Alþingi
Erindi nr. Þ 141/872
komudagur 4.12.2012

Nefndarsvid Althingis
Austurstraeti 8-10
150 Reykjavik
ICELAND

Dear Esteemed Members of the Althing,

It is an honour to submit my expert evidence to the world's oldest continuously functioning democratic parliament.

Please allow me to introduce myself briefly. I am Professor of International Banking at the University of Southampton in England, and Director of its Centre for Banking, Finance and Sustainable Development. I have previously been Professor of Monetary Economics at Goethe Unviersity Frankfurt and Sophia University, Tokyo. Furthermore, I have worked at the Bank of Japan and the Japanese Finance Ministry, and as senior consultant to the Asian Development Bank. I have been Marie Curie European Commission Fellow in Economics at the University of Oxford. In addition, I have gathered experience in the private sector as chief economist of Jardine Fleming Securities (Asia) Ltd., and as senior managing director of a large US asset management firm. I am known as the person who propagated the concept of 'Quantitative Easing' in Japan in 1994/5. I have warned of the pending Japanese banking crisis in 1991, and have warned of the Asian crisis, as well as the European banking and economic crises (e.g. in my books of 2003 or 2005).

I am responding to your call to submit evidence concerning Proposal No. 262 on the ability of banks to create the money supply. This ability of banks has indeed been the root cause of the Icelandic crisis, and it is in my opinion indeed better to separate this function - which is a function best performed by the state - from standard financial intermediation, which banks should continue to perform.

However, the separation of these two functions has to be done right. My proposal is very simple, but also overcomes some of the problems with alternative proposals.

As I have explained to a member of the committee working on the new Icelandic constitution (who contacted me quite a few months ago) it would be best to have this separation enshrined in the constitution, as it affects all other aspects of society. But it can of course also be done through legislation now.

The best would be to have state money that is issued solely by the state, who is the sovereign and hence historically the only entity with the right to issue money (seignorage). This should include digital money.

The way to take away the power from banks to create money would be to require them to hold any and all customer deposits 'in custody'. The Finance Ministry would provide such custody accounts. Please find further details in my attached report which I have quickly put together to meet today's deadline.

I visited the old and the new Althing in the summer of 2000, on my honeymoon, and was most impressed by them, and indeed by this wonderful country. I would be happy to provide witness testimony or expert advice in person in Iceland.

Thank you for your kind consideration.
Yours sincerely,
Richard Werner

Professor Richard A. Werner, D. Phil. (Oxon) Chair in International Banking Director, Centre for Banking, Finance and Sustainable Development University of Southampton Management School Southampton SO17 1BJ UK Tel. 023-8059-2549 Fax 023-8059-3844
werner@soton.ac.uk<mailto:werner@soton.ac.uk>

http://www.southampton.ac.uk/management/about/staff/werner.page

UNIVERSITY OF Southampton

How to Turn Banks into Financial Intermediaries and Restore Money Creation and Allocation Powers to the State

by Richard A. Werner, D.Phil. (Oxon)
Professor of International Banking

Centre for Banking, Finance and Sustainable Development | 8 Nov. 2012

Content:

CBFSD Policy Discussion Paper No. 3-12

How to Turn Banks into Financial Intermediaries and Restore Money Creation and Allocation Powers to the State

Executive Summary

An increasing number of observers has become aware that currently banks do not function in the way that is described in many textbooks, namely as pure financial intermediaries, gathering deposits that are then loaned on to borrowers. As is described in earlier CBFSD Discussion Papers and publications of this author (see References), banks in fact unite two functions, that of financial intermediary, taking in deposits and lending out money, with the function to issue and allocate the money supply. This combination is the answer to the age-old question: 'what makes banks special?' and the conundrum that has puzzled economists for many decades, namely why do banks choose to combine deposit-taking activities with loan granting activities.

This raises the question whether it is economically and socially optimal to unite these two distinct functions in the hands of banks. There are no known economic grounds why they should be. In particular, there is no empirically-grounded study that has provided any justification for having the function of deciding the quantity and allocation of money that will be newly created and injected into the economy for different purposes in the hands of private, profit-oriented enterprises. A survey by the author has shown that the public would not agree to have this sovereign right in the hands of the private sector. Furthermore, it can be demonstrated that it is not economically efficient to allow banks to fulfil this sovereign prerogative. It is argued that the recommended separation of money creation and financial intermediation would create significant benefits in terms of savings, economic efficiency and economic growth, in addition to resulting in greater economic equality.

