

For profound reforms of the world's financial and monetary institutions

by Maurice Allais

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For two more of Professor Allais's contributions, "On My Experiments in Physics, 1952-1960" and "Michelson-Morley-Miller: The Coverup; The Experiments of Dayton C. Miller (1925-1926) and the Theory of Relativity," see the Spring 1998 issue of 21st Century Science & Technology magazine.

If we were to consider not only the history of the recent decades, but also that of the last two centuries, and undoubtedly of previous ones, it would certainly appear that monetary and financial factors have had an exceptionally significant role in the functioning of all economies.

Indeed, if appropriate monetary and financial conditions are not assured, experience shows that there can be neither economic efficiency, nor equity in income distribution. The resulting economic instability, underproduction, inequity, underemployment, distress, and misery are major scourges.

These profound disorders can in no way be considered the inevitable result of the functioning of a market economy: They have been, and they generally are, the consequences of financial and monetary policies implemented within an inappropriate institutional framework.

More than ever, reforms, very deep and radical ones, are necessary:

- reform of the credit system;
- stabilization of the real value of the unit of account;
- reform of the stock markets;
- reform of the international monetary system.



Maurice Allais

I. The system of credit

In fact, the system of credit we have today — whose origins must be wholly traced to contingent historical events — appears completely irrational. And there are at least eight reasons for this:

- irresponsible creation (or destruction) of money and purchasing power through decisions made by banks and individuals;
- the financing of long-term investments through funds borrowed on a short-term basis;
- the confusion between savings and money;
- oversensitivity of the credit mechanism to short-term economic fluctuations;
- the fundamental instability it causes;
- the distortion of the conditions of maximum economic efficiency;
- the distortion of the distribution of income;
- and finally, the impossibility of any efficient control of the credit system by public opinion and the Parliament, because of its extraordinary complexity.

On the basis of at least two centuries of experience with disorders of all kinds and with the recurring series of periods of expansion followed by recession, we must consider that the two major factors which have considerably amplified, if not caused, these disorders, are the *ex nihilo* creation of money and purchasing power by the credit mechanism, and the financing of long-term investments through short-term borrowed funds.

These two factors could nevertheless be easily neutralized through an overall reform which would considerably diminish the scope of, if not put an end to, these short-term fluctuations.

This reform must be based on two fundamental principles: The state and the state alone must have sole responsibility to create money. Any creation of money other than the money base issued by the central bank must be made impossible, so as to do away with the "false rights" now produced by the creation of bank money. Therefore, reform of the credit mechanism should involve excluding both *ex nihilo* creation of money and short-term borrowing to finance longer-term loans, and allow only loans whose maturity is shorter than that of borrowed funds.

To meet these two conditions, banking and financial

structures would have to be radically changed, based on breaking up banking activities such as they are carried out today into three distinct and independent categories of institutions:

- *deposit banks, with no right to lend*, whose only function is to ensure the collection, payment, and holding of the deposits of their clients, the corresponding fees being billed to the latter. The clients' accounts could not be overdrawn;
- *loan banks*, borrowing at given terms and lending the borrowed funds on shorter terms, the global amount of the loans not exceeding the global amount of the borrowed funds;
- *business banks*, borrowing directly from the public or from loan banks, and investing the borrowed funds into businesses.

In principle, such a reform would exclude the ex nihilo creation of money and purchasing power by the banking system and short-term borrowing to finance longer-term loans. It would only permit loans whose maturity would be shorter than that of the borrowed funds.

Deposit banks would provide for their clients' collections and payments. They should, of course, be paid for those services which are today almost free of cost, thanks to the income banks receive from the *ex nihilo* creation of money.

The loan banks and the business banks would serve as intermediaries between savers and borrowers. They would be subject to an imperative obligation: *to borrow long term in order to lend at shorter terms, the opposite of what is going on today.*¹

Such an organization of the banking and financial system would at the same time satisfy six absolutely fundamental conditions:

- impossibility to create any money and purchasing power other than the base currency issued by the monetary authorities;
- elimination of any potential imbalance resulting from the financing of long-term investments based on short- or medium-term borrowing;
- expansion of the overall monetary supply at the rate decided upon by the monetary authorities, the monetary

1. With this system, only the central bank would create money and the revenue coming from currency creation by the central bank would be retroceded to the state, *which would allow it to abolish almost all income tax.* (See my book *Pour la réforme de la fiscalité*, Paris: Clément Juglar Editions, 1990.)

