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Designing financial institutions for a shrinking or no-growth economy

steering paper

Richard Douthwaite

Leaving insurance aside, two broad types of financial institution will be needed in a de-growth world. Some institutions will be concerned with payments. They will look after the movement of money from one account to another. Although new actors such as liquidity networks may enter the field, there seems to be no need for any significant change to the basis on which the institutions currently handling money transmission work to cope with degrowth. Accordingly, the workshop will concentrate on the second type of institution, those handling savings, investments and pensions.

People will always want to save in order to provide for their retirement and to have a financial safety net should something unexpected happen. They may also wish to save to provide themselves with the resources to achieve an objective. Their urge to save is strong and historically they have been prepared to pay a cost - such as seeing the real of their savings eroded by inflation – to do so.

People will also wish to borrow, whether to invest in a business, or to buy something like a house or car which will provide a stream of benefits for a considerable time, or to help them through an emergency.

The purpose of the institutions we are considering is to act as an intermediary between savers and borrowers. At the moment, among other activities, these institutions take in specific amounts of cash and promise to pay interest to the depositor for as long as they have the use of it. They also lend out specific amounts of cash and charge interest on it until that specific amount is paid back. The difference between the rate of interest paid to savers and that to lenders is the margin on which the institutions operate. If a borrower fails to repay, the institution must make up the shortfall out of its margin and, if that is insufficient, out of its own capital.

As the economy contracts, if the money supply contracts along with it these institutions will find it increasingly difficult to get the money they lent back from their borrowers. Only if the money supply increases at a rate equal to the net rate of interest will borrowers find it reasonably easy to get the money together to repay. (By "net rate" I mean the rate at which interest payments actually remove money from circulation. If a bank uses part of its interest receipts to meet its running costs, then it is putting that part back into circulation). Such an increase is unlikely unless it is brought about deliberately by injecting non-debt money into the economy in the way discussed in the steering paper on money systems.

If the money supply does not increase as the economy contracts the lending institutions will make losses and collapse. They therefore need to devise a new business model. Fortunately, there is one already. It's called Islamic finance, or, in Britain and the US, a limited liability partnership.

In an LLP, the investor does not get a set rate of interest or a fixed amount of money back. Instead, he or she gets an agreed share of the gross income (not the profit) earned by the company. For example, in 2002 the Hilton Hotel Group in England invested a portfolio of ten hotels in a capital partnership LLP. Another LLP then invested £350m in the partnership to refurbish and expand the hotels. The partners share the gross revenue from the hotels' operations rather than the profits.

In a shrinking economy, the conventional way of sharing a firm's income will destroy it. Fixed costs which cannot be renegotiated downwards in the short-term – interest payments, rents, salaries – will force it into a loss. Firms therefore need to become LLPs by converting their fixed payments into shares of their revenue stream so that, if the revenue goes down, the payments go down proportionately.

A short-term way for a company to raise capital would be to pre-sell its output using bonds. This gives the purchaser a share in the firm's future income at a specific time, rather than for as long as it stays in business as would a stake in an LLP. For example, an energy company could sell bonds which entitled the bearer to take delivery of, say, 10,000 kWh in four years' time when the new supply came on stream. The company would redeem the bonds by paying the bearer the value of the electricity on the day they were presented. The money for the repayment would, of course, come from the company's customers. This feature would allow the company to become customer-owned if the promoters so wished. If these bonds were in small denominations, they could be used as a savings currency.

I suggest that the workshop thinks through how these two models – sharing an income stream and pre-selling output - could be applied to the savings account one has with a bank, to a mortgage and to a pension scheme. Perhaps an institution could offer a savings account as a “tracker” - the value of your deposit would track national income, and so would the loans it had made. Alternatively, the institution could buy bonds and pay a dividend to its savers based on the return when the bonds matured. Your pension scheme could be made up of shares in the income flow from perhaps twenty LLPs, assembled by your pension provider. House purchase mortgages might be provided by relating the monthly repayment to average incomes.

Possible questions for the workshop to consider

1. Will it really be difficult to pay debts denominated in money in a shrinking economy? If so, can debts be denominated in other ways? Or is specifying a proportionate share of whatever is available a better way?
2. If the value of the money one had in a savings account was related to national income, and it was known that national income was going to fall, would people gain or lose purchasing power? Would they withdraw all their cash? What would they do with it? Would hoarding be a problem? How would money transmission accounts be affected?
3. If companies were to raise capital by pre-selling their production in the form of bonds, what functions would the institution which enabled them to do so have to perform?
4. It's easy for firms producing a commodities like electricity or sugar to specify how their bonds will be valued when they mature because the market price is there for all to see. But supposing I make furniture, how could my future output be valued as I won't be making the same things in five years' time that I am today?
5. If mortgage payments were related to average incomes in a country, how would the savers who provided the funds for that mortgage be rewarded?