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# A Hamiltonian national banking plan for East Europe

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*The author presented this speech to the Schiller Institute conference on May 2, 1992, in Kiedrich, Germany, to an audience which included numerous representatives from formerly communist countries in central and eastern Europe. The intervening months have made the situation he describes even more chaotic, and the solution so much the more urgent.*

It is becoming clear to nations of eastern Europe that the International Monetary Fund policy for economic reform is a recipe for catastrophe. The question is, what concretely to put in the IMF's place? What follows is our concept of what a national economic alternative could be. We refer to the model developed by the first American treasury secretary, Alexander Hamilton, who set out to rebuild the economy of a war-torn, bankrupt, and indebted United States in 1790, after America's revolution against English "free market" colonialism.

Various models have been proposed by the IMF, by Milton Friedman, Jeffrey Sachs, or in the extreme, by Paul Volcker, who argues east Europeans should have *no* central bank, until they first have built some mysterious, undefined thing called a "free market." In opposition to these Bretton Woods, or more properly, latter-day Versailles System schemes, nations of eastern Europe must urgently move to establish sovereignty over their own national economic policy.

This sounds simple, but it is fundamental. In the West today, there exists a perverse mirror-image of the old communist "world imperialism," under the banner of "globalization" or multinational "economies of scale," which tramples on the essential rights of the nation-state.

We address ourselves here to what supporters of both Karl Marx and Adam Smith would seek to destroy: the economically sovereign development of the nation-state.

Essential to such national economic sovereignty is establishment of a mechanism to direct credit to projects and enterprises, deriving its legitimacy from duly elected national representative bodies or parliaments. Let us call it a national bank, more or less on the model of Hamilton's First Bank of the United States.

Unlike today's U.S. Federal Reserve, such a national bank would not be the captive of a tiny elite of powerful private banking interests, imposing policy by fiat. It would rather be answerable to popularly elected government bodies. The management of the bank should be positions of the highest national trust and honor, staffed by persons selected from a cross-section of national life—agriculture, industry, science, economists—not merely bankers.

The national bank's charter must give it the explicit mandate to foster the general welfare and prosperity of the nation as a whole. Given the extraordinary tasks at hand, the bank must not be limited, as the German Bundesbank is, to a narrow mission of maintenance of "price stability and stable foreign exchange." Rather, national bank policy must be broadly to nurture the increase of "potential relative population density" of the nation, as defined by American economist Lyndon LaRouche in his *The Science of Christian Economy* and elsewhere.

According to the specific conditions pertaining in each country, this national bank must be able to utilize various tools to accomplish economic growth, consistent with the principle of promoting technological progress, orderly trade with other states, and a rising per capita living standard, as well as providing for the general safety and defense of the



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nation. This explicitly should be mandated to include promotion and maintenance of productive agriculture and industry, as well as electrical, water, transport, and communications infrastructure.

There also must be a provision embedded in the national constitution, providing for the impeachment of bank officials in the event that they have forsaken their mandate to promote such productive credit generation, or have been proven guilty of conduct breaching the public trust placed in them.

What exactly would such a bank do?

The dangerous notion has been fostered among the people of East Europe that any form of state intervention smacks of the old regime, and must be avoided. This dangerous fallacy is being opportunistically used by people such as Harvard's Jeffrey Sachs, to replace tyranny of a communist elite, with a new, equally pernicious tyranny of supranational control, this one mediated through the dollar and the IMF. The specific aspects of this IMF control have been detailed by us elsewhere. The policy mandate of the national bank must reject wholly any interference by the IMF into sovereign national affairs.

## Creating the new national currency

The national bank must be the sole issuer of the national currency. The supply of credit from the bank must encourage the maximal rates of industrial and agricultural growth, while at the same time preserving living standards of the population by ensuring against undue rates of inflation. This is only possible through the bank's maintaining steady rises in per capita output via establishment of more effective economic infrastructure and rising technological capacities in the productive economy.

First, in order to establish confidence in the national bank, in the face of rampant corruption, market anarchy, and price inflation in many places in the East, the national bank must establish a new currency. This currency must be backed by the one hard commodity which has over centuries been accepted as the international anchor of value: gold. A recommended ratio of gold to total credit in the reserve of the national bank would be on the order of 10-15%. The Reserve Bank of South Africa, for reference, the world's largest gold producer, holds a quite high, 25% gold reserve, as it has access to the metal in ample supply.

A word about the role of gold in basing the new currencies: Since the introduction of Sachs and the IMF economists into the debate, discussion of using gold to back eastern currencies has mysteriously vanished, in favor of a "dollar-based" currency reform. There is a reason for that: Since Aug. 15, 1971, the United States has unilaterally abandoned its gold redemption for the dollar, in order to cheat the entire world trade system by inflating its currency at will, forcing trading partners to take the inflated dollars to pay for oil and other goods.

By making the dollar the currency of trade in East Europe, Washington is able to tie the economies of the region to the dollar at a time that the dollar itself faces the greatest devaluation pressures in its history. Prudence would make it essential, then, to have a recognized hard unit of value—gold—as anchor to the new currencies. The dollar is no longer in this sense a "hard currency."

Gold reserves much larger than 10-15% would unduly hamper expansion of credit for economic growth. Higher ratios of gold reserve would put the most severe brake on credit growth imaginable, and precipitate the kind of crisis such as occurred under the British gold standard during the 1873-96 depression.

But the secret to maintaining the value of the new currency is that its gold-backed issue be accompanied by real and rapidly visible improvements in production of essential goods to the economy. Once the population realizes the existence of a genuine government commitment to this overall production improvement, confidence in the national currency will stabilize, and the black market or shadow economy will fade into the background.

The key is the increase of essential production through the credit policy of the new national bank, as will be elaborated below.

The national bank creates the new currency by calling in all old currency and exchanging it for new. This has the benefit of enabling the government to control the dangerous black markets rampant in the eastern economies. Each holder of old currency would have to account for its origins in the exchange process, or forfeit it without compensation. This must be done in a manner to gain the confidence of a distrustful population, which is sensitive to repeated betrayal by state officials.

The national bank must impose exchange controls—just the opposite of IMF demands—and, as its initial act, call in all foreign currency circulating through the economy. The phenomenon of "dollarization" of the economies of East Europe in recent years, is a direct parallel to the process by which looting of the resources of Third World economies, by those able to command dollar currency, was carried out over the past decade.

If this cancerous dollarization is not brought under control, and offenders dealt with as criminal offenders against the public interest, no independent national economic policy is possible. But, once the central bank buys the stock of dollars—under some form of short-term amnesty for dollar holders—in exchange for its new national currency, perhaps with an initial inducement to make it attractive, the national bank can use the foreign currency to back the country's international trade transactions. In Russia alone, there is estimated to be some $10 billion circulating in the black economy. Many industrial countries, including France and Italy, Taiwan and South Korea, have maintained exchange controls for much of the postwar period.

Simultaneous to this creation of a new national currency

and imposition of exchange controls, the national bank and the respective governments would begin, where relevant, a "rollback" of the price and other monetary shocks of the recent IMF measures, to more rational levels.

Under the old Soviet system, "domestic debt" did not exist as a category, as the central government owned the means of production, and legally the people and the state were synonymous. Thus, when the Soviet state began to incur dramatic economic problems, notably following the 1986 collapse of oil-based dollar export earnings, the state simply ordered the Gosbank to print more ruble notes to meet shortfalls in receipts under the state plan—much like Washington does today.

The Soviet state budget deficit grew fourfold from 1985 to 1990. But the physical production of the rotting industrial economy was falling sharply, meaning an explosive increase of rubles in the hands of a public which had fewer and fewer goods to buy from official state shops. This led to a predictable flourishing black market. As exchange controls fell, it became common for unscrupulous western traders to come to East Europe loaded with only borrowed dollars to buy up valuable raw materials at dirt-cheap western prices on the black market.

In short, the national resources of eastern European economies are being looted shamelessly for the interest of a corrupt handful, in the name of the IMF's "market economy." Such "dollarization" is one of the real objectives of IMF demands in East Europe, a supranational neo-colonialism.

By pegging a national currency to the dollar, as Sachs did in Bolivia in the mid-1980s, a less-developed economy is made hopelessly dependent on terms of trade, which can never be to its own national advantage. The only difference between this and 19th-century British financial colonialism, is that the Bank of England has been replaced by the IMF and the dollar.

## Administrative guidance

Now, how does the national bank direct credit to the areas where it can most benefit the country? The major problem is how a country can proceed in an *orderly way* from centralized top-down economic control to a mixed economy in which the individual firm or family farm is more and more the basic unit of initiative, in the context of a rising overall living standard.

In many economies of eastern Europe, the most basic cultural requisites of experience with decision-making initiative are lacking, owing to the history of the last decades. The paradox of economies wanting market structures while having centralized state ownership, has to be addressed in a way which will allow the development as rapidly as possible of experience with more direct initiative of farm or factory in context of an overall national economic policy. The process whereby the population gains such confidence is essential.

One proposal would be to build the experience base in a clearly defined transition away from top-down to decentralized economic life, using the national bank as the centerpiece.

For example, factories in the East are today often rife with discontent, as demoralized workers and technicians confront the absurdities of central planning, which calculates the number of screws or bolts based on a bureaucratic central plan made in Moscow or somewhere remote from the production site. Examples abound of capacity left idle due to a bureaucratic failure to send such things as electric sockets so a new factory can operate!

The national bank, on the mandate from parliament, could, for example, encourage self-interest of the individual factory or farm producers, by issuing State Share Ownership Certificates, a legal title but at "no par value"—say, one share per each worker or employee in a former state-owned factory or farm. The shares would be non-transferable, and without cost. In event of a worker's death or retirement, the share might pass to the remaining employees. The operative principle being, that now the factory is no longer owned by the state centrally, but by the persons most directly engaged with its output.

Further, this factory or farm unit must be transferred "debt free" by the national bank. Any previous debts under the state system were legal accounting fictions or central planning tools, which must not be allowed to hamper the priority goal of improving physical output of the economy. Other countries must not permit the tragic error of the German Treuhand in honoring this old debt.

Then, the individual factory or farm group would bid for credit from the national bank, via a network of regional banks—banks initially state-run, but later adding private, regulated banks as much as possible. This bidding process, analogous to discounting of bills of exchange or letters of credit in a western banking system, gives the national bank, as source of currency issue, the ability to guide economic development, consistent with overall national economic priorities as, say, would be set out in parliamentary deliberation.

Initially, with the crucial difference of elected parliamentary decision replacing that of an old Communist Party bureaucracy, the formal aspects of national planning would superficially appear to be somewhat similar to the old idea of a national plan. Without planning, no nation in history has succeeded. The crucial difference is that, by issuing, free of cost, share ownership of the means of production, the state has taken the first major step in removing itself from the inefficient business of running everything, and has begun the process of developing individual initiative in the broader context.

Then, under this new, let us call it the National Enterprise Ownership Law, the ownership of state-run factories and farms could be transferred to the local farm or factory em-

ployees, in the form of such shares of ownership, for a predetermined period—say, 8-10 years. This could then be reviewed by the national bank or designated representative local banks, on a periodic basis. After the 10 years were up, or before, if deemed appropriate by the share-owners, ownership of the factory or farm could be sold to others. This guarantees, if imperfectly, a transitional mechanism of placing responsibility as well as incentive rewards for greater efficiency and productivity, with those producing.

The difference from IMF "price shock" approaches, or "privatization" to foreign investors who can grab assets for dirt-cheap prices, owing to the temporary disadvantage of the economy in transition, is that we preserve essential national production capacities and work force, while introducing a mechanism for a process of transition and modernization of the economy and ownership. Around major infrastructure projects, smaller subcontractors grow up, which bid to perform specialized jobs in construction, electrical installation, etc. for the large project, thus forming the seed crystal of a genuine *Mittelstand* [the German term for small and medium-sized enterprises].

Then, as the factory begins to generate a "net profit" above the initial contracted production volume needed for the national parliamentary plan, that net profit should be divided, specified as well in the legislation. Let us say one-third would go directly to the employees as dividend or profit-sharing; one-third would go into the capital investment of the firm itself, for modernization of machinery, etc.; and one-third would go, in the form of taxes, to the national government. As profitability gradually begins to increase, the state builds a tax base and is able to substitute this for financing its essential operations.

The economy of Yugoslavia, after a break in 1952 with Stalinist state planning, moved in some respects to such a factory initiative. Indeed, until they began to abandon it after the 1974 oil shock, the approach produced dramatic increases in the national growth rate. But one fatal flaw limited the adaptability of that model: The communist regime feared to turn over *ownership* to the local unit, only operational control. Such a full break is essential.

## Productive credit generation

How then does credit get to the enterprises most able to productively use it for the greater prosperity of the overall economy in this transition?

Initially, for the first several years until a genuine industrial *Mittelstand* is established, most national economic activity must originate from the central government. For example, the parliament might in year one, approve a national budget in which the goals of credit allocation are as follows: 40% to transportation, energy, and communications infrastructure; 20% to manufacturing and mining; 20% to agriculture; 8% to housing construction; 5% to defense; 7% to other expenses.

The state government then finances its overall annual expenses by issue of state treasury bills, essentially IOUs of various duration—say, 12 months to 10 years. These bills are then "discounted" to the national bank, which credits the government with the face value, *minus* the accumulated interest the bill offers until maturity—the so-called discounting. If it is, say, a one-year treasury bill of 1,000 rubles, bearing a 5% yield, then the government would get 1,000 minus .05 times 1,000, or 950 rubles on its account at the national bank.

The state government then offers credit via the banking system, which then, perhaps on a competitive bid system where practicable, makes funds available to local enterprises to fulfill government annual requirements for construction, infrastructure, etc. The national bank, by altering its discount rate of interest for funds, can determine the rate of credit circulation in the economy. Local or commercial banks must be required to place a certain percent—say, 10% of total liabilities—into a reserve account with the national bank, in the event of bad loans. The rest they loan out to local enterprises at a specified rate of interest—not to exceed, say, 5-6% annually, preferably less.

Thus we have established a national banking system tied to the overall guidance of the elected parliamentary body, with the mandated task of developing the national economy along lines specified above.

As rapidly as private or local assets in the community can be consolidated, local communes or agricultural co-ops could begin to apply for a charter, upon satisfaction of basic prudential requirements, to establish their own local or private bank.

Such a system would develop over time, as savings capital accumulated in a growing economy. But the national bank constitution must explicitly set the basis for such a banking system to develop. Such local banks would then obtain capital from the national bank at a price set by the national bank's discount rate. Local banks would put up their bills of exchange or letters of credit from their lending to local industry and agriculture, to the national bank, which then "discounts" it to make credit available to the local bank for further lending. This ensures overall control over money and credit in the national bank, a guard against the kind of fiat money problem of local banks arbitrarily creating their own money—a problem also in the United States before the creation of the national bank in 1790.

## Foreign trade

From the standpoint of such an organized national bank, the problem of orderly international trade relations is solvable. First, as with the young United States in the first years under the Hamilton national bank after 1790, or Germany after the 1870s, under the influence of Friedrich List's Customs Union (*Zollverein*), the parliament must establish the desired national economic policy of fostering the nation's

own industry, to lessen dependence on foreign ones, and to encourage economic self-sufficiency insofar as is practical.

This point is essential, for without it, no national bank can carry out its necessary mandate to order the monetary affairs of the nation and to defend the national currency. Again, the opposite of IMF policy.

Such a policy ensures that the national economic mandate of the bank, as laid out by parliament, coheres with the foreign trade policy of the nation. This gives the national bank a clear criterion to provide the orderly basis for foreign trade. Initially, as was the case in the United States in the late 1780s, most foreign trade will tend to be organized around large barter transactions. An example might be Russian crude oil of a stated grade delivered in Kiev, for so many tons of Ukrainian grain.

*If nations of eastern Europe pursue a strategy of national economic sovereignty, and invite nations such as Germany or Japan to negotiate on a strict bilateral basis, this could break one of the worst barriers worldwide to human progress we have in this century: the power of the IMF. The nations of eastern Europe possess far more power than they have yet realized. This is what the friends of Jeffrey Sachs in Washington fear they might realize.*

Such arrangements, outside the destructive notion of "world market price," must be made to secure the essential major commodity flows of the nations of East Europe. The very notion of "world market price" is a false one. There exists no such thing as a "world" market, but rather many regional or national or even local markets. The "world market price" idea has been fostered by the IMF economists and multinational corporations to further a global monopoly role in the trade of vital raw materials. Thus today six giant companies, all either American or British—Royal Dutch Shell, British Petroleum, Exxon, Mobil Oil, Texaco, and Chevron—control the entire terms of trade of the international oil markets. Some four giant firms—Cargill Inc., Continental Grain (Tradax), Archer Daniels Midland-Töpfer, and ConAgra—control 85-90% of all international trade in grain. They are the ones that speak of a "world market price," but in reality it is the price which they seek to impose on local markets, to their own advantage.

Thus, rather than orient to such a disadvantageous "world market" at the initial fragile stage of national economic development, the nations of eastern Europe would be better advised to seek trade on a mutually beneficial basis with other countries sharing similar problems. This would include developing new trade ties with nations of the South—India, the Middle East, Asia, Africa, including the Republic of South Africa. These are emerging economies with, in many cases, similar economic problems.

Ultimately, of course, barter is a cumbersome necessity, to be superseded as soon as this is practical by some form of international clearing mechanism. Postwar western Europe, with collapsed industrial capacities and no currency convertible to another, established such a system, the European Payments Union, which served during the initial postwar period of reconstruction and "dollar scarcity," from 1950 until the European Community was formed in 1958, and the national currencies of western Europe gradually became convertible with one another.

The problem with certain trade clearing proposals proposed today, is that they insist on a model with the reserve based only on the dollar. This would further tie the Community of Independent States and other East European trading partners to dollar dependency. The problem is clear from what has been outlined above on "dollarization."

One alternative suggested would be a pool from the major trading countries of an agreed reserve of deutschemarks or European Currency Units (ECUs), to reflect the reality of import and export relations. But, to avoid total dependence on major currencies which "float" against the dollar, such as the deutschemark, the fund should include a contribution from member countries of a mix of gold and, say, deutschemark hard-currency reserves. This provides the margin of security sufficient to assure other trading parties that the risk in orienting trade flows to the stated export market is worth taking. The reward is resumption of industrial export markets, while the various national economies begin to order their internal economic improvements as described above.

The initial issue of where and under whose guardianship this, let us call it, East European Payments Union (EEPU), should reside, to instill the greatest confidence in all parties, must be negotiated. Perhaps the institution which does this clearing function might be in Kiev, Prague, Budapest, or Minsk. It would not represent a central bank, but merely a clearing mechanism to facilitate early stages of resuming trade, to replace the old imperial arrangements of the "convertible ruble."

But once this payments union mechanism is established, in the context of the appropriate national banking model described above, essential cross-border trade flows could

resume on a far more promising basis. Such an approach would also keep the emerging fragile economies of the East from undue dependence from unscrupulous western interests or the inevitable IMF blackmail threats.

One quite economical proposal for the present "cost-concerned" German government, would be for Germany to set aside, with no IMF or other conditions attached, a special deutschemark or other European Monetary System member currency fund (not dollar), in an amount which, according to one estimate, would not have to exceed some DM 4 billion. This would be a one-time payment to help set up the East European Payments Union. That fund, which would not oblige individual eastern economies to lock up their scarce hard currency, would also reward the German government by giving eastern German firms today facing bankruptcy in a western market, immediate potential to resume profitable export to the eastern markets.