Such a reform has the advantage of being both clear and transparent. Today, revenue due to currency creation is anonymously distributed among a crowd of actors, but no one can really identify who the winners are. This revenue only causes instability and unfairness and, *by encouraging investments that are not really profitable for the community, it leads to squandering capital.*

In essence, the present ex nihilo creation of money by the banking system is identical, and I do not hesitate to say it in order to make my point well understood, to the creation of money by forgers, which the law rightly condemns. Concretely, it leads to the same results. The only difference is that those who gain from it are not the same.

supply being solely made up of the money base;²

- a major, if not total, reduction of the magnitude of fluctuations due to short-term conditions;³
- allocating to the state—that is, to the collective community—the gains resulting from money creation, and the consequent lowering of present taxes;
- allowing public opinion and Parliament to easily control the creation of money and its implications.

All these advantages would be essential. The profound changes required would naturally come into conflict with powerful interests and deeply rooted prejudices.

But, given the major crises that the present credit system has constantly produced since at least the last two centuries, and still does today, and that the monetary authorities have been unable to control, this reform would seem to be a necessary condition for survival and efficiency of a decentralized economy.

II. Unit of account

A market economy functions on the basis of many obligations on the future. For the economy to be efficient as well as equitable, these obligations must be met, the economic calculations must not be distorted, and neither creditors nor debtors should be despoiled. *It is therefore necessary that the contracts be carried out without the perverse effects of variations in purchasing power of the unit of account.*

In fact, with respect to these variations, only the compulsory indexation, in real value, of all future obligations, and especially of all loans and borrowed funds, as well as all employment contracts limited in time,⁴ could guarantee efficient and equitable functioning of the economy.

This would entail the *legal obligation* to specify for all future medium- and long-term borrowed funds, by the state, companies, or private individuals, a guarantee in terms of purchasing power, principal, and interest. Reimbursements and interest would be indexed in real value, based on the general price index.

Such an indexation would boil down to implicitly introducing a stable unit of account into the economy, for all future operations. Use of such a unit is indispensable for a proper working of the economy, both to ensure its efficiency and to avoid a distorted distribution of income.⁵

2. Growth rate of the monetary base would be equal to the growth rate of the real GNP, plus the desired rate of price rises, in principle about 2%.

3. As thorough econometric analysis shows.

4. In fact, *distribution of corporate gains among employees and shareholders would certainly be easier, if the salary involved three elements:*

- *a main element indexed to general price levels, according to a salary contract of limited time;*
- *a specific element by which employees benefit from good management and which is differentiated according to their activities in the company;*
- *a complementary element indexed on the company's real income and variable according to the company's earnings or losses.*

5. Compulsory indexation in real value of all obligations toward the future beyond a certain length of time, which could reasonably be set at one year,

It is important to fully understand the nature of such a system of indexation. It is not meant to lock the economy into a set of incompatible and impossible constraints. *It just means making it more efficient, freeing it, in large part, from all constraints linked to future uncertainties, and fully establishing the principle of honesty in the application of contracts. Such a system would tend to exclude price and income distortions. It would allow the economy to be efficient and income distribution to be equitable.*⁶

In itself, indexation would *fundamentally reduce uncertainty toward the future* and, by that very token, assure efficiency.⁷ In any event, refusal to index future obligations would be tantamount to institutionalizing unsound economic calculations and to despoiling either debtors or creditors.

III. Stock markets

The fact that stock exchanges have become casinos, where gigantic poker games are played, would perhaps not seem so important after all, the winners simply counterbalancing the losers, if general price fluctuations did not cause *deep waves of optimism and pessimism that have considerable influence on the real economy*. There appears the *insane and harmful* character of the stock markets' present institutional framework. The present system is fundamentally anti-economy and detrimental to the smooth functioning of economies. It is only advantageous for very small minorities.

Stock markets, to be fundamentally useful, *as they can be*, must be reformed:

- the possibility to finance stock operations through *ex nihilo* creation of means of payment by the banking system *must be eliminated*;
- margins corresponding to future purchases and sales *must be greatly increased and be in cash*;
- continuous quotation of stock values *must be eliminated and replaced on every stock exchange by one single quotation per day per value*;
- automatic buy and sell programs *must be eliminated*;
- speculation on stock-index futures and derivatives should be suppressed.

One single quotation per day on each stock exchange would certainly be preferable; it would greatly reduce costs and benefit all investors, minor or major. A market is all the more efficient as it is large.

is a precondition for both efficiency and equity. Indexation could advantageously be based on consideration of the deflator of the nominal Gross National Product, which takes all transactions into account.

Cash balances, which by nature would not be indexed, would be devalued at the desired rate of price rises, in principle 2% (see footnote 2). Thus their hoarding could not be profitable.

6. See my book *Pour l'indexation* (Paris: Clément Juglar Editions, 1990).

7. If all money obligations would be indexed, markets would set real interest rates at levels ensuring the economy *all the real savings it needs*. Historical experience of all periods of monetary stability shows that these rates would be relatively low, around 3 to 4%.

