for this reason, to assure liquidity and stable prices, that governments monitor the total quantum of goods & services in an economy, along with the number of people, and inject or withdraw money as required: an activity that takes a 12-18 month time lag to register, meaning that forecasts must be accurate – to play catch-up is the height of folly. Economists' mathematical formulae are frequently inaccurate or out-dated and their solutions are frequently inappropriate templates developed for elsewhere, not tailor made. Furthermore, economies are complex, vast and constantly changing so this monitoring is a difficult, expensive and quite unreliable process, easily conducive to mistakes and action in ignorance.

Inflation exists when there is too much money (cash and loans) sloshing around in an economy chasing too few commodities: spenders are willing to pay more to get what they want and prices rise: in the short term this stimulates a spiral of increasing production, employment and wage-demands which works unevenly (warping & distorting price relationships). In the later stages the economy 'overheats' because consumer demand is satiated and/or wage-demand becomes impossible: so consumption stalls, prices collapse, workers are laid off, highly-leveraged borrowers cannot repay and the inflationary bubble is pricked, collapsing the economy into a depression.

Many economists argue that about 6% unemployment is essential for a healthy economy as it creates competition for jobs and stops inflationary wage-demands. This is a sad position since unemployment diminishes production and causes human misery, frustration & welfare dependence. It is also a false position: the increased employment and higher wages would be accompanied by increased productivity and demand. The core of the 'overheating' problem in fact lies in land prices. Where the community fails to capture the entire rental value of sites it is pocketed by the site-holders, so price attaches to sites beyond the value of improvements. In boom times this abuse fosters speculation in sites, which diverts investment from productive enterprise (e.g. buildings & machinery) and forces producers to pay higher rents. Eventually the sandcastle of high rents, high employment, high wages and high prices becomes unsustainable and crumbles: demand, production and employment diminish, land speculators are unable to get tenants or service their debt and are bankrupted, even banks fail because their imprudent loans (upon

the security of inflated land prices) have no real asset backing. The economy lurches from boom through another interlude of bust.

Inflation devalues money and is particularly bad for bondholders, people with savings (the value of which is eroded) or those on fixed incomes (eg pensioners). Governments, via their central banks, can adopt policies determining money supply. This enables abuse, as governments profit from inflation which allows bonds to be repaid with "cheaper" money, decreases the real value of government debt and wheedles political support from imprudent banks (which have lent against security which is now eroded) and from businesspeople who have over-borrowed: in each instance their debt is effectively diluted away. Borrowers benefit from increases in inflation, and support politicians who favour it. Also, when newly created money is spent, the government or bank is able to get goods without having to produce anything. This revenue, called "**seignorage**", is effectively a tax on the total production of an economy. Arguably, seignorage spent on public infrastructure (eg bridges) enhances general productivity and so the artificial currency does get to be reflected by real goods & services. However, in a Site Revenue economy expenditure on valuable infrastructure is always economic, since it increases site values and hence pays for itself – but such expenditure must be made from site revenues, not by artificial printing of currency.

Stagflation is a condition where inflation and unemployment are present together.

Deflation exists where there is too little money in the economy, such that prices fall in an effort to entice sales. If the money supply contracts, the long-run response is a deflation of prices, not a change in the rate of interest.

Central bankers **reduce inflation** "from the supply side" by constricting injection of new currency or "squeezing credit" and "from the demand side" by increasing interest rates. These manipulations transfer money from debtors (consumers) to creditors (savers), causing less demand, less investment and less consumption. Governments may also withdraw liquidity from an economy by tightening welfare payments or public sector employment. Unfortunately, bankruptcies and unemployment are part of the chain of causation leading to lower investment and consumption. Whereas high interest rates send existing businesses broke, a credit squeeze stops new businesses from starting up. Whereas high interest rates discourage present consumption by penalizing past consumption, a credit squeeze limits present consumption directly. Either way, the result is reduced effective demand, hence unemployment. High interest rates and credit squeezes are merely alternative means of restraining a symptom.

Site Revenue prevents sites (not made by humanity) being confused with goods & services in the marketplace, and so simplifies & renders real any assessment of their quantum in an economy. It also terminates instantly any sort of speculation in the value of sites: a prolific source of destabilizing price-spirals and a major distraction to productive investment. By permitting inflation or by deficit-spending governments can artificially create excessive liquidity: investors then purchase sites at ever-increasing prices and a speculative boom ensues. The focusing on investment away from speculation into productivity (factories, machines, research etc.) increases efficiencies and economies of scale, (reducing prices) and makes workers more content thereby reducing wage-push inflation. With a high standard of living population growth ceases, such that the production of goods & services stabilizes, as do wage levels. Site Revenue thus fundamentally stabilizes the marketplace and minimizes or ousts the 'need' for monetary manipulation.

