SCOTTISH DEMOCRATIC ALLIANCE

07.01.12

Monetary Policy in an Independent Scotland

This is a Statement of political principle. The associated detail of implementation and transition is contained in separate documents.

Objective

We propose a Monetary Policy which will deliver a fair society within a stable free enterprise economy with an expanding infrastructural asset base. This will require significantly greater regulation of the present banking business, but is fully achievable by a sovereign state within the context of globalisation. The written Constitution of an Independent Scotland will enshrine the principle that the origination of money, the National Credit and the management of the National Balance of Payments must ultimately rest with the State and cannot be delegated to any other entity, be it an individual, a corporation, another State or currency union. The Constitution must therefore provide for

- A Constitutional Monetary Authority (CMA) - the sole arbiter over the issue of new debt-free sovereign money and credit. The Authority may authorise an increase in liquidity only upon the undertaking of the Administration that the entire sum will directly fund the formation of fixed public assets.

- In assessing proposed major projects received from Central and Regional Government priorities will separate domestic and imported labour and material content in the context of employment and Balance of Payment considerations.

- The consent of the CMA will also be required for the issue of any government debt securities. The only exception will be in times of National Emergency and for a limited period to facilitate the transition to Full Reserve Banking.

- The CMA will enjoy a trustee status similar to the Judiciary.

- The capping of the National Debt at whatever level is negotiated upon Independence.

- On behalf of the CMA the new Central Bank will manage the transition from fractional to full reserve banking and thereafter regulate the banking and payments system. It will also fix the base rates of interest and foreign exchange and also monitor cross-border capital flows.

- A new currency unit – the Merk or the Scots pound. It is not possible to achieve the objectives above without a sovereign currency.

Philosophy

Conventional economic appraisals are presently evaluated in terms of money. Affordability governs what economic agents can or cannot undertake, and yet the primary purpose of a fiat currency is to optimise economic activity and facilitate tangible public investment - not to constrain these elements. This is a key dichotomy, because whilst individuals and corporations must regard money as a scarce commodity to be earned by work and enterprise - the State, through its Constitution and Parliament, is charged with creating and managing the currency to ***secure*** this outcome. Our currency is our means of exchange - we must ensure it is neither corrupted nor inflated for private or political gain at the point of issue.

The current fractional reserve system leverages its depositor and private capital base by a factor of ten or twelve times, and often a great deal more, yet it is reliably estimated that less than ten per cent of bank credit finances the productive economy. Historically there was some rationale in banks leveraging a commodity based currency which was in limited supply, but that has no relevance within a fiat currency

regime. Recovering the ability to monitor the currency is the most effective tool available within a sovereign State to stabilise its economy. These anomalies are addressed within this interpretation of monetary policy.

The Balance of Payments measures the value of our imports and exports – get this out of kilter international friction is generated - the country becomes a sovereign debtor or creditor. The debtor State becomes beholden to the creditor country which can then use the money to buy up national assets and generally exert an influence over domestic political freedom. But that is only one aspect of BoP - the rate of exchange for currencies governs the price of imports and exports. A State allowing its currency to be valued by financial markets or external influences denies itself a major tool in shaping its future – e.g. cheap imports may be attractive in the short term but can develop into a WMD for the local economy.

Scottish banks will be chartered as Mutuals or Corporate bodies to conduct domestic retail banking which will include the financing of exports and imports. They will not lend to nor borrow from foreign governments. Scottish merchant or investment banking will require to obtain market funding and their indirect financing by bank credit (shadow banking) will no longer be permitted. The intention is to return money to being a means of exchange - a means to an end, and not an end in itself.

End Note

In short, Governments which relinquish control of their currency leave themselves open to external interventions beyond the control of democratic institutions. Independence offers a unique opportunity to learn from these mistakes and to go back to where it all started to go wrong. The banking business will not reform itself from within, nor under the aegis of Government Inquiries populated by Establishment grandees who benefit from the status quo. When the argument starts and the lobbyists and ministerial advisors assemble, we must remember that there is nothing wrong with the present banking system – it works precisely the way the bankers want it to work.