This raises the question of how to restore the money creation prerogative and benefits to those to whom it belongs: the people. A number of plans have been presented on how to do this: the Robertson-Huber plan (including its Positive Money version), the Kotlikoff plan, and the Chicago Plan, which has recently been endorsed by senior IMF staffer Michael Kumhof.

In this paper a simpler method is presented to achieve the same goal, which has some advantages over alternative proposals.

How to Turn Banks into Financial Intermediaries and Restore Money Creation and Allocation Powers to the State

1. Introduction

An increasing number of observers is becoming aware that currently banks do not function in the way that is described in many textbooks, namely as pure financial intermediaries, gathering deposits that are then loaned on to borrowers. As is described in earlier CBFSD Discussion Papers, banks in fact unite two functions, that of financial intermediary, taking in deposits and lending out money, with the function to issue and allocate the money supply.[1] This combination is the answer to the age-old question: 'what makes banks special?'

The realisation of this reality raises the question: should these two distinct functions be united in the hands of banks?

The author has argued elsewhere that keeping these two functions together in the hands of banks creates many problems. For one, modern bank regulations and even monetary policy implementation treats banks as mere financial intermediaries. Domestic banking regulation and international capital adequacy rules have been designed as if banks do not create the money supply. This explains why the discussion surrounding Basel III introduced the idea of counter-cyclical capital adequacy rules based on the logic that during times of economic boom higher capital requirements would slow bank credit extension. In actual fact, the economic boom is a function of bank credit creation, which means that banks have been expanding the money supply (see Werner, 2010a). Hence it will be possible for banks to meet higher capital adequacy requirements without slowing bank credit creation: the latter creates more money that can circulate and partially be raised by banks as new capital (via preferred shares for instance).

Since the 1980s, bank regulation has not recognised that banks fulfil two functions at the same time, and has focused only on the financial intermediation task of banks. As a result, the credit creation aspect of banking has remained unchecked, despite the fact that studies have warned since the early 1990s that bank credit for transactions that do not contribute to GDP (i.e. asset transactions) are the cause of asset inflation, asset price bubbles and the recurring banking crises, and hence monetary and banking authorities need to monitor them and curb them. A simple rule that central banks could follow would be to ensure that bank credit growth stays in line with nominal GDP growth. The most effective way to avoid such unproductive and unsustainable credit creation for non-GDP transaction would be to impose a banking regulation that allows banks to only lend for transactions that contribute to GDP.

However, since national and international banking regulation has, despite warnings to the contrary, continued to treat banks solely as financial intermediaries, hence making the recent North-Atlantic banking crisis possible, it may now be time to consider an alternative option to solve the problem: instead of waiting for more

[1] Richard A. Werner (2010b), Towards Stable and Competitive Banking in the UK - Evidence for the ICB, University of Southampton CBFSD Discussion Paper 2010, submitted to the Independent Commission on Banking, UK (Chair: Professor Sir John Vickers), submitted 19 November 2010 http://eprints.soton.ac.uk/342277/1/Werner_Soton_Towards_Stable_Banking_201011.pdf

suitable banking regulation, it would be more effect, and yield a number of major economic and social welfare benefits to simply separate the two functions and via legislation render banks as financial intermediaries. This would mean that banking regulation would become suitable and asset bubbles, boom-bust cycles and banking crises would become history.

Furthermore, there is no empirically-grounded study that has provided any justification for having the function of deciding the quantity and allocation of money that will be newly created and injected into the economy for different purposes in the hands of private, profit-oriented enterprises. Here, banker-sponsored economics comes back to haunt its sponsors: since economics has argued for many decades that banks are mere financial intermediaries, the bankers have not developed any justification for their other, little-known but pivotal function, namely to decide the quantity and allocation of money that will be newly created and injected into the economy for different purposes.

2. How to separate money creation and financial intermediation

This raises the question of how to restore the money creation prerogative and benefits to those to whom it belongs: the people. A number of plans have been presented on how to do this: the Robertson-Huber plan (including its Positive Money version), the Kotlikoff plan, and the Chicago Plan, which has recently been endorsed by senior IMF staff.

Here, I would like to explain the simplest method to render banks mere financial intermediaries, and hence allow the state to create the money supply.

Effectively, all that is necessary to take away the money creation power from the banks is to require them to conform to the same rules when it comes to 'client money' as other non-bank financial institutions.

