

PART ONE  
UNDERSTANDING THE PROBLEMS

# Chapter One

## The Nature of Money and Credit

There is probably nothing in this world which influences every aspect of our daily lives more powerfully and consistently than money does. We sacrifice so much of our precious time on this earth in order to get it and it lies at the root of all of the major problems plaguing society ...unemployment, poverty, crime and even pollution. Yet relatively few people have much more than a basic understanding about what money really is or where it comes from.

### *What is Money?*

Most people, when asked this question, will laugh and say “That’s easy, it is what I never have enough of”. But if you persist with your questioning until you get a serious answer, they will probably tell you that money is something that gives them purchasing power or the ability to consume goods and services. While this explains what money does, it does not say much about what money really is.

Modern transactions may involve many forms

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of money or “financial instruments” such as cash, cheques, debit and credit cards, money orders or electronic fund transfers. While all these “mediums of exchange” may increase our purchasing power, they do not bring us any closer to understanding the true nature of money. A five-dollar bill may represent five dollars, but what is a dollar? If you can’t see it or feel it, and its value is changing every single day, can you ever really understand it?

A dollar is really nothing more than a notion in motion, an abstract concept, an increment of faith. It is no longer backed by anything other than the collective debts and obligations of our nation. A dollar does not have any concrete reference point in the real world. The closest that we can ever get to understanding it is to know its primary representative, *legal tender* currency.

Only government issued bank notes and coins are *legal tender money*. What that means is that if you owe someone \$20, for example, and you give him a \$20 bill (or two \$10 bills, four \$5 bills, etc.), then legally he is paid and, if he refuses payment in this form, then you are absolved of that debt. All other mediums of exchange (cheques, debit & credit cards, etc.) are really *promise-to-pay money*, or instruments endorsed by privately-owned financial institutions that promise to pay legal tender money

to anyone who demands it when presenting these instruments at any of their branches. Legally, no one has to accept your cheque, even if it is certified, and if they refuse to, then your debt still stands.

### *The Difference Between Money and Assets*

Paper money has little or no intrinsic value. On its own it is relatively useless. It doesn't taste very good, doesn't burn very long or produce much heat, and you can't wear it or build anything with it. It is only good when it can be used as a *medium of exchange*, that is when someone else is willing to give you something that you want or need in exchange for it. Because so many people are willing to accept it in this way, money is often said to be a storehouse of value. Bankers and accountants list it as an asset on their balance sheets and financial traders buy and sell it as if it was a commodity itself. In reality, however, money has few of the attributes of an asset.

*Assets* are goods or services that have an intrinsic value or are useful in and of themselves. Food, clothing and housing are important basic assets. Cars, televisions and computers are more exciting assets. But assets can also be non-material too. Knowledge and experience, skill and talent,

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creativity and intelligence are valuable assets. Good health, a clean environment and safe communities are very important assets as well. If you were ever stranded on a deserted island with nothing but a suitcase full of money, you would soon appreciate the important difference between money and real assets. Unfortunately, many of society's most precious assets have little, if any, recognized monetary value in the economy. You will not find any credits on a balance sheet for clean air and water, good health or an educated population. Nor will you see any debits representing the tragic cost to society of unemployment and poverty, either in terms of wasted potential, lost production or human pain and suffering. In economic terms, a tree has no value until it is cut down and a human life has no value unless it is devoted to working. That so many of our best assets and greatest liabilities must be left unpriced in order for the economy to operate, is one of the primary weaknesses of the current monetary system.

### *What is Credit?*

Most people when answering this question simply state that credit is borrowed money. Some may mention interest in their reply but only a few take their thinking much further. If asked to explain

where this borrowed money comes from, most people become uncomfortable, an indication perhaps that they are entering unfamiliar territory.

To help clarify the true nature of credit, we need to distinguish between “money you own” and “money you rent”. *Money you own* can be either cash in your pocket or earnings deposited in your savings or chequing accounts. It is money that you have already earned from your own labour and initiative. *Money you rent* is any borrowed money that you must eventually repay. Interest is the *rental charge* that you must pay to the lender to use his money for a period of time.

Another way to look at interest is as a *tax on future potential*. The lender assesses your future earning potential. If you have sufficient collateral, and he believes that your ideas, experience and initiative will likely generate a steady and reliable income, then he will monetize your potential and lend you the right to develop your own abilities. While the government taxes all your *past* accomplishments, the lender taxes all your *future* achievements. Both feed on your energy and initiative. If you are aggressive in the marketplace, after paying them both, there may be enough of your earnings left over for you to live on.