Nor will the pseudo-science of economics further this debate - even the Keynesian school is constrained by the Debt Voodoo. In the real scientific world the boundaries are under constant pressure, but in Monetary Policy we tinker with interest rates and set targets for inflation and growth which are little more than fig leaves to disguise the interests of the City of London. Just as with fractional reserve banking, the system works well – for those who benefit from it. And for as long as these same interests control the political process, little will change.

Notes – matters related to Monetary Policy but not constitutional.

1. The 2011 euro-crisis was compounded because it arose within a currency union. Several governments had issued debt in the form of bonds. Various banks, domestic and foreign, bought these securities, mainly but not exclusively, for euros. The ‘indebted’ States then spent the receipts on current account. These fractional reserve banks did not actually have real euros to lend – more accurately they extended credit, and for as long as the interest was paid the loan was regarded as sound. But borrowing more euros just to pay the interest on previous loans meant the debt was growing exponentially. This led to a loss of confidence and demand for repayment.

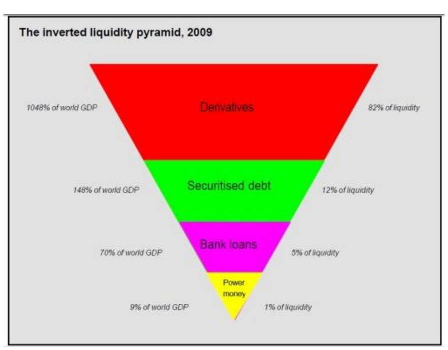
It is not widely appreciated that these banks do not lend real money i.e. the money of savers or investors, so if the loss exceeds a bank’s reserves, then it will became insolvent. Fractional reserve is no more than ‘promises of money ‘which collectively form a chain of interbank loans. If one link fails the system collapses - hence it cannot work without implicit State guarantees. With 100% reserve banking, i.e. where loans cannot exceed resources, the ‘hit’ is taken by the defaulting bank’s investors and that’s where it stops. A conventional administration process would then apply whereby the business was either reconstructed or wound up.

2. The vast bulk of Financial Institutions provide responsible and useful services - pension funds, investment trusts, insurance and many more specialised functions. They will all gain from the financial stability of full reserve banking and constructive financial regulation. Rash and ill-considered lending will be significantly reduced because the loans will be the ‘real money’ of investors and shareholders. They will not tolerate ‘gambling’ and moral hazard will once again have meaning. This will prompt changes to company law whereby the influence of members and shareholders will be more effectively represented in the boardroom.

3. Scotland will have its own Stock Market. It will be regulated to focus primarily upon raising capital for private enterprises. It may however be usefully noted that of the huge volume of transactions conducted by the LSE less than 2% serve this function. It would perhaps be desirable that the establishment of a new Exchange might, as touched upon above, initiate fresh consideration of corporate investment management - nominee holdings, computer managed trading and short selling which have all occupied a number of official inquiries in the City of London over the years, but which have never resolved these problems.

4. Pensions and savings have become volatile areas and a review will provide scope for reform. Full reserve banking offers a large repository for such funds categorised in various degrees of risk to return ratios. Savings within Mutual and National Savings Institutions is a key to a stable financial regime.

5. Like an inverted pyramid, fractional reserve banking has absorbed massive public resources to keep it stable. Even so it wobbles about pretty regularly and every so often it threatens to topple completely. These latest financial crises stem from 1986 when the Thatcher/Reagan regimes opened the Pandora’s Box of bank deregulation and most of the props disappeared.



Up until then it had been the stability of the Building Societies which underpinned the financial system - every penny lent came from the savings of others and the societies financed virtually100% of residential mortgages. Residential mortgages are by far the largest lending sector in Western economies. When the banks bought up the Building Societies, house prices soared and mortgages became tradable financial assets.

6. Many responsible politicians are calling for substantial State borrowing to fund public investment in order to fight economic stagnation. The objective is laudable, but the means is not. Constitutional Money resolves this problem.

Corporations must balance their budgets or go bust; they also borrow for Capital Investment motivated by the potential for private profit. Similarly the State raises taxes to balance its current revenue and expenditure. A State also requires to look beyond its day to day revenues in order to make public investments. However a Nation is not constituted to compete with private business or to make a profit, rather it is charged with optimising the environment within which such enterprise can prosper - and thus provide for the welfare of all its citizens.