The 'Client Money' regulations affect all firms that accept money from others. In the UK they have been imposed and are currently still policed by the FSA. They require the segregation and safe custody of client money, so that, in the case of insolvency of the firm, the client's assets are not affected. Currently, under UK legislation, banks are exempt from this client money rule. As a consequence, when money is 'deposited' with banks, this money becomes an asset of the bank, and is not held in custody or safe custody. It is also not held in accordance with client money rules. Instead, the money 'deposited' with the bank is now owned by the bank. The 'depositor' has in actual fact become a general creditor to the bank.

It is important to note that these legal facts are not in line with the general understanding of the role of bank deposits in the public. The terminology used to refer to such investments with banks – namely the habit of referring to them as 'deposits' – has generated the false impression among the public that money paid into a bank is held in custody, or safe custody, by the bank. This is not the case. To the contrary, unknown to the majority of the general public, when money is deposited with a stock broker or asset manager, this money is held according to the FSA client money rules, and hence is held in safe custody. In case of default of the stock broker or asset manager, the client's assets are unaffected. Meanwhile, the situation is the opposite with banks. Since money placed in a current account with a bank is not held in custody, it becomes owned by the bank, and the usage of the term 'deposit' is somewhat misleading.

It is the exemption of banks from the 'client money' rules that allow banks to create credit and produce the money supply: when a bank grants what is called a 'loan', it will credit the borrower with the amount of the loan, although no deposit has been made by the borrower. This is so, because deposits are not held in custody, and hence the bank can create new deposits without any money having been transferred away from anywhere inside the bank or from within the economy – because it can create a liability to itself without reference to others. By contrast, if the bank is required to also implement the client money rules, deposits by clients would truly become 'deposits' in the sense of being money held in safe custody, and banks could not create such custody accounts, or 'true' deposits at will, since they would have to be held outside the bank, and separate from the assets and liabilities of the bank.

Presently, when a client of a UK stock broker puts money into his account with the stock broker, with a view to (at some stage) purchase securities (and the account could be a regular one or a tax-advantaged savings account, such as an ISA or SIPP), then the stock broker holds this client money according to the FSA client money rules, namely in deposit. This means that it is not booked as an asset of the stock broker. The stock broker does not own the money. But the stock broker deposits it with a bank. As a result, we see that the current usage of custody accounts has created and sustained systemic problems, which would be resolved in my proposal: while your money with the stock broker is not the stock broker's and hence is safe if the stock broker goes bust, it is not strictly speaking safe (beyond the deposit insurance payoff of currently GBP 85k) with the custodian, since this is a bank that likely holds the money as a straight deposit, not as a segregated custody account, since banks are exempt from the Client Money rule and need not hold client money in segregated custody accounts.

This is indeed the core of the problem, and the main reason why there is an abyss in understanding between the general public and the actual reality. People think money they deposit with a bank is held 'on deposit' and hence in a segregated custody account. With stock brokers I think the general public thinks the opposite, namely that the money they transfer to their stock broker is likely part of the assets of the stock broker. But in reality it is the other way around. Money with a stock broker is safe and not encumbered by the bankruptcy of the stock broker. Money with a bank is owned by the bank, not in a segregated custody account, but part of the assets and liabilities of the bank itself, and hence directly affected in case of bankruptcy. If a bank goes bust, depositors are ranked as 'general creditors', after super-ordinated creditors with higher claims – although before subordinated debt and of course before equity owners.

So the solution is to turn reality closer to the situation that the general public thinks we already have, namely abolish the banks' exemption from the client money rule and require them to hold client money in segregated accounts with a true custodian.

In order to render this proposal workable, it is necessary to designate a suitable entity as the location for custody accounts. Since this should not be any form of bank, it is here proposed that this function should be performed by the Treasury (Finance Ministry) itself. In other words, the Treasury (or Finance Ministry in other countries) offers named safe custody accounts to the public – to individuals, firms and also to banks.

This would mean that money deposited with banks is not owned by them, while they would have to make a transfer of funds to their Treasury custody account. As a result, when banks grant a loan, it is necessary for them to transfer money from other

accounts to the Treasury, without being able to simply invent a client account that is their liability (as has been the practice so far).

In order to use the current 'grid' of payments systems between banks, the Treasury would have to itself join the settlement systems (RTGS, SWIFT, BACS, CHAPS, Faster Payments, and the cheque clearing houses) – which is not a problem. But the Treasury would by law be the only entity exempt from the client money rule, and hence be the only remaining 'true bank'. This would make sense, because the Treasury would represent the sovereign and exercise the sovereign right to create credit.

