Funding the Future

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The FT ran a report on Monday that said:

Non-bank lenders have overtaken US banks to grab a record slice of government-backed mortgages, after regulatory curbs on risk-taking and billions of dollars in fines forced mainstream providers to retreat from the $9.8tn home loan market.

So-called shadow banks such as Quicken Loans, PHH and loanDepot.com accounted for 53 per cent of government-backed mortgages originated in April – almost double their share in April 2013.

They explained as follows:

Shadow banks perform banklike functions such as lending but are subject to lighter supervision because they are funded by professional investors rather than retail depositors protected by government insurance schemes.

This is deeply worrying. As a new Working Paper for the Bank of England, published in the last few days, has shown the idea that banks are intermediaries between savers and borrowers is just wrong, in which case the idea that some banks are funded by retail depositors and others by professional investors is also just wrong. As the Bank of England paper says (my emphasis added):

In the intermediation of loanable funds model of banking, banks accept deposits of pre-existing real resources from savers and then lend them to borrowers. **In the real world**, **banks provide financing through money creation**. That is they create deposits of new money through lending, and in doing so are mainly constrained by profitability and solvency considerations. This paper contrasts simple intermediation and financing models of banking. Compared to otherwise identical intermediation models, and following identical shocks, financing models predict changes in bank lending that are far larger, happen much faster, and have much greater effects on the real economy.

In other words, the whole model of bank intermediation on which the UDS regulatory model is based is wrong: there is no such thing as intermediary banking. In the real world all bank loans are created out of thin air and are dependent upon there being confidence that the bank will be able to meet its obligation to others when call is made upon the funds created in the course of this process.

Official recognition of this reality, which some of us have talked about for a long time, has been slow in coming, and was only officially recognised by the Bank of England in 2014. It is high time that regulators caught up with it: regulation based on a completely false model of how banks work can never be effective. But, the sting is also in the tail of the above comment from the Bank of England working paper: the reality is that a true understanding of our banking model shows just how vulnerable it is there any loss of confidence because there is nothing else that backs it. If confidence disappears money can vaporise remarkably quickly, as we saw in 2008.

Positive Money suggest that the appropriate response to this is to remove bank's capacity to create money, and to transfer it entirely to the Bank of England. I am aware that this has quite a lot of positive support amongst left of centre think tanks, but I have my reservations, as does Ann Pettifor. No one who reads this blog can doubt that I believe the state has an enormous capacity to do good work on behalf of the people of the UK, but I also think that there are many occasions when this must be undertaken through positive partnerships with business. What I mean by a positive partnership is one in which each party recognises the importance of their role, and respect that of the other, and works together as a consequence to achieve a common goal.

In the case of money creation it is my belief that this requires the recognition that all money creation is, effectively, the responsibility of the state, which is the only authority with the eventual legal and practical capacity to define the legal tender of a jurisdiction. However, it also requires recognition that decision-making on loan creation has to be devolved if it is to be effective to meet the needs of a modern economy. This means that I do not think the total money supply can be rationed by a central committee which is a proposal at the core of Positive Money's suggestions. The right to lend does, instead, have to be given to banks but be subject considerably more direct regulation than at present where such blunt, and ineffective, instruments as interest rates are used in a vague attempt to regulate the process with some of the disastrous outcomes that we have seen in the past.

I admit that it amazes me that the Bank of England's recognition that bank intermediation does not exist has not, already, given rise to such suggestions which are the obvious consequence of that realisation. I can only presume that the reality of banking has yet to permeate the Treasury. It is high time that they did because until action on this issue is taken the risk that we face in the next financial crisis (which on balance of probabilities must happen within the next few years) will be greatly increased.

When that understanding is matched by the correct awareness that tax is not about revenue raising, but is in fact the process of reclaiming the money that the government has created and spent into the economy we will also be in a considerably better place. After all, the processes are linked: just as we got almost everything about banking wrong by thinking that banks lent other people's money when in fact they create all the money they lend out of thin air, so have we got taxation wrong. Precisely because the government is, and always has been, the effective banker of last resort and creator of the national currency it has always had the ability to spend before it is had revenue precisely because money can be created out of thin air, and it has the power to do that. Taxation is, then, as Modern Monetary Theory suggests, the process of reclaiming money from the national economy for three fundamental reasons.

The first is to prevent inflation from excess money printing.

The second is to validate the national currency by requiring that tax be settled using it. This does, of course, give the government effective control of its domestic economy which could otherwise use any currency it so chose.

Thirdly, the aim is to regulate the economy: by withdrawing more or less money from the economy than the government has spent fiscal control is achieved.

It is about time that these realities are understood, and respected. Precisely because they are not we have the absurd situation that at present it is supposedly illegal for a central bank to lend to a government under EU law, even though such loans have always been the basis of the effective functioning of any national economy. It is true that the quantitative easing process seeks to get round this constraint, but only by forced use of an intermediation process which is wholly artificial, and unnecessary, and which is solely designed to benefit the banking system, unjustly.

It really is time that new economic understanding informed the management of our economy: then we might have a chance of making real progress.