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# The Bank-State Bargain

***by Graham Barnes***

*"I react pragmatically. Where the market works, I'm for that. Where the government is necessary, I'm for that. I'm deeply suspicious of somebody who says, "I'm in favor of privatization," or, "I'm deeply in favor of public ownership." I'm in favor of whatever works in the particular case."* J K Galbraith

There's no getting away from it. Banks create money out of nothing when they extend loans and then charge borrowers interest on this newly created capital. The result is an ongoing multi-billion pound/ dollar subsidy breaking the basic rules of capitalism. What is perhaps even more surprising is that there appears to be no explicit description of the 'bargain' underlying this important arrangement. What follows is an exploration of elements of a possible rationale for an unspoken agreement.

Until quite recently there was surprisingly fierce argument over the way in which money is created. Thanks largely to determined and repeated enquiry by monetary reformers [1] and propogation of the issue via social media, there is now consensus over the role that private banks play in originating money in the form of loans, essentially ex-nihilo - out of thin air.

Recently the Bank of England somewhat belatedly broke their silence and joined this consensus via an in-house publication on the subject [2]. So we have a little light shining in on the phenomenon of which J.K. Galbraith in 1975 wrote: "The process by which banks create money is so simple that the mind is repelled.[3]"

The amount of money in circulation has increased rapidly since 1970 [4]. According to one source, in the UK alone more than £200 billion a year seigniorage (profit from money-issue) is achieved via interest on loans to banks [5]. The money that is loaned out does not represent the fruits of the banks' labour or innovation. It is created at a stroke of a pen. The extent to which banks are constrained by rules and regulations (reserve ratios, capital adequacy) can be debated to some extent, but it appears to be negligible. The extent to which this unearned £200 billion carries corresponding costs (e.g. reserve costs, operating costs) can also be debated, but it is minimal. What exactly do banks provide in return for this bounty?

The answer (although as we say, it does not appear to be articulated anywhere) may be that banks are seen to provide:

i) trustworthy, stable influence over the quantity of money-issue ii) superior quality of capital allocation iii) the provision of essential financial services iv) the operation of payment and settlement systems v) deniability - providing a buffer for politicians enabling denial of responsibility for unfavourable events vi) an agency role in pacifying the population through the burden of debt vii) front-line capability (and a quartermaster role) in international financial wars

We can look at these briefly in turn ....

The Quantity of Money, in orthodox economics, is moderated by the price of money - the interest rate. The base rate determines a floor to the price, and the private banks in turn 'mark up' the interest rate according to the risks they perceive on a particular loan and the demand for money. This 'money market' narrative has never adequately described the real world. Even neoliberal economists recognise 'market failure' in this area, and have been content to support state intervention in the form of Quantitative Easing. (A likely fruitless sidetrip is possible here, so we will content ourselves with the observation that QE is preferred to so-called helicopter money because - the argument is - it can be 'unwound'[6]. In other words the troubled assets/ bonds bought, releasing money into circulation, can be sold at a later date removing that circulating money. Of course the price achieved is irrelevant.)

So if it is widely accepted that private money-issue left to its own devices causes crises that need periodic intervention, exactly what role in the private/ public mix does it play? Each round of regulatory measures aims to reduce the frequency and severity of crises but never does. It is as if the errant son is regularly forgiven and put back in charge of the shop after each bailout with minor changes to his groundrules. Such indulgent treatment makes him progressively cavalier about his behaviour. He knows whatever he does will be forgiven, and after a short period of public penitence resumes business (and bonuses) as normal.

The Quality of Capital Allocation is just as problematic. The assessment of risk is faulty - to the extent that interest rates achieved are more a measure of insider status than assessed risk. This preferenced access to capital reserved for friends of the casino has unfortunate side effects, including the taking out of innovative start-ups by less effective incumbents with better access to capital via leveraged buyouts. Worse still, there is no national (or planetary) strategic guidance over capital allocation. The banks are implicitly trusted to be the proxies of the market and to allocate funds 'efficiently'. Unfortunately their idea of efficiency will likely result in a dead planet for our grandchildren. Maybe the 'free market' can be safely trusted to produce all the things we dont need but for the stuff-of-life market failure is the norm - failure in terms of socially unacceptable outcomes.