The purchasing power of an *owned dollar* is

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equal to *exactly* one dollar. The purchasing power of a *borrowed dollar* is equal to one dollar *less* the amount of interest (per dollar) that is charged by the lender. The purchasing power of a *loaned dollar* is equal to one dollar *plus* the amount of interest that is charged by the lender.

For example, if you have one-hundred owned dollars in your pocket, you can purchase goods and services worth exactly one-hundred dollars (ignoring taxes for now). If you have one-hundred borrowed dollars, and the interest rate charged is ten dollars (or ten percent) then, after subtracting the interest that you must pay, you can purchase only ninety-dollars worth of goods and services. Or if you buy one-hundred dollars worth of goods and services, you will have to earn one-hundred-and-ten dollars later on in order to be able to pay back your debt. If you have one-hundred loaned dollars, on the other hand, when they return to you with interest added, you will be able to purchase one-hundred-and-ten dollars worth of goods and services. This is why the wealth of people with many loaned dollars grows much faster than the wealth of people using many borrowed dollars.

### *What is the Money Supply?*

When economists refer to the *total money sup-*

*ply* what they are really talking about is the total amount of *legal tender money* that is circulating outside of the chartered banks *plus* all of the *deposits* that are held in financial institutions throughout the country. All of the money in the economy was created originally as debt. Even the government's own legal tender was originally issued as credit notes which, up until 1931, were redeemable in gold upon demand. Since then, the only thing that has been backing our currency is the public's faith in it.

When a bank issues a loan, it does not loan out the money of its depositors. It cannot tell someone coming into the bank for his money "Sorry, but we loaned your money out to one of our other customers". The bank continues to have an obligation to fulfill the requests of all its customers who ask to withdraw all or any part of their deposits. When a bank issues a new loan then, it actually creates new *promise-to-pay money* the moment it credits the account of the borrower with the amount of the loan. At that moment, the money supply increases by exactly the amount of the new loan. As the principal amount of the loan is repaid, the money supply is reduced again, in a similar fashion. For example, if a bank has two-million dollars in deposits and one-million dollars out in loans,

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then its contribution to the total money supply is three-million dollars, for it is fully obligated to provide its customers with their two-million dollars and it has already loaned another one-million dollars into circulation.

Nearly ninety-six percent of the money that we use today is not the government's legal tender but rather is the private bank's promise-to-pay instruments. The bank will give you legal tender if you want it, but it knows that most people don't want legal tender. It is unrecoverable if lost or stolen, and carrying large amounts of it could be dangerous. What people do want is a chequing account or a debit card so that they can send the bank's promise-to-pay to folks they owe money to ...folks that also don't want legal tender but do want to deposit other bank instruments as credits to their own accounts.

Up until 1994, financial institutions were *required* by law to maintain, at least, a *minimum reserve* of cash (or a combination of cash and extremely short-term securities) either in their own vaults or on deposit with the Bank of Canada (*the Bank of Canada is discussed on page 20*). These *required reserves* were a safety precaution which ensured that a bank would always have enough cash-at-hand to complete its daily transactions. The re-

serve amount was set as a percentage of deposits and each type of deposit had its own particular rate. By limiting the amount of promise-to-pay money that a financial institution could lend into circulation, reserve requirements restricted the potential interest income that a bank could earn.

For example, imagine that a person wanting a loan of \$100,000 walked into a bank that was already at its minimum reserve ratio of 10% with \$1,000,000 in reserves and \$10,000,000 in deposits. If the banker approved the new loan, opened a new account for the person, and credited the new account with \$100,000 of the bank's promise-to-pay money, then the bank would still have only \$1,000,000 in reserves but its total deposit liability would have risen to \$10,100,000 and its reserve ratio would have dropped below the legal minimum to 9.9%. If the person then withdrew the \$100,000, either in cash or by writing a cheque that would be cashed by someone who had an account with a trust company, then after the cheque cleared, the bank would have only \$900,000 in reserves, its total deposits would be back to \$10,000,000 and its reserve ratio would have dropped again, to just 9%. With minimum reserve requirements in place, the banker would be prohibited from making the new loan and if the bank's annual interest rate on loans

was 10%, then the bank would have to turn away a potential interest income of \$10,000 a year. It is easy to see why reserve requirements disappeared. Since 1994, each individual banker has been free to use his own good judgement to determine what level of reserves is appropriate for his bank.

