Funding the Future

Economics can no longer live with this sort of crap

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I suggested that economists need to wake up and see the world as it really is yesterday
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Steve Keen sent me a link to a paper he described as 'crap' in response. As some will know, I think 'crap' is a technical term meaning 'completely rubbish approximations' so I took a look.

The paper is by Salomon Faure and Hans Gersbach and is entitled 'Loanable Funds vs Money Creation in Banking: A Benchmark Result'. In essence it looks at whether economics need look at money creation the way it actually happens, as modern monetary theorists describe it, or whether economists can continue to pretend that banks are intermediaries who take in saver deposits and lend them out again, as may have been true when the world was ultimately linked to the gold standard before 1971.

The authors spend 52 pages working through their task. And as Steve says, it is crap.

How do I know? You only need to read a little bit of the paper (which was last revised in November 2017) to know that because, as they say:

Almost all models of banking - be they micro- or macro-oriented - are based on the so-called "loanable-funds approach to banking": Banks are financed through deposits, equity, and other financial contracts, and then they lend to firms or buy assets. In our current monetary architecture, however, the opposite process is at work. Banks start lending to firms and simultaneously create deposits. Firms use deposits to buy investment goods, and deposits flow to households who decide about their portfolio of bank deposits, bank equity, and other assets they want to hold. Subsequently, households buy consumption goods, and deposits are transferred back to firms that, in turn, repay their loans. We call this approach the "money-creation approach to banking."

So far, so good then: they recognise that almost all economics has got banking wrong and they realise the way the world really is. But then they ask this:

In which circumstances do the money-creation and loanable-funds approaches yield the same outcomes? In our paper, we establish a simple benchmark result. In the absence of uncertainty and thus of any bank default, both processes yield the same allocation. Hence, in such cases, using the loanable-funds model as a shortcut does not imply any loss of generality.

So, having recognised that economics has got banking wrong these two authors then expend considerable effort in trying to prove that they can ignore what they know to be right and can instead persist in using a model that they know to be wrong. What is more, they claim to have shown that this is possible, because what else can the word 'establish' mean? All they asked their fellow economists believe is that there is a world in which there is no uncertainty and that banks cannot, as a result, ever default. Or to put it another way, they say 'let's just assume that 2008 did not happen and carry on as we did before'.

There are those who would like to suggest that Howard Reed was wrong to say that economics needs reconstruction. You do, however, only need to see a paper like this, which is designed solely to maintain the economic status quo based upon an absurd set of assumptions to support the claimed existence of a market that cannot, and does not, exist in reality, to see why that reconstruction is essential. We can no longer live with this sort of crap. Or to put it another way, we can no longer live with this sort of completely rubbish approximation to the truth.