The Quantity and Quality of capital allocation as credit can be (and is) articulated as part of the neoliberal narrative - the superiority of profit-motivated decision making, the inability of governments to 'spot winners', the highlighted failures of public procurement projects.

It is true of course that core financial services are vital. Producers need to insure against events and hedge risks. But most of our over-financialised economy is betting on other peoples risks rather than insuring our own. The resulting market in derivatives is so complex that no-one knows where the risks actually lie should the bets need to be unwound. This inherent uncertainty, which cannot be resolved except through a crash, results in a political inability to let businesses fold. The financial services industry is too interconnected to fail, and politicians dont want to take the risk of triggering a crash on their watch. It might be containable but it might not. No-one knows. Essential financial services should be provided via a stripped down version of the sector. We have, through sins of omission, allowed the real economy to be relegated to a corner of the casino.

There are many inter bank payment and settlement systems enabling national and international funds transfer, interlinking ATM networks and so on. They are run by a variety of bank consortia and co-operatives and enable a range of valuable personal and corporate services. These valuable services act as a sort of 'human shield' for the casino extremists. There is no reason that their function could not be provided by neutral 'outsider' or public service networks but it has to be accepted that this level of corporate re-engineering is not likely to be attempted. The complexity of interconnection, though, adds to the uncertainty surrounding any domino-collapse scenarios, and contributes to the general market failure of the banking sector. The uncertainty, which is often cultivated by the banks themselves when crisis threatens deprives the banks of that divine right of capitalism - the right to fail.

The importance of core financial services and payment systems is emphasised in the prevailing narrative, but these are presented as inseparable from banking per se. Arguably the dismantling of barriers to functional diversity (like Glass Steagall) have facilitated the 'complexification' and loss of resilience of modern banking, in the process creating the uncertainty that governments find it so hard to confront.

Of course, for politicians the idea of the free market is immensely attractive. The 'invisible hand' of the market works away, automatically allocating resources where they are best used and encouraging competition so that progress is guaranteed. That's the theory. And none of it calls for any difficult value judgements. If things go wrong it was nothing to do with decisions they made because they didn't make any. Unfortunately free markets don't exist and the idea that if we tweak the regulations right we can get them to is to deceive ourselves. As Galbraith says in the quote at the beginning of this article we have to be more pragmatic about intervention. A good rubric would be 'if it doesn't really matter leave it to the market'. And money really matters.

In a previous article [7] I argued that there are three fundamental problems with mainstream money - the misallocation of capital referred to earlier, the impact of interest-based debt and the monetisation of everything. Certainly the level of debt and the interest burden taken on by the current generation is grinding it down and acting as a drag on the economy. We can be forgiven for imagining that the resulting pacification is not entirely unwelcome to the 1%. To Orwell's Prolefeed [8] we can add debt burden debilitation. After earning enough to service our debts (and our childrens) we may not want to do more than sit down on the sofa with a Big Mac and Eastenders. No energy for activism? Shame.

Finally, perhaps the most distasteful part of this unstated bargain is the role the banks play as the front line troops and quartermasters in financial wars. Alongside the use of drones, financial war is perhaps the favourite modern flavour of conflict. The bodies of victims are not so obviously visible. Wars may be national, like the measures being taken against Russia and Iran, or (shock-horror) class-based like the austerity wars of the Eurpean periphery. In either case banks act on the front line, taking measures which match the prevailing ideology and providing to some extent the 'deniability layer' for politicians. It's nothing personal. James Rickards and others have written in some detail about this aspect of the financial system and the likely currency wars of the future. The amoral mindset required to be a diligent financial foot-soldier of the prevailing neoliberal truth is arguably a key factor in the degradation of modern banking. The moral vacuum gradually being uncovered represents a key element of the Deprecated Domain [9] - a driving force for us to design better money-forms than the one currently imposed on us.

These last three aspects - deniability, debt-peonage-management and financial warmongering represent the real 'value for money' that justifies the multi-billion subsidy provided to the banking fraternity via debt-interest. Because these elements of the bargain are not publicly recognised, and for obvious reasons will not be, they cannot be easily attacked. It is for this reason that I believe policy change with respect to money-issue will not be achieved, no matter how compelling the case.