Compared to the DM 180 billion or so today being spent by the German government on unemployment compensation in eastern Germany, this is a ridiculously small sum, which would in a matter of weeks pay for itself many times over, as productive labor is again used to make goods for export, saving German taxpayers billions almost immediately. One can argue that such is the only feasible solution for the present mishandled German economic policies in the new federal German states. But any East European clearing mechanism must not wait for Bonn or any other western state to see the light of reason on this issue.

Whether or not the authorities in Bonn are rational in this regard, the establishment of an EEPU among the trading states of the region is urgent. Based on such barter agreements bilaterally among the various states, the EEPU would then use its hard currency and/or gold reserve to make annual settlements, but only of the balances outstanding between specific countries. Because of the existence of a central hard-currency and gold reserve, member-states of the union would have confidence that, unlike the old imperialist "convertible ruble" system of the Comecon era, which never was "convertible" but merely left other states with increasingly worthless rubles at year-end, trading partners would have the confidence of gold or hard currency settlement of that small portion of trade in surplus or deficit at year-end. Properly done, this would create confidence in each national currency as an internal medium of exchange (not outside the EEPU), and would contribute enormously to stability of present chaotic trade in the region, without touching national sovereignty.

## The hard-currency debt

A word is in order regarding the problem of the hard-currency foreign debts incurred under the pre-1990 era of communist relations: $160 billion or more for the entirety of East Europe, including Russia.

From the standpoint of effective national banking and a regional clearing mechanism for trade, the hard-currency debt problem—today a devastating obstacle to growth—becomes one of the simplest to solve.

The basic approach of the Adenauer government in the 1950s London debt conference, as described earlier, should be the model. No penny of hard-currency debt is repaid until trade surplus on current account begins to create the account with which such debt can productively be serviced, without damaging the priority of national economic growth.

Each debtor country must consolidate all foreign hard-currency debt, and the national bank issue against it 10- to 30-year state bonds. To show good intent in honoring ultimate debt obligations, even those undertaken by the illegitimate previous regimes, the government could offer to pay a nominal interest, of its *own* determination, not that of the IMF, of not more than, say, 3-4% per annum for a transition period of 5-10 years. Then, as the economy begins to function, the servicing of principal could be added. But in no case must the old interest arrears be allowed to be added onto the future principal—what the IMF calls "interest capitalization," which only ensures that "the more you pay, the more you owe." Interest is a political creation, nothing else, and must be so treated.

Precedents exist. When Washington imposed a political credit embargo on South Africa, South Africa in turn froze all foreign debt. They put it all in a "box." This was a debt moratorium, though terrified western bankers agreed never to name it so. Then South Africa negotiated, country by country. It found that West Europeans were not happy with Washington's pressure—which had to do with control of South Africa's vital strategic raw materials, not racial justice. South Africa offered two options: "If you agree to our terms, we take you out of the 'box.' Your debt is then a 'registered debt' or special bond, on which we pay interest for 10 years, until which time we can repay in a lump sum the old debt. Otherwise, we will pay you a mere 2-3% interest, and nothing on principal." The banks had no choice.

As remote as it might seem from the vantage point of Kiev or Prague or Warsaw or Zagreb, as the Bretton Woods order is now collapsing in the West, it is possible to split individual creditor governments from the "iron front" of London, Washington, and the IMF. Washington today is indeed a bankrupt "emperor with no clothes." If nations of eastern Europe pursue a strategy of national economic sovereignty, combined with the strength of the regional barter arrangements we have described, and from this strength invite individual nations such as Germany or Japan to negotiate on a strict bilateral basis, this could, if done right, break one of the worst barriers worldwide to human progress we have in this century: the power of the IMF. The nations of eastern Europe possess far more power than they have yet realized. This is what the friends of Jeffrey Sachs in Washington fear you might realize.