



THE ECONOMICS OF PROSPERITY

Roads, bridges, piped water, electricity, telecommunications, these and many more constitute vital elements of a nation's infrastructure. But outweighing them all in importance is a properly functioning monetary system.

*Our present economic/financial system doesn't work.
It is open to, and frequently subjected to extreme abuse,
and fails to provide support for industry and development.
It requires some fundamental reforms
if it is to deliver the prosperity of which it is capable.*

The Formula for National Prosperity is very simple:
EVERYBODY WORKING
EVERYBODY WORKING PRODUCTIVELY.

If 5% of the working population is unemployed, 5% of productive capacity is wasted. Total production, output, purchasing power and prosperity will all be reduced by 5%. That is basic mathematics.

If everybody is working, but working inefficiently and unproductively, using old machinery with poor organization, poor allocation of resources, and enforced idleness due to lack of components or spares, then again, overall production, and thus output and potential prosperity, will be reduced.

We become prosperous, not just by working, but by working efficiently, constantly seeking ways to maximize productivity, to produce more output for the same or less input of labour.

Unemployment in itself reduces potential prosperity. It also has a depressing effect on productivity. Productivity, producing more and better goods and services tomorrow with less work than it took yesterday, inevitably involves reducing the work content thus putting people out

of work. In times of full employment this is no problem as there are always alternative jobs. But when there is permanent unemployment, employees will oppose productivity increases for fear of becoming unemployed.

Productivity creates prosperity. Opposition to productivity, is opposition to prosperity.

A prosperous nation requires full employment and continuing maximization of productivity. Full employment removes objections to labour-shedding productivity increases, and also encourages automation and more efficient use of labour.

ONE:

Our Banking System: Basics, Crisis, Reform.

THE BASICS OF BANKING

Banking is widely regarded as the world's greatest confidence trick. Does not the bank create money out of thin air with a simple stroke of the pen – or keyboard – then charge interest for its use?

The shenanigans of 2008 and onwards involving ultra high-tech gambling, bank failures, costly tax-payer bailouts and ensuing recession of historic proportions have done nothing to enhance bankers' reputation.

Yet the basic principles of banking are both sound and simple. Bankers take fixed assets (like the deeds of your house) as security and give you an equivalent in liquid assets (cash or credit, or purchasing power) in exchange for the duration of the loan. No new wealth is created. The bank simply exchanges one type of asset for another.

Banking was, and is subject to certain basic rules of conduct. The bank must at all times remain "liquid", which means that it must always hold enough cash and near-cash to satisfy the demands of depositors for withdrawals. Second, the Bank must assure itself of the true value of assets taken from borrowers in exchange for credit.

Since banks create purchasing power, either government or the central bank must regulate the total quantity of current purchasing power relative to demand and the capacity of the economy in order to control inflation.

Go back thirty or forty years and banking very much reflected these ideals. High Street banks housed themselves in imposing buildings, the interior presented a mood of seriousness and solemnity. Banking was a privilege which the customer should accept with deference and respect.

Anyone wanting a loan would be ushered into the Manager's Office where, behind the privacy of frosted glass, he or she would be subjected to a procedure much resembling a bad boy's interview with a disapproving headmaster. Personal loans would be the major business, mortgages, small business loans, home improvements, all subjected to careful scrutiny.

Purchase of stocks and shares would be a personal, private matter, individual investors making their own choices which they would finance out of income or savings. The growth of professionally managed investment funds allowed individuals to buy into a fund or mix of funds according to the fund's focus and objectives.

How, then, did a major part of the world's banking system reach a state of bankruptcy and total collapse?

THE GREAT BANKING CRISIS OF 2008

Though it is quite natural to regard a nation's banking system as a vital, if not the most essential element of its infrastructural services and facilities, banks are in fact privately owned and as such, their primary loyalty is to their shareholders. Not only must they show a handsome profit, these days performance is monitored on a quarterly basis, and market expectations are very demanding. Hence the drive is on to find ever more new and increasingly exotic ways of maximizing profits.

Standards for the calculation of "safe" mortgage commitments have slowly declined, as banks, and in the USA especially less-than-honest mortgage brokers, allowed increasingly untenable mortgages. Again going back a few years, the calculation was simple: your mortgage payment shouldn't be more than a quarter of your gross income. This was also a simple calculation because few people had revolving credit or any debt other than a car payment.

In the USA by 2007, mortgage debt to income had reached into the 40-60% levels before considering any other debt and living expenses. The "safe" mortgage in the USA passed the affordability curve long before sub-prime became an issue. Factor-in non-mortgage debt – for cars, domestic appliances and credit cards – and simply put: people were carrying much higher consumer debt loads than ever before, and devoting a larger share of their income to servicing that debt than ever before, all with the active encouragement of the banking and finance sector. In Britain, the situation was no better. In 1999 British households were already the fourth most indebted among the G7 economies. By 2002 Britain had taken the lead, with a debt burden equivalent to almost double disposable income, the money you have to spend after essentials are covered.

Another "old tradition" of mortgages was that the bank would lend up to 80% of the assessed value of the property, the applicant having to raise the rest. But Northern Rock – the small bank with the big impact – found that too limiting for its customers. Northern Rock is a relatively small British bank. Yet its spectacularly imprudent mortgage strategy caused the first run on a British bank in more than a century.

Northern Rock's first mistake was its willingness to relax normal lending criteria. It granted mortgages at six times the applicant's income, and lent up to 125% of the value of a property, despite already inflated property values.

Secondly, it depended on borrowing money short-term in the interbank market and lending it long-term as mortgage finance. The bank's dependence on the wholesale market - around 70 per cent of its funding came from this source - was a catastrophe waiting to happen. It was a fundamentally irresponsible strategy, which presumed an unending rise in property prices, perhaps punctuated at worst by brief 'corrective' falls of up to 5%. But the UK property market was already grossly inflated, and the collapse of the sub prime mortgage market in the US led to a cascade of bad debts through the banking system. Interbank lending froze, making it virtually impossible for Northern Rock to raise fresh funds as its loans fell due.

On 14 September 2007, the Bank sought and received a liquidity support facility from the Bank of England. 22 February 2008, the Treasury was forced to rescue and then nationalise the bank to protect the wider financial system.

And that was just the start.

Property mortgages were not the only cause of economic troubles. Credit Card departments of banking institutions advertise actively for business – “no credit checks, instant acceptance guaranteed”. Why such rash promises? Surely there will be defaults. Yes of course there will be. But there will also be the “poor but honest” who maximize their card debt then have to pay interest at an annual 19% plus. Encouraged by multiple credit cards, consumers committed their incomes weeks, months even years ahead – always assuming of course that their jobs and incomes would outlive their commitments. When downturn and redundancies struck, the incomes dried up, but the debts lived on. While governments desperately tried to restart their economies by encouraging consumers to “spend, spend, spend”, ordinary folk apparently knew better, devoting what money they had to running down their debts.

In the pursuance of profits, major banks take substantial risks in financial speculation on a huge scale, or at local level, in unproductive ventures operated by relatives or thinly disguised associated companies. The history of banking provides numerous references to major banking scandals where banks have made substantial loans to dubious real estate companies, or, more recently, where banks have played the foreign currency markets using complex high-risk gearing techniques. The situation remains unchanged, and a new major banking scandal can break at any time. The complete collapse in 2008 of major banking, investment and insurance institutions, though the worst to date, is only following a long-established tradition of profit-seeking risk.

Traditional banking practice is founded on “reserves”, with loans based on and securities by those reserves. But experiences in 2008 have proved conclusively that banks’ “assets” as security for their high-stakes gambling have been woefully inadequate. Reserves are in effect insurance, insurance against bad loans. But as any insurance assessor knows, insurance must be weighed against risk, and bankers’ gambles and their investment “devices” have become so complex that risk is almost impossible to estimate.

In the autumn 2008 global financial storm, UBS, Switzerland’s biggest bank, got itself into serious trouble. Not only was the bank gambling wildly, it also grossly underestimated the risks it was taking. Before the beginning of the crisis, UBS calculated its credit risk at SFr 800 million. In the event it had to write down SFr 40 *billion* – that’s 50 times more. The government had to step in and save the bank by putting in \$5.3 billion to take a 9.3 percent ownership in the bank. The “reserve of last resort”, it turns out, is the unfortunate taxpayer.

The Great New Idea of twenty-first-century banks was known as “originate and distribute.” The notion was that by packaging loans into securities that were sold to investors all over the world, the banks wouldn't get stuck if loans went bad.

Citigroup had pioneered entities called “structured investment vehicles,” or SIVs. In essence, mortgage loans were sliced into pieces, with some sold and others kept in these stand-alone units. The SIVs borrowed money by selling short-term IOUs on the market, making them vulnerable to a change in investor appetite for short-term lending. And SIV loans frequently were not shown on the banks' books.

Off-balance sheet financing is any form of funding that avoids placing owners' equity, liabilities or assets on a firm's balance sheet. This is generally accomplished by placing those items on some other entity's balance sheet.

A standard approach is to form a special purpose vehicle (SPV) and place assets and liabilities on its balance sheet. Also called a special purpose entity (SPE), an SPV is a firm or legal entity established to perform some narrowly-defined or temporary purpose. The sponsoring firm accomplishes that purpose without having to carry any of the associated assets or liabilities on its own balance sheet. The purpose is achieved "off-balance sheet."

Off-balance sheet financing is attractive from a risk management standpoint. When assets and liabilities are moved from one balance sheet to another, the risks associated with those assets and liabilities go with them. For example, if a firm transfers credit risky assets to an SPV, the credit risk goes with those assets, and therefore does not need to be “covered” by insurance capital.

A bank has to set aside capital – a cushion to absorb losses – for every loan it makes and every bond it buys. By parking the loans and securities in SIVs off the banks' balance sheets, Citibank and other banks that used SIVs didn't have to set aside capital to absorb any losses. That made the potential profits far greater than if the loans had been on the banks' books. But it also meant there was no capital cushion to absorb losses if the banks ended up taking back the losses, either because they had legal promises to the SIVs or felt maintaining reputations required them to bail out the SIVs.

In 2006, Citibank's off-balance sheet assets amounted to \$2.1 trillion; its on-balance sheet assets were \$1.8 trillion. Not only were these enormous loans hidden, but several top Fed staffers confessed later that they hadn't even heard the term “SIV” until the end of July. Neither had some senior Fed officials – even though they were charged with being guardians of the financial system. In fact, that was typical. An astounding array of derivative products had exploded across the marketplace over the preceding few years. Even market sophisticates faced a steep learning curve to keep up with what was happening, and that included Citigroup's own chief executive, Chuck Prince, who famously dismissed worries that his bank and others were counting unwisely on cheap and plentiful credit to make ever bigger and riskier loans.

“When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing,” he told the Financial Times in early July 2007.

In fact, Citiroup, in common to a greater or lesser extent with other banks, had little or no choice. A banker who didn't dance, who didn't make ever more risky loans, would find his bank's market share falling and near-term profits less impressive than his competitors'. Then the music stopped and the drama – or melodrama – took over.

And yet what might be considered honest miscalculation, however dire its results, was not to be the end of the 2008 and on-going financial disaster.

The global financial crisis, it subsequently became clear, was caused not just by the bankers' colossal mismanagement; it was due also to the new financial complexity, offering up the opportunity for widespread, systemic fraud. That the world's most famous investment bank, Goldman Sachs, was subject to civil charges for fraud brought by the American regulator was only one of a series of investigations into financial institutions around the world. A court-appointed examiner found that collapsed investment bank Lehman knowingly manipulated its balance sheet to make it look stronger than it was. In Iceland a dossier assembled by its parliament on the Icelandic banks – huge lenders in Britain – was handed to its public prosecution service.

Beneath the complexity, the charges are all rooted in the same phenomenon – deception. Somebody, somewhere, was knowingly fooled by banks and bankers – sometimes governments over tax, sometimes regulators and investors over the probity of balance sheets and profits and sometimes, as the Securities and Exchange Commission (SEC) says in Goldman's case, by creating a scheme to enrich one favoured investor at the expense of others – including, via Royal Bank of Scotland, the British taxpayer. Along the way there is a long list of so-called “entrepreneurs” and “innovators” who were offered loans that should never have been made.

Simply stated, the banks got in trouble because they gambled wildly, irresponsibly, and now it would appear, dishonestly with the resources at their disposal, bringing near-bankruptcy upon themselves, debts upon taxpayers, and serious recession upon the western economies.

Q: Are bankers Conservative or Socialist? A: Yes.

When they're on a winning streak taking in profits on bets the complexity of which few but the young whiz kids understand, when star traders and executives are taking home bonuses in the millions, the bankers are True Blue Conservative – and “Hands Off Private Enterprise!”

But when the bets turn sour and phenomenal winnings turn into ruinous debts, suddenly they're Socialists, standing in the lineup, their top hats held out for government welfare – and welfare on a scale which dwarfs unemployment benefits for ordinary out-of-work folks. And so the government steps in with a rescue package. For the banks, it's a win-win situation.

Yet while traditional economists make dark threats about the dangers of governments running the banking system, the reality is that a nation's banking and monetary system is a vital, indeed the most important element of its infrastructure, and furthermore, when it's threatened, government is the banker of last resort.

There is thus ample justification, if not an urgent necessity, for a fundamental review of our banking and finance system, what we require from it and how best our needs for trade, and investment in commerce, industry and infrastructure can be supplied efficiently and cost-effectively.

BANKING REFORM

The Big Crash starting 2008 brought with it a widespread awareness of the extent to which banks have bent over backwards to invent ever more complex gambling devices without apparently any thought that gamblers might one day lose their (or our) shirts, awareness, too, of their gross misuse of resources at their disposal and scant regard for their status as guardians of the nation's monetary system. The complexity of the risks they were increasingly taking and their subsequent downfall is the major element in our current financial troubles.

Solutions have been proposed. In 2009 the hot topic was the separation of banking functions. Ruth Sutherland summarized the idea in The Observer's Business & Media section dated 22.03.09:

“It doesn't take the biggest brain on the planet to divine that casinos and savings banks are very different beasts. That is why there is a growing clamour from luminaries including Bank of England governor Mervyn King and former Chancellor Nigel Lawson to look at introducing Glass-Steagall type rules. Glass-Steagall was the 1930s regulation in the US that separated banks' function as utilities from their gambling activities; it came out of their belief that banks' speculation on the stock markets with their savers' money helped cause the crash of 1929 and the Great Depression. Its repeal in 1999 by the Clinton administration was driven by powerful banking interests, a textbook case of politicians bowing to the finance industry, which had conducted a \$300m lobbying assault.”

Banks' gambling activities would then be conducted as separate, ring-fenced entities, selling properly described and monitored investment funds into which purchasers would invest knowing the precise activities undertaken and relevant risk/reward ratios. Indeed, Britain's Investment Fund industry is already highly regulated and responsibly marketed. The problem arises when complex risks and speculation are undertaken clandestinely, masquerading as simple deposit-taking banking.

Certainly there is ample justification for much tighter regulation. The nation's monetary and banking system is the most systemically vital of all its infrastructural services and facilities, and as such requires optimal safeguarding against any form of abuse. Additionally, government being the banker of last resort, is fully entitled to ensure that banking operations should never again impose upon government finances to the extent where even governments are pushed to the point of near-bankruptcy.

The separation of banking functions coupled with much tighter regulation are obvious remedies against future banking collapse, as is an overall limit on personal credit-card debt and tighter mortgage regulation.

EVERYBODY WORKING EVERYBODY WORKING PRODUCTIVELY:

Clearly, a dysfunctional banking system which plunges an entire nation into recession and unemployment will not contribute to either of these objectives.

However the reform and increased control of the existing banking system is not sufficient, for it lacks the capacity to generate growth: growth out of recession, growth in job-creation, growth of new industries, and growth in productivity through longterm investment in industry and infrastructure.

Everybody working, everybody working efficiently, productively. That's the key to productivity and prosperity. And a key element in facilitating this process is secure, longterm finance for industrial and commercial investment. This in turn requires a new element in banking, a new facility: Development Banking.

TWO: Development Banking: Concept, History, Infrastructure.

THE CONCEPT – PROJECT SECURITIZATION

Traditional banking practice requires pre-existing assets as security, and loans carry no long-term commitment.

Development Banking avoids these two limitations of traditional banking by securing the loan the industrial or commercial project itself thoroughly researched and costed, rather than on outside assets alone, and by making a long-term commitment based on an intimate involvement with the business or project in which it is invested. Involvement in the business ensures longterm commitment.

This facilitates the creation of new business and new jobs, as well as providing secure finance with which existing business can maximize its quality and productivity. Local infrastructure can also be financed. By setting up Development Banks to operate at regional level, focusing on regional and local needs, the benefits can be spread widely and uniformly, avoiding the usual pockets of non- or under-development.

The Development Banks would be formed to create new business and new wealth where none previously existed, not (in the words of comedian Bob Hope) “to lend money to people who can prove they don’t need it”. The availability of investment credit has enormous potential for growth, and the Development Banks should actively be seeking to maximize the productive use of this resource.

The major distinguishing feature of the Regional Development Bank (RDB) concept is that *a total project, from design through production and management to sales, becomes the loan collateral*, rather than the personal assets of individuals.

RDBs would be authorized to create loans based on project collateral, not required to maintain “reserves” in the current banking sense. In the current banking tradition, a bank’s reserves are instituted as, and traditionally regarded as an insurance against losses, but in practice insurance is no better than the risks it insures. Experience in 2008-9 has shown bank assets woefully inadequate to cover bad investments and gambling risks.

The RDBs would rely for their security on thorough research of loan projects in which they are invested, on a close working and constructive partnership with the loan recipient, and a detailed follow-up of results.

Loans would be made to encourage and develop new startup enterprises large and small, to secure, expand and improve existing enterprises, and for major regional infrastructure projects, the latter in conjunction with local authorities and national planning.

In each and every case, the granting of a loan is preceded by a thorough and complete business plan providing full working detail, proposed use of the loan funds, and precise projections of sales, income and expenditure as appropriate for each project, as well as anticipated repayment schedule.

The RDB would maintain a register of specialist firms, contractors, business advisors etc who can be called upon to verify loan clients’ cost estimates and provide setup advice in forms varying from design of factory premises to promotion and accounting. Skilled commercial, architectural and technical advice would be available, either to assist existing enterprises or to promote new ones.

Once launched, the new enterprise manages itself but the Bank receives a flow of data – production, sales, profits and so on – from which the new enterprise’s progress can be monitored and compared with projections. If anything begins to go wrong, the Bank can give timely help, with advice or further finance if appropriate. *An investment loan is best securitized by ensuring the success of the project in which it is invested.*

The partnership concept also assumes longterm commitment, resulting in the encouragement of secure long-range planning and productivity investment, research, and development of new-generation products and services.

In the case of larger businesses, the investing bank may well appoint a Director to the Board, as has been the practice in Germany. Careful monitoring will be to the advantage both of the investing bank and the recipient business, as well as to the regional economy: bankruptcy is not contributive to economic stability and prosperity.

With a guarantee of adequate long-term finance, the recipient business would be properly set up, equipped and maintained, able to maximize quality and productivity. Indeed the provision of finance for any business or project would be conditional upon the rigorous application of all relevant quality standards pertaining to product design and every aspect of the production process.

Eschewing establishment as private companies with the constant pressure to maximize profits – if necessary through risk and adventurism, the RDBs should be set up as not-for-profit concerns, possibly using the format of a Community Interest Company (CIC) as introduced by the United Kingdom government in 2005, or a newly created format tailor-made.

Regional Development Banks would set their own charges based on administrative costs and loan insurance. There is of course an element of risk in any investment. The more useful approach however, is to minimize risk through proper pre-investment research and positive on-going monitoring of physical production, sales, and accounting – precisely the measures which a banking-industry partnership system is able to undertake.

The banking-industry partnership would therefore be in a position to offer investment at a constant, and relatively low cost, possibly 2-3%, backed by the on-going monitoring of the recipient business ensuring safeguards for the investing bank, the recipient business and all those involved with and dependent on it.

The RDB could also provide investment finance for regional infrastructure, such loans to be repaid by the relevant local or regional government departments from their own revenues. Thus the RDB would prove a powerful catalyst at regional level, providing finance and subsequent ongoing supervision for business and industrial development, together with investment capital for regional infrastructure.

RDBs could also be called upon to finance micro-industries in villages, small loans to open a tea-room, to provide baking facilities in the village hall, or set up a small market garden. The RDBs should be able to focus on any and all opportunities, large and small, to provide investment which will create local employment.

Individual homes could benefit too from loans to install double-glazing or roof insulation, work which itself provides further employment. Such loans would qualify as investments, being repayable from savings derived by the borrower through lower energy bills.

Regional Development Banking provides genuine, repayable investment loans, avoiding the need for deficit-increasing grants.

DEVELOPMENT BANKING HISTORY

The Development Banking concept introduces a new form of security: the project in which the investment is made.

Although Project-Based Securitization represents a major departure from the traditional Asset-Based Securitization, the concept is not new. Founded some 60 years ago, the now highly successful Mondragon cooperative group in Basque Spain illustrates this ongoing relationship between investment banking and recipient business. The *Workers' Bank* serves three mutually inter-dependent functions: it provides investment as a local development bank, offers technical and financial advice for business startup, then monitors production, quality, and financial performance in a process of ongoing cooperation and partnership.

The ongoing partnership concept also assumes longterm commitment, ensuring finance for secure long-range planning and productivity investment, as well as research and development into new-generation products and services, ideally in conjunction with apprenticeships and higher education.

In Bangladesh the Grameen Bank (GB) has reversed conventional banking practice by removing the need for collateral and has created a banking system based on mutual trust, accountability, participation and creativity. GB provides credit to the poorest of the poor in rural Bangladesh, without any collateral, and has succeeded in improving the lot and the prospects of thousands of the very poor.

At GB, credit is seen as a cost effective weapon to fight poverty and it serves as a catalyst in the overall development of socio-economic conditions of the poor who have been kept outside the banking orbit on the grounds that they are poor and hence not bankable. Professor Muhammad Yunus, GB's founder and Managing Director, reasoned that if financial resources can be made available to the poor people on terms and conditions that are appropriate and reasonable, "these millions of small people with their millions of small pursuits can add up to create the biggest development wonder." Grameen Bank's positive impact on its poor and formerly poor borrowers has been documented in many independent studies.

The concept of loans based on, and secured by the project itself backed by continuing monitoring is basic, and simple. It can create jobs, economic expansion and productivity anywhere.

In Germany, the Regional Banks, or Landesbanken have traditionally provided low-interest loans to local firms, both as startup capital and as on-going investment. In fact, the regional, industry-sponsoring character of the Landesbanken goes back to their somewhat extraordinary origins.