That optimisation cannot be achieved by constraining the State with debt and interest on its own currency. The constraint must be solely the public interest – manifested in financing full and constructive employment of people and resources. It is for the CMA to ensure that any new debt- free money issued is literally a public subscription to new infrastructure; that is not inflationary - provided it is not spent on current account. There is no need for banks in this loop - not until the new money is paid to the contractor and the physical asset is in place. Only then does the contractor pay the money into a bank account and the new money enters circulation – matched to an equivalent increase in GDP..

The Diagram

This represents the basic monetary elements supporting economic sovereignty and stability. Outside the circle lie the main external influences which can subvert it – Fractional Reserve Banking and Sovereign Debt.

Within the 'virtuous circle' a nation state is captain of its own destiny. Even if its currency inflates it is purely an internal matter with internal controls to hand. Its external position can also be adjusted through its rate of exchange – an automatic reality check.

For this same reason the Scottish Government should minimise any official debt being held in foreign currencies and when negotiating its share of the National Assets and Liabilities (Debt) it should denominate its bonds in its own currency, offering to exchange these for equivalent value UK Sterling bonds.

The avoidance of government borrowing advocated by this monetary policy will permit the capping of the National Debt and its progressive reduction.

This is not an option if the currency is linked or shadowing some other currency or if the rate of exchange is set by external currency markets. Linking the currency to gold – or more accurately holding gold reserves and declaring a link to it, is an option but only in the absence of confidence in the management of the currency. A link to gold would of course spell the end of fractional reserve banking in any case, as only the State could then control the volume of the money supply.

The primary obligation of monetary policy is to finance a fair and productive domestic economy with near consistent full employment and a healthy balance of payments. The virtuous circle is punctured if the currency is diluted with unlimited bank credit from the fractional reserve system or if the balance of payments is permitted to accumulate consistent deficits.

Transition – an outline

The relationship between banks and government requires clarification. Banks are unique corporate entities because they play a key role within the economy. For this reason they cannot exist or function without a Charter granted by their host government. That Charter spells out the unique privileges of being a bank and also the legislation within which it must operate. No other corporate entity should be more accountable to the State.

The fractional reserve principle, by definition, creates a chain of interdependency between banks whereby the payments system, money lending and credit creation have become so inexorably linked that it is almost impossible to control. The system cannot even regulate itself let alone be democratically accountable. This monetary policy separates these functions and the CMA will rule on the increase or decrease of National Credit to be issued by the Central Bank to the chartered clearing banks. It will be charged with maintaining domestic liquidity at levels to optimise economic activity. It may decrease liquidity in the interests of exchange rate stability or in circumstances where fiscal or interest rate intervention fails to control inflation.

Scotland is not prepared to have its economy dominated by the banking system. The new State will offer to acquire existing banks at market value, but only following rigorous evaluation of domestic and foreign loan portfolios. If this cannot be achieved on a mutually acceptable commercial basis (and banks have unknown volumes of non-performing loans) they will lose their charter to trade in Scotland. They will however be invited to reconstruct themselves as Corporate Full Reserve Banks or as Mutuals within the new chartered banking legislation.

This conversion will leave a ‘rump’ of toxic debts and outstanding obligations for which, in general, no taxpayer should be responsible. The process will doubtless initiate disputes which could induce home and foreign controversy over the interpretation of how governments should guarantee the liabilities of banks operating within their States. It would be wrong to minimise the potential here for friction but mutualisation (or corporate full reserve banking) will start with a clean sheet.

Banks which have been temporarily acquired on this basis will of course also have legitimate assets and liabilities some denominated in foreign currencies and these will be disposed of either commercially to foreign banks or to the new Central Bank. Chartered Scottish Banks will deal in foreign currencies only through the Central Bank. Interbank lending, other than through the clearing system, will no longer be permitted. It will no longer be the business of Scottish chartered banks to hold foreign securities or investments other than directly linked to their domestic lending functions.

Appendices: