Towards a Stable & Sustainable Financial System

Prof. Richard A. Werner, D.Phil. (Oxon)
Centre for Banking, Finance & Sustainable Development
University of Southampton Management School
werner@soton.ac.uk

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The Questions

1. Where does money come from?
2. What causes the recurring boom-bust cycles and crises?
3. Which policy has historically been most successful in avoiding these cycles and crises?
4. What structure of the banking sector has achieved the same result?
5. How can the financial system deliver stable, sustainable growth?

1. Where does money come from?

Who do you think creates and allocates the majority of the money supply in the UK?

a) The Government
b) The Central Bank
c) The banks **97%**
d) The capital and money markets
e) The global financial infrastructure

2. Where is money safer?

2.1. If you give your money to a stockbroker, what is the status of that money?

a) it is owned by the stockbroker, and therefore at risk when the broker becomes insolvent

b) it is held in custody and therefore unaffected by the failure of the broker

2.2. If you give your money to a bank, what is the status of that money?

a) it is owned by the bank, and therefore at risk when the bank becomes insolvent

b) it is held in custody and therefore unaffected by the failure of the bank

How do banks create the money supply?

- When someone takes out a **bank loan** the bank **pretends** that the borrower has **paid in** a ‘deposit’
- But neither the borrower nor the bank (nor anyone else) has paid in or transferred any money into the borrower’s account.
- The **bank creates a fictitious deposit**, and nobody is able to tell – because banks are the settlement system of the economy, and we believe them to be honest accountants.

What about other forms of money?

- Cash is only about 3% of the money supply.
- When the Bank of England conducts **'quantitative easing'** it mainly increases **banks' reserves** at the central bank. This is money that **never leaves the central bank** and does not circulate in the economy.
- The money supply that creates GDP growth is virtually entirely dependent on **bank credit creation**. The banks are in the driver's seat.
- But it matters **who gets credit and for what purpose**.
- **Banks decide this** without conditions imposed, determining whether we will have good or bad results in the economy.

2. What causes the recurring boom-bust cycles and crises?

Credit creation must be divided into 2 streams:

C

↗ Credit used for the 'real economy', determining GDP
('real circulation credit' = C_R)

↘ Credit used for financial (non-GDP) transactions
('financial circulation credit' = C_F)

(*The Quantity Theory of Credit, Werner, 1992, 1997*)

The effect of credit creation depends on the use of money

Case I: credit creation for 'real economy transactions' C_R
→ nominal growth

two possibilities

(a) Inflation without growth:

Credit creation is used for consumption:

More money, but same amount of goods and services

= consumptive credit creation

(b) Growth without inflation:

Credit creation is used for productive credit creation:

More money, but also more goods and services

= productive credit creation

The effect of credit creation depends on the use of money

Case II: Credit creation for financial transactions C_F
➔ Asset Markets

Asset Inflation, Boom-Bust Cycles:

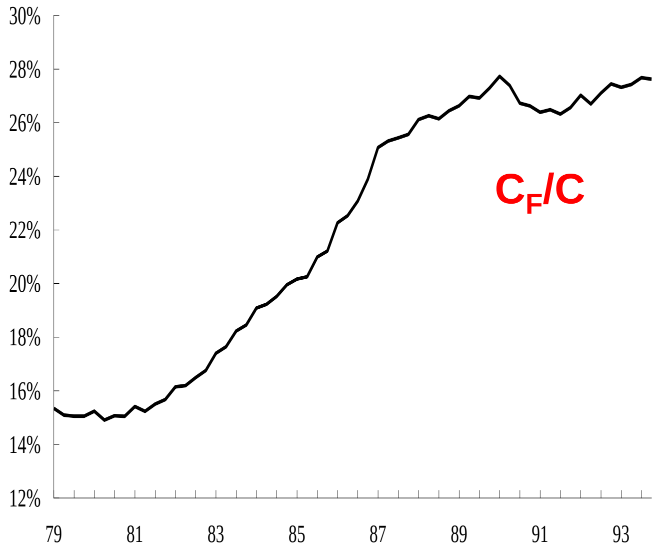
Credit is used for financial and real estate speculation:

More money circulates in the financial markets

= speculative credit creation

Credit for financial transactions explains boom/bust cycles and banking crises

- A significant rise in credit creation for non-GDP transactions (financial credit C_F) must lead to:
  - asset bubbles and busts
  - banking and economic crises



Source: Bank of Japan

C_F/C = Share of loans to the real estate industry, construction companies and non-bank financial institutions

- **USA in 1920s:** margin loans rose from 23.8% of all loans in 1919 to over 35%

- **Japan in the 1980s:** C_F/C rose from about 15% at the beginning of the 1980s to almost twice this share

- **UK banks 2001-11:** credit for the UK real economy (incl. mortgages) accounted for only **22%** of their total assets

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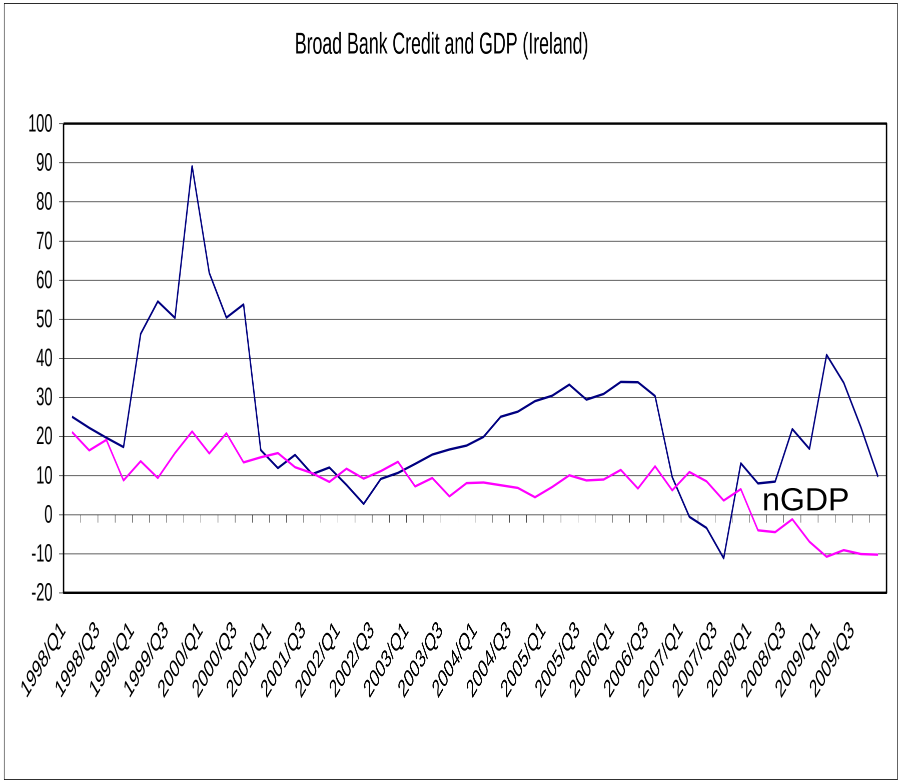
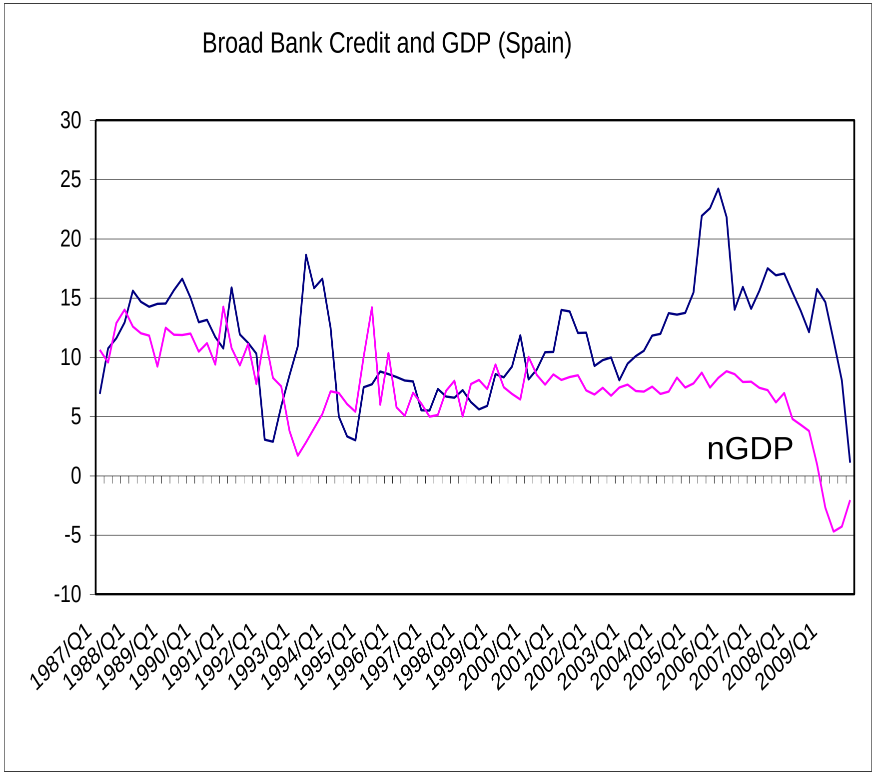
Out-of-control financial credit (C_F) is the problem, creating the bubbles and crises in Ireland, Spain, Greece, Japan, UK…





Broad Bank Credit Growth > nGDP Growth

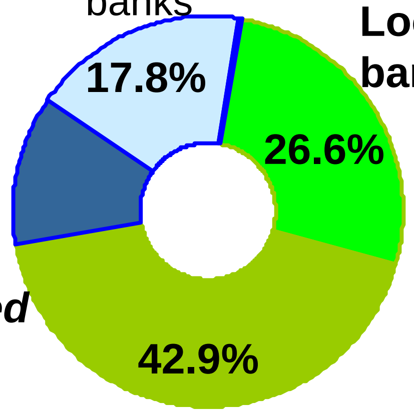
3. Which policy has historically been most successful in avoiding these cycles and crises?

- The East Asian Economic Miracle centred on productive credit creation
- Japan, Korea, Taiwan and China developed so rapidly by using **'credit guidance'**, whereby the central bank targets productive bank credit and restricts unproductive bank credit.
- A Bank of England-run system of **bank credit guidance** would also work in the UK and deliver ample **productive SME bank credit**.
- Remember, **credit is always allocated** – only currently by banks without consideration for the differing impact of their credit decisions.
- The other possibility: **State money** and banks only as intermediaries. Why should money be safer with a stockbroker than with a bank?

4. What structure of the banking sector has achieved the same result?

- **A structure of the banking sector** where banks dominate that have **no interest in harmful speculative credit creation**: **small, local banks**.

Banking in Germany



70% of banking sector accounted for by 1,700 locally-controlled small banks

5. Policy solutions

- The creation of a network of local, small-scale, not-for-profit banks, which do not lend money for speculative purposes
- Central bank ‘guidance’ of the quantity of credit and the use it is put to, suppressing unproductive credit and favouring productive credit
- Monetary reform, returning the public privilege to create the money supply to the people to whom it belongs, by requiring banks to hold customer deposits in custody, and by allowing local governments and central government to create and spend public money into circulation for productive investments. Then, interest can be discarded.

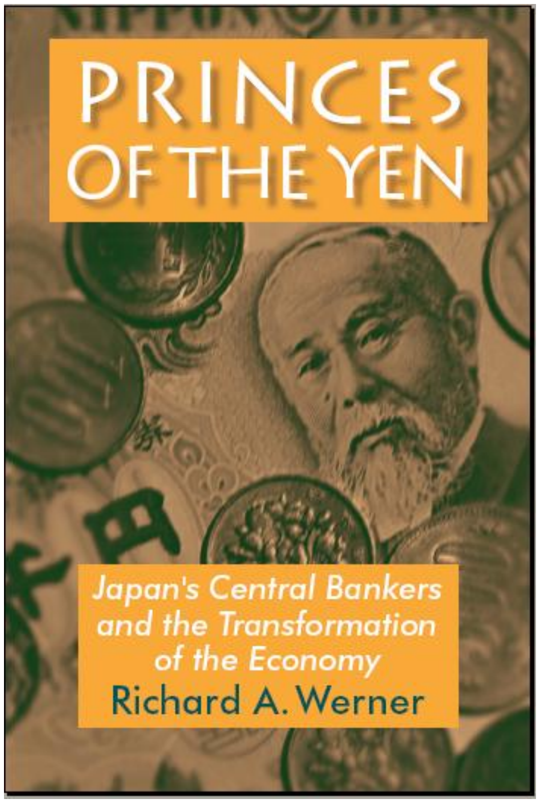
6. Usury (Interest) – Justified by economists in many ways, such as:

1. **Opportunity costs:** The lender has to be compensated for foregoing alternative uses of the money.

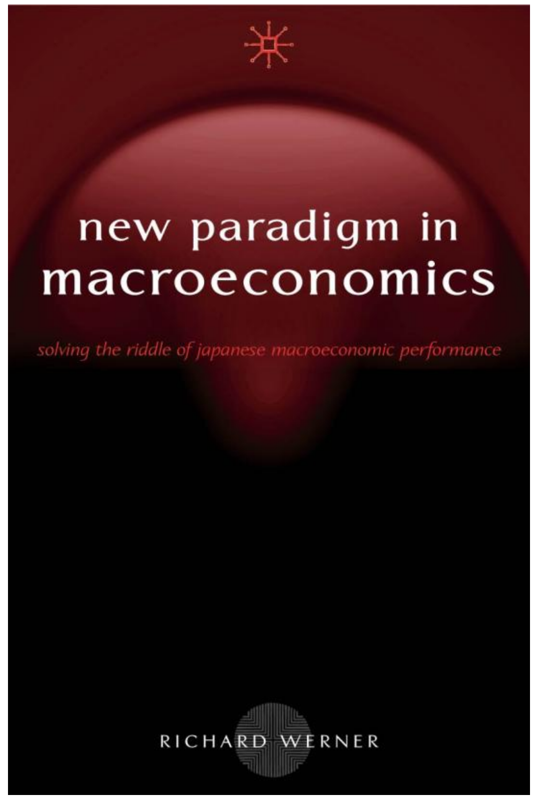
6. Usury (Interest) – Justified by economists as follows:

1. ~~**Opportunity costs:** The lender has to be compensated for foregoing alternative uses of the money~~.
   There are no opportunity costs of credit creation.

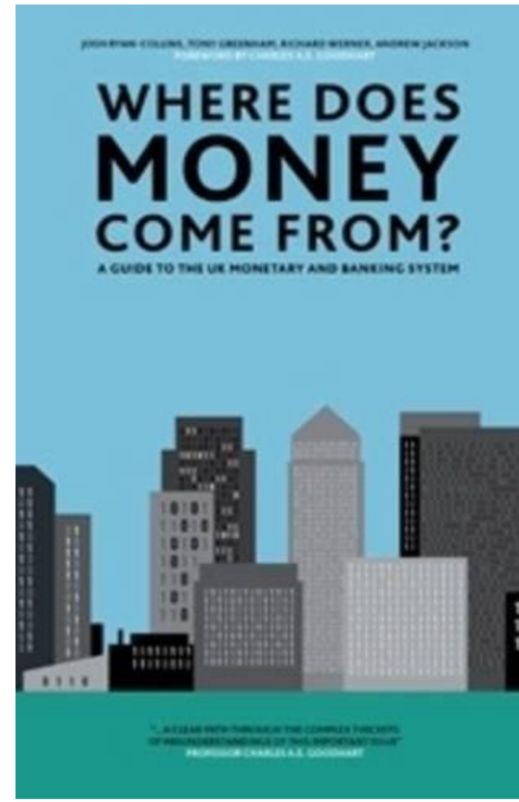
Further Reading:



M. E. Sharpe, 2003



Palgrave Macmillan, 2005



New Economics Foundation, 2012