In 1818 the Swedish government stunned Europe by offering 160,000 Taler to the German province of Westphalia as reparation for the damages incurred when Swedish and Dutch soldiers marched through the province during the Napoleonic Wars. This money was decreed the property of all Westphalia by its President, Freiherr von Vincke, and through the Westphalian Hilfskasse, or "Assistance Bank" established for the purpose, the funds were used to develop the region's economy and pay for public-works projects, but some formal policies were needed to distribute the money. The bank played a pivotal role in developing the region's economic potential throughout the 19th century.

Frederick William IV, king of Prussia, impressed by the advantages which the *hilfskasse* offered Westphalia, ordered that a similar bank be created in the Rhineland in 1847. Its government founded the Provinzial-Hilfskasse of the Rhineland in 1854.

Both banks became Landesbanken before the end of 19th century, which greatly increased their range of services, since *hilfskasse* banks had more restricted charters. Their new names were Landesbank für Westfalen Girozentrale, and Rheinsche Girozentrale und Provinzialbank, Düsseldorf. The two banks were instrumental in making the Rhine-Westphalia region one of the biggest and most productive industrial areas in Europe.

In the post-WW2 years, the Landesbanken played a major role in the creation of Germany's "Economic Miracle", in particular through the provision of on-going credit to the German "Mittelstand" (small and medium-sized companies) in their respective regions, now one of the enduring backbones of the German economy.

REGIONAL INFRASTRUCTURE

Regional Development Banks would be fully equipped to identify and invest in local infrastructure and industry, investing to provide major infrastructure secured by future income, for example from an uplift in business rates.

Applying the model to four live case studies from the cities, a report by accountants PriceWaterhouseCooper has demonstrated that by using this approach, increases of between 50%

and 80% can be achieved in housing, jobs and economic output. Note the significant factor here is that we are looking at investments, not deficit-increasing grants.

The potential benefits for many kinds of infrastructure, including transport, are considerable. The combination of largely autonomous Regions established across the country each with its own Regional Development Bank empowered to make loans for industrial and infrastructural needs can provide the means with which we can invest in new businesses, jobs, and productivity-enhancing improvements in existing industry and infrastructure.

Regional Housing Corporations

A major element in the economic and financial disaster of 2008-9 has been the phenomenal rise and catastrophic fall in house prices. Banks and mortgage brokers found ways to make unaffordable mortgages (supposedly) affordable, young first-time buyers were lured into the market, demand increased, values went up, speculators jumped in buying second and third “investment” properties, and so the balloon went up, in more ways than one.

A decent home in decent surroundings is one of the foundations of a civilized society no less important than education and healthcare, and we need a core of affordable, at-cost rental, rent-to-own or leasehold accommodation which will serve first-time buyers, and can act as an “anchor”, a realistic cost foundation which can effectively limit the free property market from excessive inflation and over-evaluation.

Regional Development Banks, through Regional Housing Corporations, can provide low-cost financing for new housing, for rental or lease “at-cost”.

The Housing Corporations should acquire “grey” ex-industrial, or unused agricultural land at its current price, rather than an inflated “with planning permission” price. When owners of land currently valued at agricultural rates sell at a huge, planning-generated profit to developers, the houses they build are already on the way to becoming unaffordable. The object should be the construction of quality, environmentally attractive cluster housing, yet built using techniques of fast-track mass-production. Availability of at-cost housing would make it possible once again for young families to afford that most basic of all needs: a decent home in pleasant surroundings.

In terms of the overall housing market, the availability of at-cost housing would act as a brake on price-acceleration in the open market. A key foundation element of a civilized life must surely include a quality, affordable home in pleasant surroundings within convenient reach of recreational opportunities and commercial facilities. A degree of stabilization in the housing market is essential if this aim is to be fulfilled.

In the general hoopla and jubilation over rising property prices, it is rarely if ever observed that rising property prices and rental costs in urban centres are economically regressive, a fact which classical economists decline to recognize. Prosperity is created by productivity, by increasing value without increasing cost. Rising land prices do just the opposite: they increase the cost of land without increasing its inherent value. And this has a similarly inflationary effect on the services using land, which become more expensive not because they are offering increased value but simply because rents are going up. “Value” in the sense of what buyers get for their money, decreases as land prices increase. This is particularly evident in major cities.

There is little or nothing in the way of goods and services which is not affected by the price of land; rising real estate prices in towns and cities affect everything from offices to retail shops, cafés, and places of entertainment. The escalation of land prices is a major contributor to the high cost of urban living. It can also cause a deterioration in urban quality of life; many of Europe’s old established city cafés which have for centuries been centres for meeting and socializing are now being forced to close as a direct result of escalating rents. Likewise the demise of urban

centres in the USA came about when steadily increasing rents finally reached the point where businesses could no longer afford them and moved out instead to cheaper green field sites thus creating new suburbs.

If the city or town centre is to retain or regain and develop its function as a gathering place, it will be necessary to ensure that newly developed areas in city centres, particularly areas reclaimed from public or industrial use, should be subject to price stability so that rents are economic for those low-profit uses such as public markets and cafés which, while lacking high profit potential, provide vitality and enjoyment for the community.

This could be accomplished, for example, by vesting tenure in the hands of a locally administered Urban Trust, which would then ensure maintenance and management of the facility. Regional Development Banks can provide finance to equip public markets, the kind which exist in almost every French town and provide facilities for the exchange of locally made produce, thus in turn creating opportunities for cottage industries and rural market gardening, again financed through the RDB.

Development Banking can spread growth across the regions, creating jobs and providing the wherewithal for existing companies to increase their competitiveness. And the benefits will stretch into the future, as a thriving, broadly based economy sends a positive signal to young people if they can see a challenging, well-paid job as the sure reward of education.

BACK TO BANKING

A nation's banking system is a vital – *the most* vital part of its infrastructure. Yet we dispose of sewage more efficiently.