Backing currency (even if issued centrally) with a reliable commodity is the primary reform. Free banking (allowing any entity to do so) is secondary. It is a total misconception to believe that the quantum of money in circulation must be increased if production increases. By supplying a reliable unit of account (e.g. gold) free banking naturally keeps prices steady since unbacked, inflationary banknotes are ignored and weak ones wither away. If the supply of goods & services increases then prices should automatically drop in the same proportion so that the fixed money supply will purchase the same volume.

Backing for Money

In a pure gold standard, such as pertained before WW1, gold *was* money and gold coins (sovereigns) were in circulation. Paper currency, which existed in parallel, was defined as representing a quantity of gold, for which quantity it could be physically exchanged upon presentation. It was a title to gold: if too many titles were issued, the issuer ran out of gold.

From the Breton-Woods agreement in 1946 until the early 1970s, the US dollar was anchored to gold at the rate of US$35 per ounce. Whilst gold was not actually money (in the sense that no sovereigns circulated), banknotes could purchase gold at a fixed rate. By 1970, however, President Johnson's massive borrowing & printing of banknotes (to finance the Vietnam war) threatened to undermine confidence in the US dollar: there was simply not enough gold to meet demands for redemption. The dollar had to be detached from gold and floated. In effect, this move canceled a significant part of the U.S. debt by drastically reducing the value of federal reserve notes. As a result US$700 - $800 became required to buy an ounce of gold and folk who had saved currency notes were badly burnt. This bought the U.S. time, but at a heavy price.

It is important that currency be backed by a real and tangible value, such value being inherent in a commodity which is useful, beautiful and stable. Whilst other decent competitors (silver, diamonds) could be used, gold "fills the bill" as such a central commodity since it has useful applications (jewellery, dentistry, electronics), is difficult to win, easily divisible & beautiful and does not tarnish. Precious metals are commodities that, over many centuries, have held a relatively stable exchange value against other commodities. Most of the gold that has ever been mined is still in gold bars and coins, so there is no inefficiency in holding the gold as money. There would be inefficiency if salt, cattle or bricks (which are heavy, mortal or in limited demand) were used as money.

Modern banknotes all emanate from a central bank and are purely fiat: although they may be used to buy gold at a floating price, they are not convertible into gold at a fixed price. If currency had to be backed by precious metal and auditors ensured this was so, good currency would chase out bad. No one could create purchasing power out of thin air; they would first provide services to others who had produced goods or produce goods for exchange. No-one would accept totally fiat currency unbacked by any real wealth. This is the concept of 'free' (as distinct from monopolistic) banking.

It is not necessary to pick a single commodity, although this may be best (in the form of an hour of unskilled labour) at a very localized level. A broad market-basket system, of say 100 widely traded goods & services (e.g. the labour rate to lay 100 bricks), can be adopted to allow the backing rate to float in line with organic economic movements and to avoid abrupt changes caused by technological advances ideosyncratic to a specific product. With 'basket' backing the issuer of a note must redeem it with any requested commodity (in the basket), or combination of them, to the mean-value of the entire basket on the day redemption is exercised. The 'basket' may contain other currencies so long as these are in themselves redeemable for an actual commodity.

In that case, single-commodity stock certificates & warehouse receipts (exchangeable for any real commodity, or range of them, selected by the converter) would substitute for vaults of gold, and the fractional reserve of such commodities could be much lower, as new wheat, etc., is coming in all the time. Such warehouse receipts, or private banknotes backed by gold or whatever, would always be exchangeable as-of-right for government "legal tender" in the fixed quantity stipulated upon its issue.

In the electronic age there is little or no need to even have currency in circulation. It would suffice for individuals to have deposits or credit at banks and to draw it down, or add to it, electronically. However,

the monetary units would have to be backed by a real commodity. Those holding credit in the bank would be treated as notionally having placed the appropriate quantity of that commodity into escrow.

The bank would monitor the markets and adjust the nominal value of each member's account to reflect changes in the exchange value of the commodity (or basket of commodities) nominally deposited. It would not be necessary for banks, either Head Office or branches, to actually hold the commodity in their vaults, but the commodity would **(i)** have to be held somewhere [e.g. by a central bank], **(ii)** be available in specie upon reasonable notice to enable redemption of notes or satisfaction of electronic credit and **(iii)** be held in that quantity which is necessary to redeem all extant notes if holders of them all were to claim redemption simultaneously.

Interest

Interest is the sum paid for the use of borrowed money. Where money represents a store of value, a borrower benefits from the "time preference" of being able to use or consume now what s/he has not yet made or produced. In this sense, interest is actually a wage paid by the borrower (who wishes to consume more than his available liquid wealth allows) to the lender for forbearing to consume.

However, this situation is complicated and readily open to abuse, in which latter event it certainly lacks legitimacy and constitutes "usury", as forbidden by Biblical injunction[2]. It should be noted that the Islamic religion forbids charging any element of interest: it does, however, permit advances to be made coupled with entitlement to repayment of principal plus a specific proportion of profits (negotiated with reference to input and risk). The Islamic approach therefore relives a borrower of remorselessly paying interest, even if his venture fails.

The following points may be made:

(a) Money represents a medium of exchange and in reality an economy becomes unhealthy unless this medium continuously circulates. Thus, when sellers & workers (as a general class) obtain payment, that money (as represented by currency, or a deposit credit entitling withdrawal as currency) must be passed on (by way of purchasing goods & services or investment into productivity or loans) to maintain a healthy cycle. In a stable economy (without inflation or deflation and with productivity above zero) a nominal interest rate (of say 1%) should suffice to entice deposits from hoarders. Indeed, in a healthy economy with no speculation in sites, investment would be directed into productivity. Resultant efficiencies (as methods and equipment improved) would lower prices and even induce negative interest rates since a sum borrowed now could buy much more in the future when returned to the lender. Lenders would actually pay borrowers to preserve and return their funds.

(b) If the money is deposited for safe storage in a bank, the bank is entitled only to payment by borrowers in respect of the interest it is paying the depositors and proper fees associated with administration, maintaining its building & plant and assessing credit applications. If banks had to operate in a free market these fees would be held to a minimum.

(c) "Nominal interest" is the amount necessary to entice savings into banks, as per (a) above. "Natural interest" is the amount necessary to cover the overheads in both (a) and (b) above. Risk (where the advance is unreliable) is a premium added to the natural interest rate, so as to insure bad loans. Risk premiums can be increased if laws regarding bankruptcy & fraud are excessively lenient. If there is inflation, the quantum of interest must be adjusted to prevent erosion of the capital sum advanced: this

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[2] See e.g. Leviticus 25:36; Ezekiel 18:17.

element comprises "spurious interest", which can be capitalized into "spurious capital": wealth not backed by any goods or services. There can also be a monopoly premium added to natural interest when the banking system is monopolized by lack of competition or the availability of loan funds is constrained by a credit squeeze: these also constitute spurious interest. In a "Geo" economy characterized by Site Revenue and Free Banking, lending would be at natural interest rates (plus an insurance risk element in less reliable advances).

(d) Enclosure of sites forces those who are cut out of monopolistic privileges to depend upon landlords, moneylenders and employers. In a Geo economy, in which all sites (whether used or not) must pay rental revenue to the community, there would be easy access to sites (even if only to live a subsistence lifestyle at the margin) and much more freedom to choose where and for whom one works. Demand for labour would increase, as holders of valuable sites sought to generate the cashflow necessary to retain them, and the reward to labour would improve due to the freedom of labourers to choose. The increased reward to, and saving of, workers would foster formation of small businesses. With all taxes abolished, individuals would immediately have more buying power. They would have their previous gross income without any deduction for taxes, less their site revenue. In addition, there might be citizen dividends as governments would find the site revenue excessive for their needs amidst the spontaneous harmony prevailing.

(e) With no further prospect of reaping from future generations a parasitic profit from increased land-price, folk would save more. Self-reliance on savings would decrease demand for borrowed capital. This diminished demand, and also the increased pool of savings, would force interest rates down. Probably savings would be pooled at a local level, in co-operatives and building societies, further reducing overheads and interest rates.

Credit Creation

Credit creation is caused by banks lending more than they hold by way of deposit. At a micro level, banks amalgamate many minor deposits to make a major loan, often by way of supplying drawdown credit to a cheque account. Such deposits & cheque accounts are not in themselves money, but just book-keeping entries, a convenient form by which credit is extended. In substance, savers (who could have spent their savings on G&S) are loaning real G&S to borrowers, however the clear balance of this is disturbed by having a 'fractional reserve' banking system.

To assure capacity to meet cash demands, Australian banks are required to maintain a "prime asset ratio" of 6%. That is, the readily-liquefiable assets of a bank (cash in till, callable deposits with the central bank) must be 6% of its debts (e.g. to depositors). Thus, from each $10,000 deposited a bank may lend $9,400. However, under the 'fractional reserve' banking system this effect becomes magnified because, across the banking industry generally, the $9,400 loaned is again deposited in a bank, and $8,836 can be re-lent, and so on. Thus, banks issue "funny money" and rake in interest on each loan. The "funny money", as with any real money, remains backed by nothing except government fiat.

Is this a recipe for a crazy, constantly-expanding monetary system with no earthing in reality? Should borrowing equal savings by being restricted to an already existing stock of wealth which the lender must do without so that the borrower may use it at a price (interest)? Or is it a healthy dynamism which benefits the community by spanning the gap during currency shortages and enabling more borrowing & wealth-creation?

Arguably, this credit creation is not a problem so long as **(i)** depositors are informed of the policy (hence it is not fraud), **(ii)** the money loaned is eventually repaid and then destroyed **(iii)** interest charged reflects real costs and is not usurious and **(iv)** there is little or no inflation of the cash base. However, this argument enables an economy which renders redemption of bank notes (for their face value in gold) quite

unreliable. The only solid way to go is to restrict banks to lending only the actual deposits they hold (which is all an individual can do).

Free Banking

There is no central bank in a free banking system (or at least, if there is, it has no monopoly on issuing currency), so economies and currencies can no longer be manipulated by financiers, governments or elites. This fosters a market which (given a site revenue context) is as pure as possible.
Banks, trading houses (e.g. General Motors) and even individuals could issue their own currency notes, but each would be obliged to exchange them for quantities of a commodity specified on their face. The specified commodity might be gold, or a new car at a pre-set price, or a quantity of new season's wheat.

Each bank would print its logo and the guaranteed gold-backing of the note upon its face, with a bar code. The total quantity of gold for which a bundle of "commonly accepted" notes must be exchanged (upon demand) by the issuer, or could be expected from a clearing house, could then be rapidly assessed electronically by an automatic scanner. At present banknotes can be used to buy gold at a floating rate, but they are not convertible into gold at a fixed rate --- the rate of exchange is theoretically determined by market conditions, i.e. supply and demand, but there is a lot of behind the scenes manipulation: if the supply of gold remains constant, but the supply of banknotes (credit) increases, then the price of gold (and of everything else) increases as inflation sets in.

In reality, only a dozen or so notes would tend to be recognized nationally although others (e.g. backed by labour hours) would be known & respected in local areas. This is essentially the mechanism of local LETS schemes. Once government demands rent or taxes in particular currencies (especially its own), free-market banking becomes impossible. There is no dictated 'legal tender' in a pure free market. Site revenue should be payable in any generally-acceptable note or commodity.

Private bonds & notes would be redeemable only by provision of the commodity to which they are tied, not (unless agreed) by more bonds, so their issuance cannot be inflationary. Having competing currencies preserves the value of currency notes generally, since weaker currencies would gradually be exchanged and wither away. If the reputation of the issuer were suspect, the public would ignore its note. Good money would chase out bad, in that the public would only accept the currency notes of issuers which were known to exchange (perhaps, in the case of localized notes, via an intermediary national note) for gold upon demand.

The issuing of credit serves a valuable function in an entrepreneurial society, creating a bridge between conception & consumption and allowing the cycle of production to flow. Issuance of notes by the private sector could supplant sale of government bonds as a method or raising revenue or obtaining advance of labour. In this way, a producer could bridge the time gap between commencing & finishing production, when the bond or note can be redeemed using new wealth.

On the other hand, if financial institutions (such as the State Banks of South Australia & Victoria, and Pyramid Building Society, in recent years) act irresponsibly, making too many loans that are never repaid due to entrepreneurial default (e.g. Bond & Skase) and lenient bankruptcy laws, then too much outstanding "funny money" is not dissolved by return to the lender, so the money in circulation expands faster than the quantum of goods and services. Often the taxpayer winds up paying the bill, as governments struggle to buttress faith in the monetary system.

Issuers would still be able to lend their banknotes, but would have to be very prudent lest confidence in their notes be lost and demands for redemption (in gold specie) could not be met, triggering personal exposure for directors, guarantors and, in the case of banks, even shareholders (as regards say a tranche equal to their initial share capital). The prudential risks attending loans would be minimized because commodity backing would keep stable the value of currency notes, the price of sites used to secure advances (by mortgage) would lack any speculative element, and there would be a reliable growth in

economic productivity stemming from Site Revenue (which eliminates much speculative, and fosters productive, investment).

Due to competition from other issuers, lenders would charge a minimal fee for the service provided rather than interest. That fee would cover administration expenses, credit assessment and insurance for risky loans. This fee is not interest: it is wages for labor and repayment of disbursements. Interest arises only when there is a monopoly in credit.

Conclusion:

The Site Revenue reform must be accompanied by Free Banking in order to found an economy which is wholly healthy and beyond manipulation.