Keynes's liquidity preference and the usury doctrine: their connection and continuing policy relevance

Abstract: The purpose of this paper is to support the spirit of the early medieval prohibition of payment for the use of money, with arguments based on the economics of Keynes. At the heart of the usury doctrine is the idea that a creditor cannot expect both the security of a claim on a fixed sum of money and to derive an income from it; security comes at a price, one way or another. The consequences of the unwillingness of modern society to accept this are illustrated by reference to two problems of the modern international financial and monetary system: bank bailouts and the lack of a supranational reserve currency.

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1. INTRODUCTION

At least since Bentham's *Defence of Usury* (1787) and the abolition of the usury laws in England in 1854, the medieval Scholastic usury doctrine has been considered in the West to be obsolete, 'buried long ago by both classical and modern economists' (Cannan at al., 1932), with the exception of some authors in this journal (Dempsey, 1948; Divine, 1959; Clary, 2011). Usury is now generally understood to refer only to exploitative lending and such debate as there is takes place only in relation to whether there should be a legal maximum rate (for example, the cap on payday lending charges introduced in the UK in 2015, partly due to the efforts of the Archbishop of Canterbury). Nevertheless the formal teaching of the Catholic Church has remained unchanged since its last exposition in the papal encyclical *Vix Pervenit* of Benedict XIV in 1745, which firmly reasserts the traditional prohibition of any payment for the use of money. The pastoral practice of the Church recognised the politics and practice of the Western secular world when in 1830 Pope Pius VIII advised the Bishop of Rennes that the faithful were not to be troubled further about this matter, pending any future statement by the Holy See – which has not so far been forthcoming!

Although practical and political considerations played the major role, political economy also played a significant part in legitimising the free market in money. The main thrust was that the usury doctrine was bad economics, as illustrated by the symposium in the *Economic Journal* (Cannan et al., 1932) prompted by Somerville (1931). The neoclassical economists argued that interest was the fruit of the union of productivity and thrift, a cost of production, neither rent nor economic profit. While Keynes supported Somerville against this proposition, he did not fully elaborate his ideas until *The General Theory* (Keynes, 1936).

If the Church's doctrine is to be taken seriously, on grounds of reason rather than religion alone, the economic arguments have to be addressed. That indeed was the strategy of the previous authors in this journal. However Dempsey and Divine do not question the legitimacy of interest *per se* but are concerned with the creation of money by the banking system, which they judge to be inflationary and so inequitable.[1]

The purpose of this paper is to support the spirit of the early medieval Scholastic position against *any* payment for the use of money, with arguments based on the economics of Keynes. This is not simply a matter of the history of economic thought. The interpretation

[1] Dempsey's own concept of 'institutional usury' depends upon the loanable funds fallacy (Hayes, 2010A). A full critique of Dempsey and Divine is matter for another paper. Clary (2011) argues that the payment of interest on central bank reserves rewards no genuine sacrifice on the part of member banks.

presented here sheds new light on the concept of usury and on several aspects of modern economies, suggesting that the ancient teaching contains wisdom of continuing relevance to present problems.

The relevance of Keynes is not simply in his brief compliments to Scholastic thought but in his overall theory of the nature of interest on money, as founded in our fear of the unknown future, manifested in the forms of liquidity preference and the state of confidence. This paper argues that Keynes's thought is still not sufficiently well understood and that he provides the basis for a technical critique of the very institution of lending at interest, although he himself did not go quite so far, for good reasons of practical policy.

Section 2 offers some preliminary clarification of the meaning of the usury doctrine in the Catholic tradition.[2] A key point is the (mis)use of the concept of *lucrum cessans* to justify moderate interest. Section 3 summarises Keynes's theory of interest and the connection between his concept of liquidity and his theory of probability. Interest is not a factor price based on productivity and thrift, bringing saving and investment into equilibrium, but an artificial rent for which there is no natural or moral justification, created by the propensity to hoard. Section 4 goes beyond Keynes to illustrate the relevance of the theoretical analysis with two examples, for the nature of banking in general and deposit insurance in particular, and for the reform of the international monetary system and of the IMF in particular. In both cases, modern society is unwilling to accept that the security offered by money comes at a price, one way or another. Section 5 concludes that the usury doctrine implies in a modern context that state deposit insurance should be limited to state-owned or 'utility' banks and that a reformed IMF should be empowered to issue a commodity-backed reserve currency.