**Conclusion**

Galbraith was right. Governments should be more pragmatic. Politicians should stop hiding behind the skirts of 'the market' and make some judgement calls. Their decisions can be influenced by quantitative analyses including economic indicators expressed in money terms. But they must reflect the fact that many of the most important things in life cannot be easily quantified, and must recognise that reducing everything to numbers leads to faulty decision-making. There is more to people, natural resources and land than a 'Natural Capital' formulation expressed in money terms.

Some of the elements of the bank-state bargain are already under attack from 'disruptive' digital developments and we can expect banking and financial services to be progressively reinvented, over time. But the neoliberal hold over private money-issue policy and its inherent banking-subsidy is secure. Certainly, mainstream media buy-in to the neoliberal narrative supports this intransigence, but the main factor is the hidden services provided to pseudo-democratic government. Without the deniability cloak, governments would be less able to claim that they were at the mercy of 'events dear boy' [10]; a less debt-burdened population would have more time and energy to reflect and question; and the loss of a financial warmongering capability would strike at the heart of the fascist state-corporate nexus. None of these outcomes is desired by TPTB.

Progress in relieving the 'externalities' associated with the beloved free market, such as the premature demise of planet earth, must therefore come from disruptive alternative projects. Some of these will be profit-oriented - so be it; increasingly as understanding and practice develop side by side, they will be commons-based or co-operative. In that context money can be 'design[ed] to serve desirable interests of cooperative users inhabiting a different monetary world' [11]. And we may see, gradually, 'the exodus from proprietary money' [11]. As @ChrisCook and others have said, we need banking but we don't need banks, at least not banks like this.

**Endnotes**

[1]: How Banks Create Money - Positive Money http://www.positivemoney.org/how-money-works/how-banks-create-money/
[2]: Money creation in the modern economy - Bank of England http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q1prereleasemoneycreation.pdf
[3]: John Kenneth Galbraith, Money: Whence it came, Where it Went p. 29.
[4]: see for example: http://www.safehaven.com/article/8030/composition-of-the-us-money-supply http://ieconomics.com/uk-money-supply-m3
[5]: In their seminal publication Creating New Money (1997) Huber and Robertson estimated the gains possible through reclaiming seignorage from UK banks at GBP 49 billion - equivalent at the time to 15% of total UK tax take. The GBP 200 billion + figure is NEF's updated calculation for 2012. Similar (1997) figures for % of tax take were 19% for Japan and between 4 and 6% for USA, Germany, Eurozone.
[6]: see Andrea Leadsom's contribution to UK parliamentary debate on money creation as summarised (and responded to) by Positive Money: http://www.positivemoney.org/2014/11/sovereign-money-response-andrea-leadsom-economi c-secretary-treasury/
[7]: The Mainstream Money Mess: http://www.feasta.org/2015/02/02/the-mainstream-money-mess-three-aspects-and-what-they-mean-for-new-money-forms/ [8]: http://en.wikipedia.org/wiki/Prolefeed
[9]: The Deprecated Domain: the pros and cons of designed exclusion http://www.feasta.org/2014/07/10/the-deprecated-domain-the-pros-and-cons-of-designed-exclusion/
[10]: As Harold Macmillan may have never said: http://en.wikiquote.org/wiki/Harold_Macmillan
[11]: http://www.dyndy.net/2011/08/our-future-our-money-the-design-of-currency-systems/

## About the author

Graham Barnes is a Currency Designer. @GrahamJBarnes He is a Member of Feasta's Co-Ordination Group and co-organiser of the Feasta Currency Group. He holds a PhD in Computer Science and worked at a senior level in IT and online marketing in a previous life. His current projects include the detailed design and delivery of currencies to be sponsored by a local authority; by a social entrepreneur to complement and enhance a well established sustainability methodology; and by a restaurant chain.

***Feasta** is an open-membership-based think tank founded in Ireland in 1998. It aims to identify the characteristics (economic, cultural and environmental) of a truly sustainable society, articulate how the necessary transition can be effected and promote the implementation of the measures required for this purpose.*