*Fractional reserve banking*, or the practice of leveraging bank deposits in order to create new promise-to-pay money, originated in the sixteenth century. For a fee, goldsmiths would store the gold bars and coins of other people in their vaults. The certificates of deposit that they issued, being more convenient than actual bullion, soon began to be exchanged like currency. The goldsmiths, however, discovered that, since not everyone wanted to redeem their certificates at the same time, they could lend out some of their depositors' gold, or issue more certificates than they actually had gold deposits for, *and earn interest*, without ever getting caught short of gold. This clever little deception became the foundation of the "fractional reserve" system of banking.

Discussing the money supply can be very misleading unless a few additional factors are considered. The concept of a money supply only becomes useful when it is related to a specific, geographically-defined trading area. For example, the money

supply in Canada is quite a bit larger than the money supply in Kingston, Ontario, and the North American money supply is many times the size of the Canadian money supply. Also, as we have seen, there is more than one type of money. The available supply of legal tender money is quite different from the supply of promise-to-pay money. Likewise, the amount of owned money is much different than the amount of borrowed money.

Another extremely important distinction must be made between the total money supply and *the portion of it which is actually circulating or is available for circulation on extremely short notice*. What bankers refer to as *the M1* is *the portion of the total money supply which includes all currency that is circulating outside of the banks and all deposits that are held in either personal chequing or current accounts*. The M1 is sometimes called “high-powered” money because it is “liquid”, or spendable, on short notice. The M1 is the monetary driving force behind consumption, and is often used as an economic indicator to make short-term, future consumption predictions. The idea behind this is that if people weren’t planning to spend the money held in these low-interest accounts in the immediate future, then they would move their deposits into longer-term savings accounts which pay

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a higher rate of return.

There is really no way of knowing exactly how much money is circulating in the economy at any given point in time. Some of the cash which is outside of the banks could be accumulating in cookie jars and piggy banks, or under mattresses throughout the land. As well, much of the money that is parked in current and chequing accounts might be far less fluid than many economists imagine.

### *What is the Bank of Canada?*

The Bank of Canada is Canada's central bank. It is owned, on behalf of all Canadians, by the federal government. It is not a commercial bank and it does not deal directly with the public. The Bank of Canada provides banking services to the government and serves as its fiscal agent. It also provides banking services to certain domestic and foreign financial institutions and serves as a lender of last resort. The Bank of Canada oversees the expansion of money and credit in the economy and provides advice to the government, and represents its interests abroad on all financial, monetary and banking issues. It alone has the power to issue legal tender money.

The Bank of Canada was established in 1934 with the following mandate:

*“...to regulate credit and currency in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate, by its influence, fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada.”*

The Bank of Canada can lend money to the federal government, the provinces, or to any public agency whose debt is guaranteed by either level of government. As the owner of the Bank of Canada, the federal government receives, as revenue, any profits that are generated from the Bank of Canada's operations. Accordingly, *the net cost to the federal government of borrowing from its own bank, regardless of the rate of interest, is zero.*

The cost of operating the Bank of Canada is so low, relative to the revenue that it generates, that it is, by far, the most profitable enterprise in Canada. In the ten-year period from 1986 to 1995, the Bank of Canada's total revenue was just over \$21 billion, its operating expense was \$1.9 billion and its profit was \$19.1 billion. *That's a profit margin of 91%!*

*The Effects of Interest*

Interest is the primary means by which the wealthy maintain and extend their privilege and power. Financing other people's need for money is, by far, the most profitable enterprise in the economy. That is why, when the ten largest companies in Canada are ranked by the value of the assets that they control, the five big banks occupy the top five positions and eight of the top ten spots are held by financial service companies (see any year of the Globe & Mail's annual magazine on corporate Canada entitled "The Top 1000").

In a truly free and competitive marketplace, there is no room for any company to maintain a significant level of profit for any significant length of time. If a company is producing a product or service that is popular and highly profitable, its profits will attract competitors into the marketplace who will attempt to compete with it by offering a similar product or service at a lower price. Over the long term, competition will squeeze any excess profits out of the marketplace, if that marketplace is truly free, open and competitive. Legal devices such as patents, licenses and copyrights restrict the open market and grant the license holder a monopoly on a product or service for a set period of time. Exclusive contractual arrangements with key

suppliers or interlocking ownerships and directorships with key suppliers can also be established to keep competitors out of a market indefinitely. In all of these examples, an effective monopoly (or partial monopoly) is established and it is this monopoly that allows profits to be generated. In other words, the free and open marketplace must either be eliminated entirely or restricted significantly in order to sustain profits.

