8 Savings and the alchemy of credit

Ann Pettifor, director policy research in macroeconomics, fellow of the New Economics Foundation, co-founder of new think tank PRIME and author of several books on government debt and international finance, argues that while savings may make sense at the individual level, government savings are not a precondition for investment – and prosperity.

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"Microeconomic activities should not be linked, by the public or policymakers, to macroeconomic outcomes."

A great many of us believe that savings are a 'good thing' – from both a moral and an economic point of view. This belief stems in large part from the archetypal form of saving: seed-corn. Wise farmers did not use all of their seed-corn at once; instead some was saved for investment in next year's harvest. When seed-corn is held back from consumption, it is saving; when sown, it is investment – and by that process, more corn and seed-corn generated. According to this theory, saving is necessary prior to investment.

Today, despite the development of bank money, and despite the transformation of our financial system; above all, despite the Keynesian revolution, that view – saving is necessary prior to investment, and households control the investment strategies of firms and governments, that view still prevails. Governments believe that in order to invest (in energy efficiency, the health service, transport, education and more), it is necessary first for the nation to save, and to cut back on the consumption of the government's goods and services. In other words, both individuals and policymakers wrongly use microeconomic reasoning to arrive at macroeconomic outcomes.

However, from a macroeconomic perspective saving is not necessary prior to investment and excessive saving can be harmful because it drags down aggregate spending in the economy, and by that means leads to economic contraction, not prosperity.

To prevent such falls in economic activity, governments should aim to counteract the impact of excessive saving, support the private sector and maintain economic activity by increasing spending during an economic downturn. But it also needs to regulate banks more effectively to prevent the reckless lending that was responsible for the recent financial crisis. Only by these means can we ensure prosperity – for governments, for business and for individuals.

The creation of bank money

The economic theory that saving was necessary prior to investment came about, in part, because banks in the past did not have the physical money to meet the demands of rapid industrialisation, and firms could not easily raise funds for large-scale investment. Instead they relied on the savings of individuals. For the Victorians, banks were merely channels, passing money from lenders to borrowers; from individuals to firms and governments. The saving habits of the past were therefore incorporated into Classical economics. They persist to this day in Neo-classical economic theory, which is still dominant in universities and Think Tanks.

But the banking system evolved so that banks were able to create credit in excess of savings. Thanks to credit-creation by the banking system, investment is no longer constrained by saving. To make loans, banks do not have 'savings' or 'deposits' – either theirs or those of others – to extend to others as credit, and on which they charge interest. The money for a bank loan does not exist until we, the customers, apply for credit.

In other words, far from the bank starting with a deposit, and then lending out money, the bank starts with our application for a loan, the asset against which we guarantee repayment and the promise we make to repay with interest. A clerk then enters the number into a computer. The bank then applies to the central bank which provides (on demand) the necessary cash element of the loan. Banks do have to hold a ratio of deposits in the bank, as cash, which is known as the cash ratio or 'reserve requirement'. However, this tends to be a small fraction of total deposits and the overwhelming proportion of credit created by both central banks and commercial banks takes the form of intangible 'bank' money.

Moving beyond savings

Bank money provided a mechanism for lending that did not depend on the generosity of individuals holding savings towards those who did not have savings. As a result, bank money widened and democratised the allocation of credit.

The invention of bank money increased the quantity of money in circulation, which led to a lowering of the rate of interest. This removed control over the 'price' of lending, the interest rate, from the privileged few. Instead, public banks could increase the supply of money, and thereby lower its price (the rate of interest). This led almost directly to the industrial revolution, as entrepreneurs and industrialists were freed from the shackles of the powerful few that hoarded wealth, and could borrow bank money for investment in new inventions at very low rates of interest.

Today, the banking system has advanced even further. For investors who operate in monetary economies, the relevant consideration is the availability of finance, not savings. There need be no constraint on finance because credit is not a commodity, like gold or oil, and there need be no limit to its creation. Unlike a commodity, it is not subject to the laws of supply and demand, so its price – the rate of interest – is a social construct, influenced not by shortages or gluts, but by committees, based in central banks and in the private banking system, who determine the most appropriate rates of interest for the economy or for the private banking sector.

Savings, investment and the monetary economy

Thanks to the development of the banking system, modern economies no longer rely on primitive, individual micro-savings for investment. Instead modern economies are monetary economies, with well-developed banking systems that create credit well in excess of savings. Indeed, as the world's central bankers have recently demonstrated to the public at large, banking systems can create trillions of dollars of what is effectively credit, and is today known as 'quantitative easing' – 'out of thin air'.