2. USURY AND INTEREST

It is important to clarify precisely what is meant by the terms 'usury' and 'interest'. By usury Benedict XIV meant any payment for the use of money under a debt contract: not simply an excessive charge. The term 'interest' was reserved for the charges that might legitimately be claimed – the difference or *id quod interest* to reinstate the lender's position – by way of cost or damages in making the loan, as opposed to a charge for use or rental. Such claims for damages attach, not to the loan of money *per se*, such as its amount and term, but to its effect on the particular lender. These claims were referred to as the extrinsic titles to interest and included charges for late payment (*poena conventionalis*) or consequential loss (*damnum*

[2] For a brief wider survey including Hindu, Buddhist and Islamic literature, see Visser and Macintosh (1998).

emergens). Originally, the claim could be made only after the event of loss and might have to be proven in court. Consistent with this, a third title (*lucrum cessans*, meaning compensation for loss of profits) was not accepted by Thomas Aquinas, or by other early Scholastics if the charge was fixed in advance (Divine, 1959; Jones, 1989; Munro, 2011). Clary (2011), following Dempsey (1948), adopts the more permissive reading of the later Jesuit Scholastics Molina, Lessius and de Lugo, which leads in turn to the modern distinction between legitimate interest and exploitative usury.

Mills (1989) argues correctly that the acceptance of claims for *lucrum cessans* from the outset of a loan was the turning point that both undermined the usury doctrine and permitted the development of modern deposit banking.[3] *Lucrum cessans* shifted from being compensation for actual consequential loss to the economists' conception of opportunity cost. Originally a claim would be made for damages consequent upon default in repayment, e.g. through preventing a merchant from investing in new stock as planned, or being forced to sell stock at a loss to meet the cash shortfall. The lender would have to be engaged in some form of commercial enterprise; the loss of the opportunity simply to lend at interest to someone else is clearly a circular argument. The loss would be assessed in relation to the particular circumstances of the lender and the general rate of profit or interest was not directly relevant. No claim could be made for money that would otherwise have rested idle.

In this paper, using the language of the economists rather than the Scholastics, 'interest' will be used to refer to any payment for the use or pure rental of money, rather than to a specific charge for costs or damages under the extrinsic titles. Indeed in modern debt contracts such additional charges are distinguished quite clearly from interest. *Thus all lending at interest today represents usury as it was understood between the 5th and the 15th centuries*. The relevance of the usury doctrine is not simply to a rent-charge at a rate in excess of a legal or moral standard of what constitutes a legitimate maximum.

At the heart of the ancient dispute is the legitimacy of lending money for profit, not to be confused with the payment of compensation for any costs arising from an otherwise unremunerated loan or credit, nor with the investment of money in capital goods for profit. The usury doctrine does not prohibit investment in capital goods, directly or indirectly, for

[3] *Vix Pervenit* stays out of the argument over *lucrum cessans*. It states clearly both that a pure rent-charge is illicit and also that there may be a legitimate basis for a payment under the extrinsic titles ('not at all intrinsic to the loan contract'). An example of a legitimate payment in a modern context might be index-linking to protect purchasing power. The Pope left the discernment of the status of a particular payment to the theologians and canon lawyers. Later Vatican documents do not provide any further clarification.

profit, provided that there is an acceptance of the risk of loss. In other words, financial investment should be a form of equity partnership.[4] Such investment involves not only risk of loss but also a relationship involving some degree of ownership and control.

The change in attitudes between the 15th and 17th centuries was mainly driven from the demand side, by the needs of commercial and state borrowers (for historical detail see Noonan, 1957; Munro, 2011). The emphasis of earlier teaching is on consumption loans and the exploitation of the poor by the rich. The changes permitting commercial banking and later, bankruptcy and limited liability, were pushed by wealthy business and financial interests, although they found a ready welcome among the growing rentier class. Such borrowers usually prefer to take loans at interest, if they can get them, rather than accept profit-sharing partners or shareholders. This preference became still stronger with the introduction of corporate limited liability, mainly to protect the rentier (Ireland, 2010). The concentration of wealth and the discouragement of alternative forms of ownership of property and enterprise may be the most important modern consequences of lending at interest. This observation is in line with the insistence in *Vix Pervenit* that usury cannot be condoned, even on the grounds that the borrower is rich or uses the proceeds for productive purposes.