One of the most effective ways to restrict new entries into a marketplace, however, is to control the access to finance. In today's capital intensive world, an "economy of scale" keeps consumer prices extremely low. What this means is that in order to compete effectively today in any of the most profitable sectors of the economy, an enormous amount of money is needed to get started because the major players who control the marketplace have already invested billions of dollars to set up the high volume infrastructure that makes it possible for them to offer such low selling prices to consumers. To compete with them in price then, a new player would also need access to enormous financial resources. Those who control such resources, however, are aware that there is only so much room at the top and they already have a vested financial interest in the existing market leaders since origi-

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nally they provided them with the money necessary to take control of the market. The financiers, then, are not going to risk loaning a new competitor money if they believe that his success will cause some of their biggest existing loans or investments to go bad, particularly if one of the directors of the bank or the investment house happens to be a representative of one of the largest current players in the new competitor's target sector.

It is clearly in the best interests of the financiers to continue to back a proven winner. If a new competitor does break through the financial barriers and threatens one of their best customer's survival, the financiers know that they will be able to make even more money by financing a successful defensive strategy or takeover move by their friend and partner, the current market leader. The federal and provincial government's industry and finance ministers also are aware of just how important and destabilizing such high level economic activities could be to the health of the economy and are prepared to get involved as necessary. It is this effective monopoly, created by restricting the access to finance, which creates the opportunity for sustained profits that a truly free market is incapable of providing.

It is the very process of financing itself, how-

ever, that is the most profitable enterprise on earth. Credit makes us all employees of the financiers. All who must borrow (which is nearly everyone when a scarcity of money is deliberately maintained) must pay a portion of the fruits of their labour directly back to the financiers. Since there is virtually no cost to the financiers of creating their product (ie. electronically generated, promise-to-pay money) then it should not be surprising that their's is the most profitable enterprise on earth. True they must absorb the cost of bad loans and investments (receiving government aid if they are substantial), but does not every business person face the same risk?

Acting as the gatekeepers of the economy, the financiers have incredible control over the nature of human society. They decide which endeavors are worthy of support and which are not. Wars are perhaps one of the best investments from the point of view of the financiers. Not only is there a strong determination to succeed, which is backed by the government, but the financiers can profit both from financing the cost of the military supplies and equipment needed to stage the aggression as well as from financing the cost of the reconstruction of the affected societies once the carnage is over. Tremendous profits were generated from the two world wars which annihilated millions of unsuspecting

citizens.

Perhaps one of the greatest indications of just how important financing really is in determining the nature of a society can be seen in the case of Japan. By the end of the second world war, Japan had been nearly obliterated. Its cities had been leveled by constant bombings and its economy lay in ruins. Now Japan is a tiny island nation with far too few natural resources to sustain its own population independently. Yet despite these two facts, in less than fifty years, Japan re-established itself as one of the world's strongest economies. Japan now controls the top two of the ten largest banks in the world. How did it do it? The single largest factor was that the Japanese refused to allow the western nations to "help" finance the reconstruction of their country. Instead, Japan used its own central bank to finance its monetary needs. By doing so, Japan avoided the excessive interest burden that it clearly understood would cripple its economy forever if it borrowed too much money from abroad.

Financing costs absorb both public and private sector operating revenues and squeeze out profit margins in the productive economy, fair labour market wages, productive infrastructure investments, social programs and most other public services. In 1993, the auditor general of Canada re-

ported that of the \$423 billion in net debt accumulated from Confederation to 1992, only \$37 billion went to make up a shortfall in program spending. The remaining \$386 billion covered what it has cost to borrow that \$37 billion. In other words, in 1992, 91% of our total national debt consisted of interest charges simply applied to the 9% of it that was borrowed to provide actual goods and services to Canadians.

In a book entitled “Interest and Inflation Free Money”, Margrit Kennedy, a professor at the University of Hanover in Germany, discusses a fascinating investigation that she conducted to determine what portion of the final cost of certain government provided goods and services was due to an accumulation of interest charges. She found that even for relatively labour-intensive operations such as garbage collection, that cumulative interest costs imbedded in the price chain of inputs accounted for about 12% of the total cost of the services provided. For services in which costs were more equally distributed between labour and capital inputs, such as water and sewage treatment systems, accumulating, imbedded interest charges accounted for about 47% of the final cost to the public. For capital intensive projects such as public housing, however, the total interest expense accumulating in the

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input chain accounted for about 77% of the total cost of providing the service. It is curious, then, that it is never mentioned in the mainstream media that high interest costs are one of the leading causes of inflation.