So the only requirement for this new system would be the abolition of the client money exemption for banks, and the provision of custody account services to all financial institutions by the state.

In this scenario the Bank of England itself would be denigrated to mere financial intermediation bank, albeit owned and directed by the Treasury. Its role would diminish greatly, as it could focus on channelling directed public lending (from the Treasury) to preferred parts of the economy (which may include the financial intermediaries).

How would this system be phased in? It does not need any phasing in. As soon as custody accounts have been opened by all financial intermediaries at the Treasury, the exemption from the client money rule could be revoked. From that very moment on, banks would not be able to create credit. They would of course continue to take deposits (in custody). Customers would be informed that they could choose to sit on 'cash', whereby the custody deposits stay put, and receive no interest, or that they could choose to invest them in different investment schemes, such as firms that the bank wishes to lend money to. Money used for such purposes would not be in a safe custody deposit, but would be transferred from the client's account tto the borrower. This would be money at risk, and would incur a higher interest than the safe custody accounts.

We see that the simplest way to separate the financial intermediation function from the credit creation function (i.e. the function of the banking system to create and allocate the money supply) is to require banks to conform to the client money rule and rescind the current exemption from it. Requiring banks to always hold customers' money in custody would end private credit and money creation by banks.

3. Who would create the money supply?

If the banks are required to comply with the client money rule, they would not be able to increase the money supply. However, for nominal GDP growth to take place, more money needs to be created and used for GDP-transactions (Werner, 1992, 1997, 2005).

This means that an alternative mechanism for money issuance is required, in order to substitute for bank credit creation, which has hitherto accounted for 97% of the money supply (the remaining 3% are created by the central bank) (see Ryan-Collins et al., 2011).

Since the privilege to create and allocate money is a sovereign prerogative, it is proposed that the state, via its finance ministry (the Treasury in the UK), perform this function. This has the major advantage that a ready process for the injection of

funds exist that does not create any further costs (such as in the form of interest liabilities). This process is government spending.

In other words, the treasury should defray government expenditure (government consumption, government investment) by crediting the safe custody accounts of the sellers, which they maintain at the Treasury. This way, debt-free money is created and spent into circulation by the government. The central bank and the banking system are not needed for this, and no interest charge (as in the case of bank loans or bond issuance) or bond issuance (underwriting) fee is incurred (as in the case of bond issuance).

Consequently, the government would directly obtain the full seigniorage of its money issuance, and hence national debt would be lower, while spending on servicing the debt would fall significantly as well.

There would be a third benefit of this scheme: the state acquires the power to allocate the newly created money to beneficial, welfare enhancing purposes and prevent abuse of this allocation power, as happens when profit-oriented enterprises (banks) exercise it.

4. Key Advantages

There are major advantages to this proposal: hedge funds and private equity funds could still try to obtain 'leverage', but they would not receive it from credit creators, as currently (which creates the unsustainable asset bubbles, busts and banking crises). Instead, financial intermediaries could lend money to them, and this would have to be reported to the lenders. Thus transparency would vastly increase, accountability would become a possibility, and true choice and competition would for the first time come about in the centre of the financial sector that had previously been occupied by credit creating banks whose activities had remained shrouded in mystique.

Most of all, banking crises and bubble and bust cycles would become history.

But how could we get growth? For this, we need productive credit creation. Since banks had failed to provide this in the past, the privilege of credit creation is taken from them, and henceforth the Treasury creates credit and ensures it is used productively: newly created credit is spent into circulation by the government. The most productive investments are in human resources, education, health and medical provision and research, R&D, and indeed the production of humans (for instance by rewarding families with GBP100,000 per newly born baby). Spending on defence should of course be cut drastically, as it is one of the most wasteful and unproductive.

For the first time in many centuries the sovereign would issue money, and people would for the first time ever be able to hold the government to account for its creation and allocation of money.

National debt would fall drastically and there would not be a need to spend money on interest on debt.

Meanwhile, until such a regime is introduced, the policy recommendations discussed in earlier CBFSD discussion papers, on how to end a banking crisis, recapitalise the banks and generate sustainable economic growth without additional expenditure apply (see Werner, 2012a, 2012b).