It is hard for us to get our heads around the idea of a monetary economy. Our first experience of money tends to occur after leaving school, when our hard work at a new job is rewarded at the end of the month with a pay cheque. We assume our effort generated that money or income. However, for the employer to have hired us in the first place, the employer would need to borrow to invest in that firm and create jobs. Invariably the employer would have raised credit or an overdraft from a bank. That credit, if soundly invested, creates economic activity. Economic activity, in turn, creates income, which can then be used to repay the credit/debt.

In brief: credit creates economic activity. Economic activity generates income and then savings – and is not constrained by savings.

6%

average annual business rates of profit

8 Savings and the alchemy of credit Continued

The risks of a monetary system

However, while the invention of bank money and the development of banking systems was indeed a great spur to industrialisation and human progress, it also posed grave threats.

Credit creation that is not governed by wise regulation and prudence can lead to inflation: too much money chasing too few goods and services. But the reverse can happen too. Banks can withhold credit, as they do after financial crises, and this can lead to deflation: too little credit for the creation of economic activity.

There is a second risk: loans made at rates of interest that exceed, for example, rates of profit, or returns on investment, will with time render debts unrepayable. The result: a 'credit crunch'.

Over the last three decades, the deregulated and increasingly globalised banking system freed up bankers (and the 'shadow banking system') to issue costly credit without consideration for the ability to repay. This 'easy money' generated vast debt inflation. It led to a series of excessive expansions and debt inflations and then severe contractions and debt deflations, beginning on the periphery of the global economy before expanding into Japan and South East Asia. The global economy was finally hit in 2007–09 as the financial system in the US and Europe imploded under the weight of accumulated private debt. Sub-primers were but the first borrowers to buckle beneath the weight of costly, unrepayable debts.

The global economy is now experiencing the destructive contraction and de-leveraging of this massive private sector credit/debt bubble. This credit was generated without full regard for the ability to repay, and at high real rates of interest (think 17% for home loans to sub-prime borrowers on low incomes) and often for purely speculative purposes.

In line with the diagnoses of financial crises made by John Maynard Keynes in his 'General Theory' – but very much contrary to current conventional wisdom – a major cause of the financial crisis was high, not low, real rates of interest, on vast amounts of 'easy money'. Geoff Tily, author of 'Keynes Betrayed', gives credence to this analysis by assembling data that shows rates facing businesses (adjusted for inflation) doubled from around 3% in the 'golden age' (1950–73) to 6% in the three decades thereafter. Annual rates of profit are on average much lower than 6% – making debts unpayable.

While monetarists are concerned with the quantity of money, Keynes's overwhelming concern was with the rate of interest on money. The centrepiece of his policy prescription was low rates of interest. He argued that monetary policy should always support private and public economic activity, stimulate that activity and prevent recession. To achieve this goal, which he believed to be essential to sustained investment and full employment, Keynes rejected deregulation of international capital flows – part of the mass deregulation of mainly Western financial markets which took place in the 1980s and 1990s. He instead favoured restricting flows of international capital and relying more on domestic credit. It is this theory, and the macroeconomic outcomes of this theory, that have been completely sidelined.

17%

interest rates for home loans given to sub-prime borrowers on low incomes

Conclusion

In a modern monetary economy, savings are not a prior necessity for investment, and for the generation of prosperity. Instead, society can draw on a great advance and public good – the banking system – for the creation of credit vital to investment.

Investment creates economic activity, which in turn generates income, and then boosts savings.

To sustain prosperity, our banking system must be wisely regulated. Bankers cannot be allowed to create credit recklessly, at high, real rates of interest. Capital flows must be restrained, if publicly accountable central bankers are to shape lending rates across the spectrum of loans – safe, risky, short, long term.

Such a policy will be of enormous benefit to entrepreneurs, to innovators and to industry at large, as it will incentivise investment. Increased rates of investment in wisely chosen, productive economic activity will in turn generate profits and employment. Increased profits and employment will generate income for individuals and tax revenues for government, which in turn will pay down government deficits.

Sustainable economic activity will create prosperity, income and savings for governments, businesses and households.

Action points:

- Finance, and in particular the commercial banking system, must give up its speculative enterprise, and once again become the handmaiden of the real economy.
- Central bankers and governments must undertake reform of the banking system to regulate credit creation, and to ensure and restore low, sustainable rates of interest across the spectrum of loans.
- The banking system must support both public and private sector investment in wise, sustainable projects that tackle the triple crisis of energy insecurity, climate insecurity, and job insecurity.
- In the low-interest rate environment created by these policies, individual savers should make the most of their money by putting it into economically productive investments with higher rates of return.