IV. The international monetary system

The present international monetary system is plagued by many evils:

- instability of floating exchange rates;
- disequilibria in current balance of payments;
- competitive devaluations;
- development of unbridled speculation on currency markets;
- worldwide use of the dollar as unit of account, although its real value internationally is extraordinarily unstable and *unpredictable*;
- fundamental contradiction between totally free short-term capital flows and autonomous national monetary policies.

Reform of the international monetary system, *a new Bretton Woods*, is absolutely necessary. It would entail:

- replacing the floating exchange rate system by a system of fixed, but adjustable, exchange rates;
- a system which would implement the equilibrium of balances of payment;⁸
- forbidding any competitive devaluation;
- totally giving up use of the dollar internationally as accounting currency, trade currency, or reserve currency;
- merging the World Trade Organization and the International Monetary Fund into one agency;
- creating regional organizations;
- forbidding major banks from speculating, on their own account, on exchange rates, shares, and derivatives;
- finally, gradually establishing a common unit of account internationally, by an appropriate indexation system.

V. Established truths against reason

We cannot make sound decisions for the future, if we don't consent to draw the relevant lessons from the past. The monetary and financial disorders that have come up time and again in the past were greatly increased, if not caused, by the absence of monetary and financial institutions able to allow for efficient and equitable running of the market economy.

In fact, those institutions that carry the seeds of their own destruction must be reformed.

It is of course undeniable that the very powerful interests of monetary and financial lobbies, as well as the ruling doctrines, are not really favorable to such reforms — *so powerful is the tyranny of the status quo*.

The past 50 years have been dominated by a series of dogmatic doctrines always upheld with the same assurance, but in complete contradiction with one another, all just as unrealistic, and given up one after the other under the pressure of facts. Instead of studying history, instead of thoroughly analyzing past mistakes, there has been too great a tendency

8. The average annual deficit of the U.S. balance of payments of over \$100 billion, on the average since 1984, is quite unacceptable. How can it be accepted that the most powerful country in the world take such a toll on the rest of the world?

to make simple affirmations, too often based on pure sophisms, on unrealistic mathematical models, and on superficial analyses of present circumstances.

In the end, all the means implemented, all the measures taken, have always had the same objective: to postpone the necessary adjustments to a later date, by granting new loans and creating possible new means of payment, which leads to further rises in the overall volume of promises to pay. These are really only expedients, in and of themselves very highly destabilizing, that increase the general potential instability of the system, making it more and more dangerous.

In fact, almost all the present problems are the result of both a total ignorance of the monetary and financial conditions necessary for an efficient and fair running of a market economy, and a structure of banking institutions and financial markets that is inappropriate.

The four reforms that I propose—of the monetary and financial system, of indexation, of stock markets, and of the international monetary system—are *independent of one another and can be applied separately in certain countries, or in all countries*. Each one of them would be *most beneficial* for the entire economy. But if they are applied jointly, these beneficial effects would be *greatly enhanced by one another*.

These reforms are not just any old reforms, akin to thousands of others, each of which was supposed to repair the damage caused by its forerunners, by creating new damage.

These are *fundamental* reforms, of concern to the everyday lives of millions of citizens. These indispensable reforms have neither been enacted, nor even envisaged, whether by the liberals, whose just concern is to make the economy more efficient, or by the socialists, who are rightly committed to an equitable distribution of income.

The reason is very simple. They have all been blinded by the incessant repetition, everywhere, of pseudo-truths, and by mistaken prejudices. The more widespread dominant ideas become, the more rooted they become in the minds of people. *However mistaken they might be, by the very fact that they are repeated over and over, they acquire the status of established truths*, which no one may challenge without being ostracized by all kinds of lobbies. The only result of this situation has been tremendous suffering for millions and millions of people, the poorer being the most hit the most hard.⁹

9. On all the above points, as well as the objections that may arise, in particular concerning the construction of Europe, see: M. Allais, "Les conditions monétaires d'une économie de marchés," *Revue d'économie politique*, May-June 1993. Also see the Introduction to the second edition of my book *Economie et Intérêt* (Paris: Clément Juglar Editions, 1998), pp. 154-186.

See especially my two books: *La crise mondiale d'aujourd'hui. Pour de profondes réformes des institutions financières et monétaires*, 1999; *L'Union européenne, la mondialisation et le chômage* (Paris: Clément Juglar Editions, 1999). The publisher may be contacted at 62 avenue de Suffren, 75015 Paris, France.

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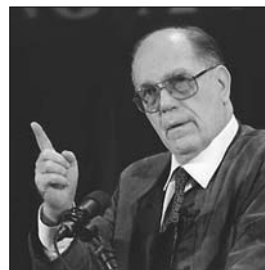
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