The first and essential reform must be the complete separation of Investment, from Utility Banking.

“Investment Banking”, involving excessive reliance on one sector such as property, and the more complex investment exotica, should be clearly separate, while “Utility Banking” provides a safe home for everyday banking needs. Credit Unions offer a not-for-profit solution with the benefits of customer-oriented banking, a concept which could usefully be expanded and given wider publicity.

But for the longterm investment needs of trade and industry, large and small, we need a new element, a new weapon: investment banking serving and supporting its clients through a longterm commitment to, and secured by, the business itself. This can best be done on a regional basis. Autonomous regions each based around a core city, each with its own development bank, can maximize their own resources and functionality, each making its own individual contribution to a productive and prospering nation.

Once again – the Formula for National Prosperity is very simple:

EVERYBODY WORKING
EVERYBODY WORKING PRODUCTIVELY.

Development Banking can provide the catalyst to increase both employment and productivity.

But there are hidden barriers along the road to the ultimate objective of Everybody Working, Everybody working productively – barriers which within our present concept of money and value cannot be overcome.

In other words, we can increase, **but never maximize** either employment or productivity.

THREE: Inflation: Anatomy, Stability, Deflation.

THE ANATOMY OF INFLATION

The ability to channel investment into areas of un- or under-employment offers the potential to expand the productive capacity of the economy to its maximum potential, that is to say, full employment.

Full employment has a number of advantages. A job is fundamental to life itself. Without a job little else can be achieved. Without a foot on the ladder, there is no hope of mounting. Unemployment also puts demands on those who do have jobs, since they must pay taxes to finance welfare benefits for the unemployed. At the national level, unemployment represents a waste of productive potential. It is an immediate waste in that 5% unemployment is a 5% reduction in potential production. And it discourages labour-shedding productivity improvements, since those with jobs are afraid of losing them.

Several years ago, when the London Underground system decided to replace ticket sellers and collectors with automated ticketing and barriers, Trades Unions opposed and blocked this labour-saving move for several years, fearing unemployment of their members. At the same time, the tramway administration in Zurich, Switzerland, decided to replace conductors with automatic ticket machines. The changeover took place smoothly as planned with no opposition. On the last day of conductor operation, there were tables set up outside the tram depot by firms seeking employees. Switzerland at that time enjoyed not only full employment, but a shortage of labour.

Some economists have suggested that a degree of unemployment is essential, since a tight labour market can hold back economic development; on the contrary, employers and managers at a Japanese labour conference in 1991, when the Japanese economy was still buoyant, were unanimous that the shortage of labour at that time had forced them into increased labour-saving productivity and automation.

A substantial degree of hardcore unemployment, on the other hand, causes employees to oppose labour-shedding productivity improvements for fear of losing their jobs and being unable to find alternative employment. This is much worse than it sounds. Prosperity is created and increased through advances in productivity, making better goods tomorrow with less labour than today. When workers in an economy oppose productivity, they are opposing prosperity.

Despite the clear disadvantages of unemployment, and the desirability of full productive use of all economic resources, the ability to expand an economy to full capacity cannot presently be realized, for as the economy expands to near-full employment, the danger of inflation causes the Central Bank to put the brakes on.

The problem is that our money has no defined value. Back in the simple craft market, all participants had a fair idea of what each product cost in terms of labour, skill and materials. But who today would know the constituent cost of a jacket or a kitchen mixer, a computer or high definition television set?

The result is that we're back to haggling, but on a national scale. We haggle over wages and prices. Money only has real meaning in terms of what you earn (wages), and what you can buy with what you earn (prices). But both wages and prices are open to continuing dispute and lack any form of definition or stability. None of our national currencies has any stable, clearly defined value, and all are subject to greed-motivated upward movement known as inflation. This in turn

prevents economic expansion to full employment, sentencing the world's economies to the waste and human distress of substantial and permanent unemployment.

And the existence of inflation as a permanent feature of every world currency is a denial of one of the basic purposes of money known to every first-year economics student from the first day: money should act as a store of value. Yet a currency which loses – at the very best – 3% of its value every year is not much use as store of value. It's about as practical as storing water in a bucket with a hole in it.

Inflation is not the complex esoteric phenomenon economists would have us believe. It is simply a matter of human greed – our natural desire to get more reward for the same work. Inflation is an increase in price without a corresponding increase in value. If the price goes up for a better product that costs more to make, that is not inflation. But if a producer asks more tomorrow for the same product he sold for less yesterday, that is inflation.

Similarly with wages. More money for more or harder work is not inflation. Inflation is more money for doing exactly the same work.

In today's economies, the level of economic activity directly affects inflation.

When the economy is sluggish, producers and retailers find difficulty in moving their goods; they respond by introducing price reductions, incentives and special offers. But as the economy expands and consumer demand expands, prices can be increased without damaging sales.

Similarly with wages. Employees are naturally reluctant to demand more money, or threaten strike action, in a time of high unemployment with a lineup of job applicants outside the door. But when the economy approaches near-full employment and staff are hard to find, now's the time to demand that raise you've been wanting!

The price of goods and services on the market increases to match or exceed the value of credit available for their purchase. This is the dominant feature of a free market economy, and balancing the two highly desirable but conflicting goals of full employment and zero inflation or stable money is the key to national economic management today.

The economy is slack and inflation is low. So the Government and/or the Central Bank expands the economy by lowering interest rates. But when near-capacity is reached in the more prosperous regions, inflation begins to rise, and the Central Bank attempts to control inflation by slowing down the economy with increased interest rates, thereby maintaining a level of permanent unemployment. Full employment and full productive use of resources in a free-market economy is an economic and financial impossibility. Thus getting a job becomes a game of musical chairs. For every hundred job-seekers, there are only at best ninety-five jobs. Similarly producers will be competing to sell their goods to a market which has insufficient credit to purchase them.

