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https://www.youtube.com/watch?v=EC0G7pY4wRE

Host Ross Ashcroft is joined also by City of London veteran financial commentator David Buik

Question - **A dominant financial sector – its effect in your view, on the real economy.**

First of all it's interesting that the national income accountants who think a lot about the overall economy, how to measure it and how to structure the data, have been struggling for decades with the question of what to do with the financial sector. Why? Because GDP is actually created by national income accounting, by adding up value-added activities, and that's where the financial sector has a problem. What is the value added?

It's been so difficult that essentially the national accounting statisticians have to make up a fictional value and just add it onto GDP and say Ok that's maybe what the financial sector is doing. Because essentially there is no value added, there's value extracted. So really you need to subtract if from GDP.

Question - **Has the finance sector, the fires sector, become a cost centre. Is there a sweet spot where it's actually serving humanity, society, and facilitating business and when it becomes a prophet generator in-and-of-itself it becomes detrimental to the wider world.**

Exactly, even the mainstream textbooks on finance, banking, and macro monetary economics will show banks as financial intermediaries. Now there's a problem with that. It's clear there is a high price that we're paying for what should be a humble intermediation service that's being performed and the salaries that are being paid, famously very high, which is very strange if they're just intermediaries.

I think there's a structural problem and that is the concentration of the banking sector. In the UK, five banks account for 90% of deposits, which is one of the most concentrated banking systems in the world.

In Germany, those high street banks account for 12% of deposits and 70% of deposits are accounted for by 1,500 local not-for-profit community banks. There is a general tendency when an organisation gets larger and larger and gets very big, essentially decisions are made without accountability and the temptations of power strike.

Lord Acton famously put it this way "power corrupts and absolute power corrupts absolutely".

So when you have very large banks, and only five them dominating the economy, and through the political mechanism and the already financial-sector-centred political system and political infrastructure - you know, the City of London having a person in Parliament that is not the elected, the remembrance of all these rights of the "square mile" as a sovereign state - what you will get is large banks only wanting to deal with large customers in order to do large deals and that's also where you get the large bonuses.

We've done the study on the US which has the biggest banking sector in the world, over 15,000 banks of all sizes and shapes. The very large banks deal with

the very large customers and give very large loans. The medium sized banks give medium sized loans. Who is lending to small firms? It is only the small banks.
Now the UK doesn't have those. So the structure has become too concentrated and what is badly needed in the UK is decentralisation. One has to break up the financial sector and have much smaller units because small banks, community banks, are locally accountable. You can't suddenly do a crazy project or big corruption because people see what you're doing.

Question – We have had those "challenger banks' but they're still tiny.
They will stay tiny, the ones that are UK challenger banks and that are profit-oriented. You know why? The moment they get a bit bigger they will be bought up and they will disappear. This is exactly what happened over the last 100 years.

Question - When you think about inequality in the UK, and it's a hot topic, and you think about, as you would like, the banking sector to be a decentralised, flatter structure, more resilient, how do you begin to talk to the public or the political class about achieving those goals?
If we want to produce something we need funding so there is a role for banks in almost everything that's happening in the economy. But what exactly is that role? Just quickly I'd like to reflect on that.
Banks are being thought of as intermediaries, but that's not really what's happening. Banks are the creators of the money supply.

Question - So you are firmly of the view the banks create money out of thin air?
Yes. I produced the first empirical study to prove that in the 5,000 year history of banking. Banks are thought of as deposit taking institutions that lent money. The legal reality is banks don't take deposits and banks don't lend money.
So what is a deposit? A deposit is not actually a deposit, it's not a bailment, it's not held in custody. At law the word deposit is meaningless. The law courts and various judgements have made very clear [that] if you give your money to a bank, even though it's called deposit, this money is simply a loan to the bank. So there is no such thing as deposit.
The banks borrow from the public. That much we've established.
What about lending surely they're lending money? No they don't. Banks don't lend money. Banks, and again at law it's very clear, are in the business of purchasing securities. That's it.
So you say OK, don't confuse me with all that legalese I want a loan. Fine, here's the loan contract, here's the offer letter, and you sign. At law it's very clear you have issued as security, namely a promissory note and the bank is going to purchase that. That's what's happening.
In layman's terms, that means that what the bank is doing is very different from what it presents to the public that it's doing. How does this fit together?
So you say fine the bank purchases my promissory note, but how do I get my money. I don't care about the details, I just want my money.
The bank will say "you'll find it in your account with us". That will be technically correct. If they say we'll transfer it to your account, that's wrong because no money is transferred at all, from anywhere inside the bank or outside the bank. Why, because what we call a deposit is simply the banks record of it's debt to the public. Now, it also owes you money [for the security it is purchasing from you]

and its record of the money it owes you is what you think you're getting as money, and that's all it is.

That is how the banks create the money supply. The money supply consists of 97% of bank deposits and these are created out of nothing by the banks when they lend. This is because they invent fictitious customer deposits. Why? They simply restate, slightly incorrectly in accounting terms, what is an accounts payable liability arising from the loan contract, having purchased your promissory note, as a customer deposit. But nobody has deposited any money.