The prohibition of interest would not mean the end of the market economy or even of finance. There are plenty of equity-based alternatives for the finance of business and indeed of housing and consumer durables, including various forms of credit co-operative. 'Utility' banking will always be needed to deal with the secure transmission of payments, the finance of the timing differences in production and distribution, and the exchange of currencies; bankers could still be rewarded for these services. It is likely that alternative forms of finance would impose higher private costs but section 4 will argue that they would also avoid the major externality costs of interest-based finance.

At the heart of the usury doctrine is the idea that a creditor cannot expect both the security of a claim on a fixed sum of money and to derive an income from it; security comes at a price. Section 4 will provide two examples where modern society insists on having its cake and eating it: by insisting on a state guarantee for interest-bearing deposits with private banks and, in the other direction, by an unwillingness to accept the cost of establishing the secure reserve asset necessary to underpin the orderly international monetary system needed for global full employment.

[4] This can take many forms, from simple partnership to incorporation as company or co-operative society. The extent of limited liability is a separate and complex issue.

3. KEYNES ON INTEREST AND LIQUIDITY

In *The General Theory* (Keynes, 1936, hereafter *GT*), Keynes draws a clear analytical distinction between money and capital, between interest on debts and the financial yield on physical capital assets.[5] For Keynes, there is indeed a significant difference between 'the loan of a horse and the loan of the purchase price of a horse' (*contra* Marshall, 1920, p. 486). Interest is indeed the hire charge for parting with money for a specified period and provides the inducement to overcome liquidity preference, or more colourfully, the propensity to hoard. His analytical device for comparing the rate of interest with the financial return on physical assets is the schedule of the marginal efficiency of capital. Keynes writes:

> I was brought up to believe that the attitude of the Medieval Church to the rate of interest was inherently absurd, and that the subtle discussions aimed at distinguishing the return on money-loans from the return to active investment were merely jesuitical attempts to find a practical escape from a foolish theory. But I now read these discussions as an honest intellectual effort to keep separate what the classical theory has inextricably confused together, namely, the rate of interest and the marginal efficiency of capital. For it now seems clear that the disquisitions of the schoolmen were directed towards the elucidation of a formula which should allow the schedule of the marginal efficiency of capital to be high, whilst using rule and custom and the moral law to keep down the rate of interest. (*GT*, pp. 351–352)

In *The General Theory* and in all post-Keynesian economic theory, the level of employment and income in a market economy is determined by effective demand, of which the primary motor is the level of gross investment. In Classical theory, the natural state of the economy is full employment and any unemployment is a matter of the deficiencies of workers or of imperfections in the labour market. In Keynesian theory, there is no natural tendency to full employment and unemployment is, in part at least, a symptom of failure at the level of the system as a whole. It is the possibility of such failure within Keynes's theoretical framework, a possibility absent from the Classical theory, that leads Keynes to write:

> Provisions against usury are amongst the most ancient economic practices of which we have record. The destruction of the inducement to invest by an excessive liquidity-preference was the outstanding evil, the prime impediment to the growth of wealth, in the ancient and medieval worlds. And naturally so, since certain of the risks and hazards of economic life

[5] Keynes had made this distinction in *A Treatise on Money* (Keynes, 1930), prompting Somerville (1931) to make the overt connection to usury doctrine, accepted with reservations by Keynes (Cannan et al.,1932). At that stage, Keynes had not fully articulated the concepts of effective demand and liquidity preference, as in *The General Theory*.

> diminish the marginal efficiency of capital whilst others serve to increase the preference for liquidity. In a world, therefore, which no one reckoned to be safe, it was almost inevitable that the rate of interest, unless it was curbed by every instrument at the disposal of society, would rise too high to permit of an adequate inducement to invest. (*GT*, p. 351)

Keynes's concern here is neither with charity nor with contractual justice (the direct concerns of the Scholastics)[6] but with the consequences of liquidity preference for the general level of activity and prosperity. Although Keynes's basic proposition about effective demand changed economic theory and policy for a period of some 40 years until the Classical 'counter-reformation', his concept of liquidity preference was never really accepted nor, it must be said, fully understood. Nicholas Kaldor recognised at an early stage that by liquidity Keynes meant something more subtle than simple marketability or convertibility:

> Mr Keynes, in certain parts of The General Theory appears to use the term 'liquidity' in a sense which comes very close to our concept of 'perfect marketability'; i.e. goods which can be sold at any time for the same price, or nearly the same price, at which they can be bought. Yet it is obvious that this attribute of goods is not the same thing as what Mr Keynes really wants to mean by 'liquidity'. Certain gilt-edged securities can be bought on the Stock Exchange at a price which is only a small fraction higher than the price at which they can be sold; on this definition therefore they would have to be regarded as highly liquid assets. In fact it is very difficult to find satisfactory definition of what constitutes 'liquidity' – a difficulty, I think, which is inherent in the concept itself. (1939, p. 4, n5)

Even a leading post-Keynesian defender of the concept of liquidity preference and of the authentic Keynes, Paul Davidson, defines liquidity in the following terms:

> In money-using, market-oriented entrepreneurial systems, liquidity is defined as being able to meet contractual obligations as they fall due. (2011, p. 18)

> By definition, liquid assets are assets that are traded on well-organized, orderly markets where the market maker assures the public that the next price will not be very different from the last transaction price, i.e. the price over time can change but it will move in an orderly manner. (2011, p. 119)

[6] Keynes did not accept the Scholastics' own arguments against the legitimacy of a payment for the use of money (Keynes, 1932). Although these arguments are worth reconsidering, space precludes doing so further in this paper.

The principal difficulty with Davidson's interpretation[7] is that on this definition liquidity is not a property possessed mainly, if not exclusively, by money. Indeed to speak of the liquidity of money becomes tautological if liquidity is a matter of convertibility into money. Davidson does indeed refer to the stability of prices and to the settlement of contractual liabilities and this is important. Yet the paradox of *The General Theory* is that Keynes so emphasises the liquidity of money within a competitive theoretical framework in which *all* assets are equally marketable or convertible. This competitive assumption explains the absence of financial and industrial structure in *The General Theory* and the treatment of capital assets as though they were all individually traded on the stock exchange.

Keynes makes the startling suggestion that in certain historic environments *land* has been the dominant liquid asset. Land can never have been preferred for its convertibility, let alone as the means of payment. Keynes claims that historically it has possessed high liquidity, despite its low convertibility. Conversely, in his discussion of organised investment markets, which come closest in practice to the ideal of perfect competition in terms of transaction costs and uniformity of price, he treats their 'liquidity' (note the inverted commas) as an illusion and something distinct from true liquidity. Listed equity securities have high convertibility, but low liquidity.

So what is liquidity for Keynes and can it sustain the distinction between lending at interest and other forms of investment? This question cannot be answered without reference to his unique understanding of probability and expectation, which has its roots in his early work, *A Treatise on Probability* (Keynes, 1921). From the current perspective, Keynes's work on probability is of particular interest as its underlying motivation was to provide a guide to ethical conduct independent of Christian faith and morals.

At the heart of his analysis is a recognition of the nature of time as a one-way, irreversible sequence of historical events, and that decisions are always made in the present, based on the unchangeable past and the unknown future. In *A Treatise on Probability*, Keynes treats Classical frequentist probability theory as a special case within a branch of philosophical logic that deals with arguments that are doubtful, but neither demonstrably certain nor logically impossible. He understands probability as an argument or logical relation between one set of propositions (the conclusions) and another set (the evidence). Mathematics deals

[7] Davidson is by no means alone among the post-Keynesians. Both Kalecki (1971) and Minsky (1975) also rejected Keynes's notion of liquidity, so that the view presented here is a minority (unique?) position among post-Keynesian economists. For a full exposition see Hayes (2006, 2012).

with analytic relations between propositions that must be either true or false. In matters of metaphysics, science and conduct, an argument is considered 'probable' to the extent that it warrants a degree of rational belief. Such a probability relation is objective, in the sense that any rational judge would reach the same conclusion upon the same evidence. Probability is not in general numerical, as in frequentist theory, but arguments can be, and often are, compared. An archetypal case is the verdict reached in a court of law.

The expected value of Classical probability theory is known (i.e. certain) as soon as the population frequency distribution is known, while an expectation in terms of Keynesian probability reflects the balance of available evidence yet remains uncertain. The confidence with which an expectation is held depends on the weight of the evidence compared with the conclusive evidence of hindsight (or hypothetical perfect foresight). Keynes illustrates this in his 1937 article:

> By uncertain knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject in this sense to uncertainty…Or, again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest 20 years hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know. (C.W. XIV: pp. 113–114)

Classical economists have tended to regard this statement as either a counsel of despair or a mandate for behavioural economics, yet Keynes himself is more measured:

> We should not conclude that everything depends on waves of irrational psychology. On the contrary, the state of long-term expectation is often steady. Thus after giving full weight to the importance of the influence of short-period changes in the state of long-term expectation as distinct from changes in the rate of interest, we are still entitled to return to the latter as exercising, at any rate, in normal circumstances, a great, though not a decisive, influence on the rate of investment. (*GT*, p. 162)

The prices of financial securities reflect not only what Keynes refers to as the 'actuarial' value, corresponding to the balance of evidence, but also the state of confidence, which is related to the weight of evidence. This distinction corresponds to 'the difference between the best estimates we can make of probabilities and the confidence with which we make them' (*GT*, p. 240). The celebrated 'animal spirits' or spontaneous optimism relate to the state of

confidence and have their counter-poise in liquidity-preference, 'the degree of our distrust of our own calculations and conventions concerning the future' (C.W. XIV, p. 116). The state of confidence is not something separate from the state of long-term expectation, but part of it. Confidence is weak when we know that our expectations are likely to change substantially, but we have no precise idea as to their future state: our present expectations already represent the best we can do on the available evidence. By definition, a change in the state of expectation cannot be foreseen or even estimated.

For Keynes then, liquidity is the degree to which the value of an asset is independent of changes in the state of expectation. Liquidity risk is the possible (*not* probable or expected) loss of value that such a change may impose; the risk reduces as the liquidity increases. Liquidity has value only because the future is unknown, and its value increases with our fear of what may happen that we cannot prevent or insure against. Liquidity-preference and animal spirits are opposite facets of the state of confidence, which is a matter of the weight of evidence behind our forecasts of the future. The propensity to hoard has its counterpart in the fear of goods (*GT*, p. 346), the reluctance to accept the hazards of physical investment. In a wider context this represents the failure of society to devise and promote local, national and global financial institutions capable of sustaining investment at the level consistent with full employment.

4. FROM THEORY TO PRACTICE

Although Keynes's name is widely associated with public deficit spending, his main emphasis in *The General Theory* is on a policy of 'cheap money'. Since liquidity preference is a matter of confidence, the rate of interest on long-term bonds can be managed down by astute policy. In *The General Theory* he emphasised the importance of the long rate for very long-term investments, such as buildings and public utilities. Furthermore, while he did think that 'a somewhat comprehensive socialisation of investment' would be necessary to secure full employment, he clearly saw this as an exercise in institution-building which would combine private enterprise with the public interest (*GT*, p. 378). For Keynes, full employment requires new institutions to supplement, not necessarily supplant, market forces and overcome the tendency of the inducement to invest to fall short of the propensity to save.

The best known example of Keynes's emphasis on the need for new institutions was his plan for an International Clearing Union (Keynes, 1942), which failed to secure support from the US at Bretton Woods, in favour of Harry Dexter White's International Monetary Fund. *The*

General Theory is not, as commonly thought, a theory of a closed economy; consider Keynes's use of his model in his extensive discussion of mercantilism. Nevertheless *The General Theory* itself did not draw out the importance of the balance of trade in allowing surplus countries to depress global income, something Keynes explicitly addressed in the Clearing Union proposal and its adjustment requirements in particular.

How do the usury doctrine and Keynes's concept of liquidity shed any light on these modern problems? Keynes in *The General Theory* was concerned with the rate of interest itself and looked forward to the 'euthanasia of the rentier', not by the legal prohibition of interest but by its reduction through monetary policy. Events have shown that it is indeed within the power of central banks to follow a cheap money policy and through quantitative easing they have been pursuing this strenuously in recent years. The real returns on UK index-linked bonds are currently negative. It might be argued that Keynes's cheap money policy has been achieved and so has eliminated interest without the need for a legal prohibition.

While this may be true for government bonds, interest remains the foundation of the banking system. The losses suffered by taxpayers through explicit or implicit deposit insurance—not to mention the ever-increasing scale of bank crises since the end of Bretton Woods in 1971, let alone the Eurozone crisis—suggest something is badly wrong with the design of our financial system. The usury doctrine is telling us that the security offered by money should come at a price to the holder of money and not be used to exact a price from others. Furthermore Keynes's theory of liquidity provides insight into the nature of this security, as stability of value in the face of changes in the state of expectation. His understanding of probability calls into fundamental question the methodology of securitization and financial liberalization; his concept of liquidity helps us define an asset capable of providing a genuinely secure anchor for the international monetary system.

History shows that the cost of liquidity, or even of the craving for it, will be levied in an unjust and arbitrary fashion under an interest-based financial system, through under-employment and tax-payer bailout. Liquidity, including security of the payments system, is a genuine need; the problem is its social cost. The next two sections consider two examples, in the national and international contexts respectively.

4.1. A first example: deposit insurance as a step too far

In the context of the finance of productive investment, the payment of interest can be seen as an information-saving device (Mills, 1989). The interest charge removes the obligation to

account for profits and avoids the agency costs of ensuring the accountability of management to owners. One consequence of the advances in information technology has been the advent of credit rating based purely on financial data, so that a credit score has become a substitute for a genuine relationship. In terms of usury doctrine, the payment of interest undermines the need and the incentive to create the more difficult human relationship involved in an equity partnership.

The standard assumption of the corporate finance literature is that a 'risky debt' contract is optimal (Gale and Hellwig, 1985) under asymmetric information with limited liability. The fact that borrowers know more about their business than lenders leads to two pathologies, moral hazard and adverse selection. Moral hazard means borrowers undertake higher risk projects with borrowed funds than they would with their own money, since the lender bears part of the cost of failure through limited liability. Adverse selection means that lenders are unable to discriminate between borrowers in terms of the riskiness of their projects. Both tendencies lead to credit rationing (and therefore a departure from the theoretical first-best optimum) but the literature argues that the second-best financial contract is a 'risky debt' contract incorporating a premium to compensate for the risk of default.

Noonan records that such a risk premium was rejected by the early Scholastics as an extrinsic title to interest (1957, pp. 128–131). Bohren (1998) has observed that there is something deeply unsatisfactory about an economic theory that depends on breach of fiduciary duty to explain widespread phenomena, if only because such behaviour (to the extent that it is carried out in practice rather than merely assumed by theory) ultimately leads to market failure. From an ethical perspective, it is disturbing that interest-based finance positively encourages opportunistic behaviour—cheating—and the use of limited liability as a calculated strategy, rather than as a protection from unforeseeable events beyond the control of the borrower.

The concept of risky debt is at the heart of the explosion of credit associated with securitization. The direct relationship between investor and user of the funds is eliminated by the move from 'originate and hold' to 'originate and distribute'. The concept of the CDS (credit default swap) and the conversion of sub-prime lending into secure investment grade securities by the alchemy of the CDO (collateralised debt obligation) depends on the treatment of loans as simple transferable claims on future cashflow with well-behaved probability distributions of default. Beyond the Keynesian critique of confusing uncertainty with risk, the deeper issue for our purposes is that this system is only possible through lending at interest on a completely impersonal basis. From the perspective of the usury

doctrine, the dishonesty of mortgage brokers and investment bankers merely compounded the intrinsic immorality of the underlying financial model.

Ironically, the change in the banking model associated with risky debt was accompanied by the introduction in 1979 of deposit insurance in the UK and EU along the lines of the US model. Deposit insurance compounds the breach of the usury doctrine by increasing the security of interest-bearing deposits. Financial liberalization encouraged the development of universal banking, in which a single entity raised finance in many different forms other than traditional deposits, and undertook many different kinds of financial activity. This change corresponded to a shift in the regulatory regime from one of structural regulation, in which each type of financial institution specialised in a particular type of finance, to prudential regulation, under which financial institutions became free to pursue any type of activity provided they maintain the appropriate level of capital to protect creditors. Deposit insurance was introduced in Europe in the mistaken belief that prudential regulation made the banking system more secure and reduced risk. Government deliberately stood back from directing the allocation of capital and credit, leaving it to the wisdom or otherwise of the market.

Underpinning prudential regulation and the securitized model are measures of capital adequacy based on the Classical model of probability. The model of structural regulation was based on a combination of relationships with customers, collateral against loss and lending decisions by experienced managers with specialised knowledge of their particular sector. These traditional banking methods do not make clever assumptions about probability distributions and are more robust in the face of Keynesian uncertainty. Structural regulation is a much *more* secure basis for deposit insurance, as it had been in the US since 1933 until the onset of deregulation, beginning with Savings and Loans institutions in the 1980s.

The change in the banking and regulatory model and the introduction of deposit insurance in Europe led to substantial growth in the scale of financial institutions. The line between retail and commercial banking on the one hand, and investment banking on the other, was blurred, then erased altogether. The growth in scale and consolidation of the financial sector meant that bank failures came to pose systemic risk to the monetary system. It became axiomatic that depositors must be protected and insured by the state, whether explicitly as in the case of retail deposits, or implicitly as in the case of Ireland and other Eurozone bailouts. When the crash came in 2008, a high proportion of the losses were passed to the state, with far-reaching consequences that we are still experiencing.

A number of proposals have been made since 2008 to re-introduce a degree of structural regulation and to separate 'utility' from 'casino' banking. However the protection of depositors, with its implications for the capitalization of banks, has remained a central concern and the more radical proposals, involving formal separation and the break-up of banks 'too big to fail' have foundered. The UK Vickers Commission envisages the introduction of internal firewalls within the existing institutional structures. Past experience suggests these will not operate as a material constraint and that the banks will always outwit the regulators. Even a critical commentator such as Kane (2010) considers the reintroduction of Glass-Steagall provisions impractical. The tacit assumption shared by all commentators is that deposit insurance for all banks is essential.

From the perspective of the usury doctrine, the global banking system continues to be founded upon two unethical premises, which have combined to create a lethal mixture: the centrality of the risk premium in the system of securitization and the guarantee of interest-bearing deposits against risk.

4.2. A second example: international money

Keynes did not draw out explicitly the importance of trade surpluses as a form of excess saving until after *The General Theory*, in his proposals for an International Clearing Union (ICU) (Keynes, 1943). His underlying concern was with the tendency of an advanced economy to run financial surpluses, internal and external, representing lost output that is neither consumed nor invested in physical provision for the future. In *The General Theory* the primary focus was on internal surpluses and the need for a cheap money policy. In his later work, informed and driven partly by the imperatives of war finance and post-war reconstruction, Keynes recognised the need for mechanisms that would promote global full employment with balanced growth in international trade in goods and services. This would include the translation of any long-term trade surpluses into foreign lending to deficit countries, so as to ensure equilibrium in the balance of payments, taking both the current and capital accounts together. The mercantilist desire to accumulate foreign exchange reserves including gold— a policy entirely unavailable to the world as a whole—is the international equivalent of the domestic propensity to hoard (Carabelli and Cedrini, 2015).

The economic case for a reform of the international monetary system along the lines of the ICU has been made by several authors over many years (e.g. Hart, Kaldor and Tinbergen, 1964; Davidson, 2011). Post-Keynesian economists consider a managed system far superior

in principle, in terms of full employment and global economic growth, to the system of flexible exchange rates and financial liberalization favoured by mainstream economists. Such a system would require as key elements: the creation of an international money as the reserve asset in substitution for the dollar and other currencies; balance of payments adjustment by surplus as well as deficit countries; and the reinstatement of capital controls. The political obstacles are clear, as shown by the outcome of the original Bretton Woods negotiations relative to Keynes's original proposal.

Of the many flaws in the final design of the International Monetary Fund, the most relevant is the nature of the reserve asset. Keynes had proposed the formation of a banking institution that could create credit in a unit of account (bancor) transferable only between central banks. In theory the need for international reserves can be met, not by holdings of foreign currencies or gold, but by an overdraft facility, creating reserves *ex nihilo*. However this would mean that the credit balances in the system at any time represented claims, not on gold or convertible currencies, but on member states. This was unacceptable to the US as the major creditor in 1944, so that the institution which emerged was not a bank but a fund, created by the subscription of existing national currencies and gold.

The liquidity preference of sovereign states manifests itself in the desire for a reserve asset, like gold, whose value is considered stable in the face of fundamental uncertainty and does not depend on the economic or foreign policies of any individual state. Once again, the issue here is not simply convertibility, since no-one doubts that US dollars or sterling can be exchanged for goods. Since 1971, when the US dollar became no longer convertible to gold, the world has by default been on a dollar standard, sustained only by the relative size and strength of the US economy and its financial markets, not to mention its political and military power, and the use of the dollar as the unit of account in most international trade. It is no accident that this dominance has coincided with a period of financial liberalization and flexible exchange rates, which have favoured the dollar's use as a key or vehicle currency in foreign exchange trading and its continuing reserve status, *faut de mieux*.

The Euro was created partly in response to the post-1971 turbulence in exchange rates but no account was taken of the implications of monetary union for the balance of trade between member states. It would have been better to have re-created a version of the European Payments Union (Amato and Fantacci, 2012), with an additional provision for an automatic, compulsory, adjustment of national currencies against the clearing currency, in line with domestic costs and to address structural disequilibrium. This would also have made explicit

the need for private capital inflows to be justified in terms of their positive contribution to net exports over the term of the investment, as Greece, Spain and Italy have been harshly reminded.