Recession or inflation? Our economic managers have two choices. Expand the economy to full employment and we get inflation. Or reduce inflation, by slowing down economic activity, creating unemployment and recession. The art of economic management as currently practiced lies in attempting to compromise between the two.

Apart from fiscal dishonesty and irresponsibility (printing money to gold-plate the presidential palace), inflation is not a monetary, but a social factor. In hard times people behave themselves. But when things get easier, producers put prices up for the same product or service, and employees demand more money for the same amount of work.

That is not an economic factor, to be explained with complex formulas and obscure economic jargon. It's simple human nature. Or to put it a little more plainly, it's simple human greed.

The underlying economic factor which makes this situation possible is that pay and prices are settled by a form of disputation. The price is as much as the producer can get, or as little as the consumer is willing to pay. Similarly, the wage is as much as the employee can get, or as little as the employer can get away with.

This process is commonly known as *free collective bargaining*. But it is inherently unstable and subject to continuous upward pressure fuelled by the simple human desire for more. While the desire for more wealth and prosperity both personally and nationally is a very reasonable one, an economy and its participants should seek to increase their personal and collective prosperity by becoming more productive, not by demanding more money for the same work or the same product.

The process of establishing pay, profits and prices by disputation results in friction, industrial disputes, loss of productivity, inflation, and permanent under-employment. It represents a facet of anarchy, in that it is a process of settling differences by unregulated dispute rather than by a system of debated and agreed guidelines and regulation.

STABILIZING VALUE

Free Collective Bargaining on the wage, or pay side combined with totally unregulated market pricing is the key factor which prevents expansion to full employment. What, if any, are the alternative options?

A potential solution to this problem already exists, and needs only to be applied on a standardized national scale in order to bring stability – and justice, that essential pre-condition of stability – to the economy.

For many years, a number of government agencies and corporations large and small, have been using a system of *job evaluation* to evaluate the work each employee contributes. Each job is analyzed, and its essential characteristics and demands, such as training, responsibility, working conditions and physical/mental effort involved, are measured on a series of common scales. The job "value" is then directly related to remuneration. In this way, pay is fair, both in relation to the work done, and in relation to the pay and the work of others.

Currently there are several such systems in use, well tried and working successfully. It would not be difficult to analyze and compare their different features in order to establish a single standard. This would become in effect a national standard of value for measuring the work element contained in a product or service, so that pay becomes a true reflection of the work required of a job. Society already measures apples and gasoline; it could hardly get along otherwise. Yet of all the things traded every day, work is the most important, and work is the one commodity we do not measure.

A national standard would provide a point of reference, of justice indeed. Everyone would know how much they should get for the work they do, without hassle or argument or strike.

Labour evaluation can ensure remuneration stabilization. This process can be carried through to price stabilization.

A factory's, or a business's total costs consist of three elements. First, the cost of bought-in raw materials and components; second, the direct labour added in the factory; and third, the costs of capital write-off, overheads and finance.

These are the costs of making a product, of supplying a service. From these costs a Unit Production Cost can be calculated for each product or service supplied. If this Unit Production Cost then becomes the Selling Price, there would be a direct and fair relationship between cost and price, and therefore between pay and purchasing power.

But the Unit Production Cost is not normally equated with the Selling Price. The difference between the two is commonly referred to as the net profit. How is the net profit currently disposed of?

The prior destination for profits has traditionally been the investors, or shareholders. But today this is changing, reflecting in turn a new perception of the need to create a greater sense of teamwork.

Investment is vital, as also is the equipment it provides; but the machine is no longer the exclusive source of productivity and indeed its operation can be rendered useless without the intelligent participation of the workforce. The reality today, becoming ever more widely recognized, is that the people who work in an enterprise are equally vital: their inventiveness, their enterprise and initiative, their attention to the job in hand, their commitment to quality, their extra thought and effort... these are the factors which if encouraged and harnessed can turn investment into productivity and prosperity, and which can turn a company's fortunes. Thus an annual workforce bonus reflecting performance of the company may also be included.

Apart from investor dividends and employee bonuses, the other major destination for the disposal of company profit is re-investment, either in research and equipment or increased working capital. The advantage is that in-house or self-generated investment comes without future servicing cost or commitment to repay.

There is one more claimant to a share in the profits, and that is the customer. Profits have to come from somewhere – or someone. In fact it is the customer who pays the price and generates the profit; with this view a further claim on profits would come from the consumer, demanding lower prices.

The stabilization of prices would require the establishment of public policy for profit distribution. This could take the practical form, first, of an overall profit ceiling.

Of the profit made, broad percentage bands could be established and gradually stabilized, distributing profit according to a pre-set formula as between co-workers at all levels, investors, and the internal needs of capital for reserves and re-investment.

As they do today, government revenue departments would continue to require that companies prepare in timely fashion properly audited annual accounts. Company profits would be examined in order to ensure that they are apportioned according to a consensus formula which respects the claims and contributions of consumers, investors, co-workers, and the future security of the business itself.

It should be noted that price stabilization effected in this way, through annual account regulation, would permit the same degree of latitude in pricing "deals" and special offers. But the profit ceiling would ensure an ultimate price stability.

Pay and price evaluation and stabilization would provide guidelines ensuring fair exchange between employer and employee, as well as between producer and consumer, without the need to argue or strike. More importantly, stable pay and prices would permit economic expansion to full employment without inflation.

Guidelines for remuneration/pay evaluation coupled with profit limitations would replace dispute with rules, and would move to stabilize pay and prices even in times of economic expansion. In such circumstances it would be possible to expand the economy steadily to full employment and hold it there indefinitely without fear of inflation. The results would be seen in full employment, monetary stability, and a high level of productive efficiency and thus prosperity.