I wonder how the FCA deals with this because in the financial sector, you're not supposed to mislead your customers.

So the banks create the money supply by inventing these claims on themselves, these fictitious deposits. But that can be actually positive for the economy, as long as this money creation is in line with the creation of new goods and services and implementation of new technologies, therefore adding value, and adding value in the economy is funded by this money creation. If that happens and we talking about business investment, productive loans, productive bank credit, you will have no inflation. These loans can also be serviced and repaid and you have a stable economy without problems and with low inequality.

So countries that achieve this, where the banks lend mainly for productive purposes, whether it's Germany in much of its 200 year history, or in the last century the East Asian economies, where bank credit was largely for productive purposes, then you find that equality is significantly lower, inflation is lower and the real economy is booming. That's when bank credit creation is focused on productive lending for productive purposes as opposed to speculation.

There are two other types. If banks create credit for consumption it's obvious what's going to happen. You suddenly have more money created and more demand for goods but with the same amount of goods and services so you're creating consumer price inflation, and central banks are watching that a little bit, and that's good.

What's less well understood and what's the biggest in the UK, it's probably more than 70% of all lending, actually way more than that, is bank credit creation, so money creation, for financial transactions for asset transactions for purchasing ownership rights. So then you have a problem. Why? Because you're creating new money, but you're not creating new goods and services. You're simply giving somebody new purchasing power over existing assets and therefore you must push up asset prices.

So you can draw a chart where you show asset prices, land prices, and property prices in the UK and they will match very closely, as I have shown in Japan and other countries. That also creates the inequality - so when the banking sector has focussed too much on unproductive lending - and in the UK it's dominant.

Question - It strikes me that what you're telling me, and tell me if I'm wrong, is that lending, in order to get round this deposit / loan situation, needs to be categorised.

You're right. We need to look at where the money is going. That makes a whole world of difference. So if money, that is bank credit, is extended for productive purposes, you're fine. You get a good economy, no inflation and financial stability and also you don't have this inequality problem.

Question - Do you think there should be different capital ratios?

No. The whole Basel capital approach doesn't work. Why? Because it's premised on the idea that banks are just financial intermediaries, but they're not.

They're money creators. We need bank regulation that recognises the reality of how the banks actually operate.
Clearly this is a regulation problem. We need different regulation, and the only regulation that actually has succeeded in history, [is guidance of bank credit] and we have good data for the 20th century in particular, in preventing asset bubbles and banking crisis. [These] are all driven by this bank credit for financial transactions. It leads to this asset boom. It's a game of musical chairs where you have to play it -it's rational to play while the music is playing - which is how asset prices are driven by ever more bank credit for financial transactions. The moment it stops, asset prices fall, you get the first bankruptcies. Banks get risk-averse, the whole thing goes into reverse and banks go bust.
But you can avoid this. The only regulation has succeeded in avoiding this is guidance of bank credit. Simple rules. The simplest form of bank credit guidance is to simply ban bank credit for financial transactions. It doesn't mean financial transactions are banned. No, let the speculators speculate and let them even borrow money, but not from banks. That would make a whole world of difference. They can issue bonds or borrow in the markets, whatever they want, but they shouldn't get access to the public privilege of money creation. That creates the problem. That creates the boom bust cycles.
In some countries they've succeeded in preventing this asset inflation, such as Germany, without even credit guidance, by having a banking structure, banking system, that's dominated by banks that don't want to do this financial speculation in the first place. These are the community banks. In Germany 70% of the banks being the smaller ones. There are 1,500 of them. They're actually the main banks in Germany. There are so many of them. Each is small and they lend mainly for productive purposes to small and medium-sized enterprises - the *mittelstand* - which has been the backbone of German economic success for the last 200 years despite wars and disasters. They have only been successful because they have their local small banks funding them all the way through. That doesn't exist in the UK and that's been why the small and medium-sized enterprise sector has always had a problem in the UK.
The solution is of course to create these small banks. They're the natural lenders to small firms. The public wants stable growth - none of those boom bust cycle banking crisis, with public money used to bail out banks. People don't want that. In Germany these community banks dominate. They've never used public money. In at least 200 years not a single one has ever been bailed out with public money and no depositor has lost any money.

David Buik - I have to say this has been brilliantly explained.

Question - Has the UK got a finance curse?
Is that a trick question? Because the UK doesn't have finance, the City of London has, and it's not part of the UK.

David Buik - Good answer.
The City of London is outside the UK. Did you know that? It's really shocking. Therefore it's also not part of the EU, which explains why it couldn't be part of the EU. Because you have to have democratic elections, and the City of London doesn't. It's the banks that have the votes based on their staff (numbers). And it's not part of the UK because the Queen is not allowed to enter without permission - she's not the Sovereign (of the 'City") therefore it's not part of the UK and that's since 1688, since the foreign invasion.