The Financial Crisis – the collapse of trust

Credit - from the Latin 'credere' – to believe or to trust. Banking relies heavily on trust and confidence. But the banks do not trust each other and the public are losing confidence in the banks.

We all rely on the banks for creating 97% of the money we use for everyday transactions.

The banks have dis-credited themselves by too much debt creation. The debt creation was largely for speculative purposes – this means basically that they were gambling and lost.

We are all dependent on bank money for our transactions so a banking collapse would be catastrophic. This means that the banks expect to be bailed out if things go catastrophically wrong. This encourages excessive risk taking.

In the last few years deposit banks have become highly interdependent on other financial institutions so that if these go bust they will pull the banks down with them – these have to be bailed out too – e.g. insurance companies that insure against credit defaults. In the 'derivatives market" one institution's insurance was actually another institutions bet.

Common Mis-understandings about money creation:

The government creates money, the people put it in the banks and banks lend it on – ***Wrong***

The Banks create the money that they lend – they lend it into circulation - but must keep a proportion of their assets in cash firstly in case customers want to withdraw deposit money and secondly for interbank settlements. The central bank helps them achieve this - ***Right***

Bubbles and leverage - speculation with borrowed money

Example of Leverage on the way up. **I buy the shares of a company for £100million and use £1million of own money + £99 million borrowed money. The price of the shares of the company go up by just 1% so that the shares I own are now worth £101million.**

I now sell them and repay the debt. I started with £1million and ended up with £2million.

Leaving aside the interest payments - with a 1% gain in stock values, I have doubled my money.....This kind of situation encourages frenzied buying which bids up prices in a self fulfilling spiral....until the bubble pops.

Leverage on the way down. **The price of the shares bought for £100million with £99million credit and £1 million of own money goes down by 2% - I have lost all my money and must find £1million from somewhere that I cannot raise by selling the shares which are now worth only £98million.**

This creates a financial panic and unleashes a "deleveraging avalanche" across the financial sector.

In this example the maths have been simplified and exaggerated – but many financial institutions in Europe are leveraged by 30 or more – if not the 99 as shown here.

The Avalanche of Debt Deflation

When people fear mass insolvency, lenders stop lending and the indebted stop spending. The result can be the "debt deflation", described by the American economist, Irving Fisher, in 1933 and experienced by Japan in the 1990s.

(1) Speculators sell, the prices of the assets that they bought with leveraged credit falls even further - e.g. falling house prices – so they get further into negative equity. (2) People cut back on their spending to pay their debts but reduced spending means reduced sales and reduced incomes for others who find it even more difficult to pay their debt.(3) Companies cut back on investment expenditure which reduces income of the producers of capital goods – so debts are more difficult to pay.(4) As prices and incomes fall the value of outstanding debts gets more onerous. If prices and incomes halve then the cost of living to income ratio remains the same but the burden of debt repayment and interest rates will have doubled.

The money system needs to be run on different principles

Climate change and peak oil both mean that the energy and production system cannot expand any more without immensely destructive effects.

It is only practical to lend money into existence as the banks do if it can be repaid with interest but if the economy cannot expand then there is no additional output that the banking system can share in when it claims its interest payments.

With the banking system discredited now is the time for citizens to launch campaigns for taking away from banks the right to create money and cleaning up widespread fraud and corruption in the finance sector. It is also the time for local or regional currencies – preferably with the support of local authorities. At all events the money system should be run in the public interest not as a side effect of lending by bankers.

There are many examples of local communities using local currencies both in crisis times and otherwise – to help survive banking crises but also to encourage local exchange and a flourishing local economy.