However the precedents offered by the EPU and the ICU rely on an acceptance of sovereign risk. In the context of the EPU and the Eurosystem this acceptance is feasible because secession from the European Union in order to repudiate foreign debt is (almost) unthinkable, as the experience of Greece so far has shown. The Eurosystem appears to be surviving for political reasons, despite the weakening of democracy and the economic costs involved in reversing current account deficits in order to repay foreign debt, now embodied in the TARGET2 balances between central banks and the ECB. However this mutual commitment does not exist for the world as a whole. If the much-needed reform of the international monetary system is to take place prior to any global pooling of sovereignty, the need for a reserve asset independent of national sovereignty will have to be addressed (Hayes, 2013).

It is not beyond the wit of man to design the secure reserve asset needed to anchor the international monetary system and provide a firm reference value for a system of adjustable exchange rates. In 1964 Nicholas Kaldor, supported by Hart and Tinbergen and following the earlier work by Keynes, Hayek and the two Grahams, drew up and presented to UNCTAD a blueprint for an international commodity reserve currency (Hart, Kaldor and Tinbergen, 1964). This represented a refinement of Keynes's earlier ICU proposals and proposed that the IMF issue bancor in exchange for a basket of the 30 major commodities that dominate international trade. Bancor would thereby constitute a stable and universal standard of value in real terms – in Keynes's terms, the ultimate source of liquidity.

While some fiduciary element (i.e. loans to central banks denominated in bancor) would be desirable, the commodity basket substitutes, like gold, for the ability to impose taxation which ultimately supports national fiat currencies. Crucially, security against political risk can be provided by distributing the physical warehousing of the commodities approximately in line with major holdings of bancor. Such a scheme comes at a price, rather than generating an income. Yet the present system imposes economic costs through underemployment, inflation or default, invariably on the poorer members of global society who are less able to protect themselves. A more just and rational international monetary system would recognise these social costs explicitly and distribute them equitably.

5. IN CONCLUSION

The ancient prohibition of payment for the use of money embodies wisdom which remains relevant today. Its central idea is that a creditor cannot expect both security and income, while a debtor should not presume to offer them. The doctrine fell into abeyance in the West after the 17th century as society changed, at least partly because the new commercial classes preferred to borrow at interest rather than take in formal equity partners. Once personal bankruptcy and corporate limited liability were accepted in the 19th century, it became possible to create a whole financial system based on 'risky debt'; the payment of interest as compensation for risk had been explicitly rejected in the 15th century. The economists of the 21st century have done great harm by their encouragement of securitization. The elimination of any human relationship between borrower and lender and the introduction of state insurance for private bank deposits has made it impossible to justify banking as even an imperfect form of risk-sharing partnership.

Keynes was among the few economists to recognise the importance of the distinction between money and capital. His analysis was based on a concept of liquidity which has been neglected or misunderstood from the outset, as something considerably more than convertibility. For Keynes, the peculiar role of money is grounded in the nature of time and our fundamental uncertainty about the future. Our fear of the unknown prompts a craving for security, a propensity to hoard rather than to invest in physical productive assets. This liquidity preference imposes a social cost in terms of underemployment yet the lender can command a premium for forgoing liquidity, in the absence of an ethical and legal prohibition. Keynes argued that the power of interest-bearing debt needed to be countered by a policy of cheap money and by the creation of financial institutions oriented towards long-term equity investment and the promotion of full employment.

Undoubtedly there is a legitimate need for a secure store of value and means of payment. The usury doctrine implies that the security offered by money, i.e. liquidity in Keynes's terms, comes at a price and this cost should be borne by the holder of money and not externalised. We have applied this principle to two very different policy areas, the insurance of deposits and the nature of foreign exchange reserves. In the first case, deposit insurance should be restricted to 'utility' banks that provide essential payment services and collateral-based finance. Their depositors would be unlikely to receive interest and rather would pay charges for safe custody. Depositors in uninsured institutions would have to recognise and accept their risk, which would encourage the development of more democratic financial institutions (Hayes, 2010B). In the case of foreign exchange reserves, a condition of the reform of the

international monetary system towards the promotion of full employment is the independence of the value of the global reserve asset from the economic and foreign policies of sovereign states. This requirement could be met by a variant of one of the well-known commodity-reserve schemes, which offer, indeed, security at a price.

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