“A fair day’s pay for a fair day’s work” – a fine-sounding slogan but hardly a reality today. The vast majority of working people slog away in factories and offices for the best part of their lives with nothing but a meager pension at the end of it – and even that may be in doubt. At the other end of the scale, the “fat cats” walk away with millions for having done little but presiding over a company’s decline. While this is causing growing, and justifiable resentment, the problem is very much deeper and more fundamental.

One major element of public contention during the crisis of 2008 was the fact that CEOs and executives who had presided over the near ruination of their banks and major finance houses were walking away with golden handshakes in the millions. Is that fair, people were asking? But how can one answer that, when we have no concept of relating pay to anything, and our monetary unit – if anyone bothers to think about it – has no concrete definition.

Our monetary unit has no basis, no defined value. Powered by the fundamental human desire for more, it tends to float gently upwards, and can be controlled only by recession and unemployment, which in turn creates opposition to productivity and thus to prosperity.

Many economists and observers have long been aware that money has no defined value. A response has been the suggestion of returning to commodity-based money, like gold or silver. But the limitations of such rigid restrictions have already been experienced. Credit needs to be available, and to expand, in direct relation to the economic activity it has to support, lubricate and finance.

In any case, precious metals themselves fluctuate in value, if for example a major new source of gold is discovered, its “value” relative to other commodities will necessarily fall.

But in the search for monetary stability and “something solid” on which to base it, we have constantly overlooked the most basic commodity of all: human labour. Everything comes back to labour. It’s the only thing we’re trading. The price of gold is ultimately defined in terms of labour: the amount of labour involved in exploration, location, mining and processing.

Labour is the one single commodity on which all else is based, in terms of which all else is measured and defined. It is the ultimate commodity on which to base our monetary unit.

Apart from irresponsible banking practices, many of our ongoing financial and economic troubles arise out of our monetary unit’s basic lack of definition. From this we get not just an underlying instability, but in practical terms, the need for a permanent degree of unemployment which in turn discourages productivity through fears of job losses. And it cannot be said often enough: prosperity is created through productivity, and opposition to productivity is opposition to prosperity itself.

Social Security in its widest possible sense is the goal of every well-governed society, and the only true "Social Security" is full employment, that utopian condition in which there is a rewarding job for everyone who wants one, with the guarantee of a fair day’s pay for a fair day’s work.

DEFLATION

The longterm effect of productivity maximization combined with a labour-based monetary system is negative inflation. This becomes a completely normal, natural process. As productivity increases, the labour-content decreases, and it becomes possible for goods and services to be produced and offered at lower prices, thus progressively lowering the cost of living.

This has already happened in the field of computers and other electronics. Buy a computer today, and it is almost guaranteed that in three months' time the price will be lower for a faster machine with more storage space on its hard drive.

This in turn means that as we get older we can look forward to increased purchasing power for our savings. A wild dream? No. This is as it should be, the normal course of events. We should be increasing productivity, producing more and better at less cost. And with a stable monetary unit, increased productivity involving less labour is reflected in lower prices. Currently we are forced to rely on pension schemes defined in terms of inflating currency, and government schemes which are already heading for deep deficit. So we console ourselves with inflated home prices, ignoring the warnings that bust can follow boom.

Money which increases in value over the years... an ideal which most "ordinary folks" with ordinary common sense would heartily applaud.

And yet our economists regard deflation with absolute horror. Do they know something the rest of us don't?

There are two issues which need to be addressed.

The first is that economists are contradicting themselves. Check the first chapter, indeed in the first few lines of any first year economics textbook, and there it is: "money is useful as a medium of exchange, **and as a store of value**. And yet no one, economist, financial advisor, banker... indeed no one at all would ever suggest putting currency coins and notes under the mattress and hoping that by the time you retire they'll be worth anything. We can all remember "how things used to be", and the older you get, the more you see the rapidity with which money – the economists' store of value remember – is losing its value.

Indeed the word "inflation" is hardly an appropriate term. "Depreciation" would be a lot more accurate. Instead of talking of "3% inflation this year", it would be more realistic to speak of "a 3% depreciation in the purchasing power of our currency". Inflation is a word with a good connotation; it means "bigger", and that in turn has to be good. "Depreciation" reflects reality: our currency is slowly deteriorating in real value – and by the time you need to spend your pension savings, your money will only be worth half what it is now. Likewise, instead of "deflation" we should talk of currency "appreciation".

So once again, why do economists dread deflation?

The answer is simple: inflation reduces the value of debts. If you owe £1,000 and pay it back in three years, its value will have fallen. It will be easier for you as the debtor to pay it back because your wages/salary will (hopefully) have increased.

This is particularly significant – and useful – for debt-ridden governments, which issue five-year bonds happy in the knowledge that with a currency deteriorating in value by 3-5% the real debt will be that much lower.

Inflation – a depreciating currency – is an incentive to spend now, pay back later.

Conversely, an appreciating currency encourages saving, which in turn as a number of spin-off consequences. A nation which saves has more money available for investment. And when people can be confident that their money is naturally increasing in value, they will be less inclined to seek refuge in dubious investment practices.

The choice is plain: do we craft a monetary system to favour debtors or creditors, people who save, or those who spend now and (hope they can) repay later?

Development Banking has the potential to *increase* employment and productivity across the nation. But only the addition of a stable currency can *maximize* employment, and thus also productivity, without inflation and the inevitable resort to putting on the economic brakes.

Ultimately the prosperity of a nation and its citizens individually can best be guaranteed by full employment, fair remuneration, and increasing productivity in a stable economy. And this in turn requires that the nation's credit flow, its most vital resource, be given stability of value, protected from abuse, and directed specifically towards releasing full productive potential.

Roads, bridges, piped water, electricity, telecommunications,
these and many more constitute vital elements of a nation's infrastructure.
But outweighing them all in importance is
a properly functioning monetary system.
*Only with fundamental reform
will our monetary system
deliver the prosperity of which it and we are capable.*