Most of the other proposals to end 'fractional reserve banking' and take away the power to create the money supply from banks (such as the Chicago plan) suggest that money creation should be conducted by the central bank (in the US, the Federal Reserve). However, since the Federal Reserve Bank of New York, which is the de facto central bank within the US banking system, is 100% privately owned, this leaves money creation in the private sector and would still require the government to get indebted to fund spending that exceeds tax revenues. Furthermore, a substantial amount of tax revenues have to be devoted to servicing interest on government debt in such a scenario.

I thus recommend to issue state money and not rely on a central bank. Central banks have historically become very independent from governments and even when legally not independent have lacked meaningful accountability. Thus it is not justifiable with the principles of democracy to vest the most powerful economic policy tools – monetary policy, i.e. the power to create and allocate the money supply – in an institution not democratically elected and not accountable to democratic institutions.

My proposal overcomes this problem as the state is the issuer of the money supply.

References and Further Reading:

Lyonnet, Victor and Richard A. Werner (2012), Lessons from the Bank of England on 'quantitative easing' and other 'unconventional' monetary policies. International Review of Financial Analysis. 25, 1-17, doi: 10.1016/j.irfa.2012.08.001

Ryan-Collins, Josh, Tony Greenham, Richard Werner and Andrew Jackson (2011), Where Does Money Come From? London: new economics foundation

Werner R. A. (1995). How to create a recovery through 'Quantitative Monetary Easing'. The Nihon Keizai Shinbun (Nikkei), 2 September 1995 (morning edition), p.26 (in Japanese). English Translation available at http://eprints.soton.ac.uk/340476/ .

Werner R. A. (1997). 'Towards a new monetary paradigm: a quantity theorem of disaggregated credit', with evidence from Japan. Kredit und Kapital, Duncker and Humblot, Berlin, 30, pp. 276–309. available at http://eprints.soton.ac.uk/36569/

Werner R. A. (2002), 'How to Get Growth in Japan', Central Banking, vol. XIII, no. 2, November 2002, pp. 48-54

Werner R. A. (2003), Princes of the Yen, Japan's Central Bankers and the Structural Transformation of the Economy, M. E. Sharpe

Werner R. A. (2005), New Paradigm in Macroeconomics. Palgrave MacMillan.

Werner, R. A. (2009). Financial crises in Japan during the 20th century. *Bankhistorisches Archiv*, 47, 98-123, available at http://eprints.soton.ac.uk/186635/1/Werner_Bankhistor_Archiv_2009_postfinal.pdf

Werner, R. A. (2009). Financial Crises in Japan during the 20th Century. Bankhistorisches Archiv, Beiheft 47, pp. 98-123

Richard A. Werner (2010a), Comment on Strengthening the Resilience of the Banking Sector, official submission to public call for comments on 'Strengthening the Resilience of the Banking Sector, Consultative Document' by the Basel Committee on Banking Supervision, September 2009. Submitted 16 April 2010; published by the Bank for

International Settlements, Basel. Available at http://www.bis.org/publ/bcbs165/universityofsou.pdf or http://eprints.soton.ac.uk/342280

Richard A. Werner (2010b), Towards Stable and Competitive Banking in the UK - Evidence for the ICB, University of Southampton CBFSD Discussion Paper 2010, submitted to the Independent Commission on Banking, UK (Chair: Professor Sir John Vickers), submitted 19 November 2010 http://eprints.soton.ac.uk/342277/1/Werner_Soton_Towards_Stable_Banking_201011.pdf

Werner, R. A. (2011). Economics as if Banks Mattered – A Contribution Based on the Inductive Methodology, Manchester School, 79, September, 25–35. doi: 10.1111/j.1467-9957.2011.02265_5.x

Werner, Richard A. (2012a) The Euro-crisis: a to-do-list for the ECB. Southampton, University of Southampton (Centre for Banking, Finance and Sustainable Development Policy Discussion Paper 1-12). Available at: http://eprints.soton.ac.uk/341648/

Werner, Richard A. (2012b) How to end the European crisis – at no further cost and without the need for political changes. Southampton, University of Southampton (Centre for Banking, Finance and Sustainable Development Policy Discussion Paper, 2-12). Available at: http://eprints.soton.ac.uk/341650/

Werner, Richard A. (2012c), Towards a New Research Programme on 'Banking and the Economy' – Implications of the Quantity Theory of Credit for the Prevention and Resolution of Banking and Debt Crises, International Review of Financial Analysis, 25, 94-105, doi: 10.1016/j.irfa.2012.06.002

Werner, Richard A. (2012d), Time for Green Quantitative Easing, Policy News, vol. 3, no. 1, University of Southampton, Centre for Banking, Finance and Sustainable Development