WRR

THE NETHERLANDS SCIENTIFIC COUNCIL FOR GOVERNMENT POLICY

Summary of WRR report

100

MONEY AND DEBT

The public role of banks

SUMMARY

Money and debt

The Netherlands Scientific Council for Government Policy (WRR) was established on a provisional basis in 1972. The Council was given a formal legal basis under the Act of Establishment of 30 June 1976. The current term of office runs until 31 December 2022.

According to the Act of Establishment, it is the Council's task to supply, on behalf of government policy, scientifically sound information on developments which may affect society in the long term. In doing this, the Council is expected to draw timely attention to likely anomalies and obstacles, to define challenges relating to the major policy issues and to indicate policy alternatives.

In accordance with the Act of Establishment, the WRR sets its own working programme after consulting the prime minister, who seeks the advice of the Council of Ministers in this regard.

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THE PUBLIC ROLE OF BANKS

SUMMARY OF WRR REPORT 100

Netherlands Scientific Council for Government Policy

Accountability
This publication is a summary of WRR report 100 *Money and debt. The public role of banks*. The conclusions and recommendations presented here are based on in-depth analyses of the policy and academic literature that can be found in the full report.

The report *Geld en schuld. De publieke rol van banken* (ISBN 978 90 80899 70 4) was presented by the Council to the government on 17 January 2019. The report can be downloaded free of charge in PDF format from www.wrr.nl.

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SUMMARY

Everybody uses money. As the saying goes: money makes the world go round. Our modern society would not be possible without it. Credit is of equal importance. Borrowing allows businesses to invest and provides consumers with the opportunity to buy goods and services today against their future income. Credit can thereby contribute to our welfare. Money and debt are thus of fundamental importance to our society. At the same time, the actual functioning of these is not always easy to understand.

In several countries, citizens' initiatives – such as *Vollgeld* in Switzerland and *Positive Money* in the United Kingdom – have pushed for a debate on a fundamentally different monetary system, called the sovereign money system. In the Netherlands, the citizens' initiative '*Ons Geld*' ('*Our Money*') has made issues relating to money and debt part of the public and political debate. Its proposal to place money creation exclusively in public hands gathered more than 120,000 signatures, leading to a Parliamentary debate on this topic. This led to a request to the Netherlands Scientific Council for Government Policy (WRR) to investigate the advantages and disadvantages of different monetary systems. The WRR published this report in January 2019.

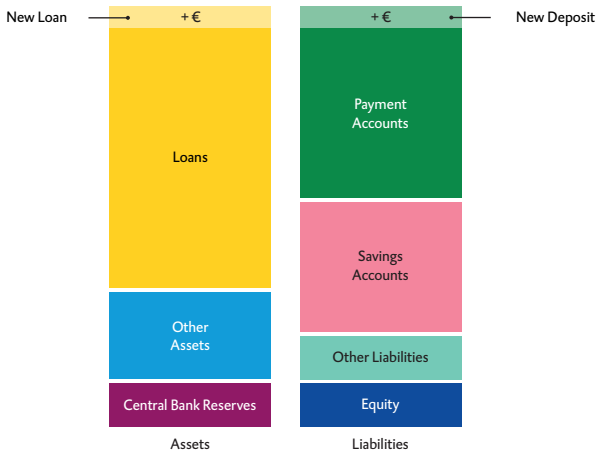
The report explains how money creation works in today's economies and how the circumstances for money creation have changed drastically over time. It discusses the problems of the current system and investigates whether a 'sovereign money system' offers an effective solution to these problems. Finally, it includes a number of recommendations to address these issues. This document provides a brief summary of the report.

MONEY CREATION

When we think of money, we usually picture banknotes and coins. But cash makes up only around seven percent of the money supply in the Netherlands. By far the largest part of the money supply – 93 percent – consists of bank deposits, i.e. money in bank accounts. Bank deposits are in fact debts owed by the bank to the account holder. This type of money is created when commercial banks make loans.

How does this work? Whenever a bank grants a loan, the outstanding loan is a new asset for the bank; the borrower has to repay it with interest. At the same time, the bank creates a new deposit in the borrower's bank account, equal to the amount of the loan (see Figure 1). This deposit is a debt owed by the bank to the account holder. The account holder can withdraw this money in cash, or use it to make debit card or electronic payments.

Figure 1 Money creation: changes in a bank's balance sheet



Money, debt and banks are thus intimately related in our current monetary system. But while commercial banks create money by making new loans, this is not an unrestrained process. There are three important factors that influence money creation in the economy.

The first is the behaviour of citizens and businesses. Their demand for loans determines to what extent banks can make new loans and create money. It is also important how the new money from the loans is spent. If it is used to buy goods and services, and the recipients do the same, money creation can lead to additional expenditure. But if the recipients use it to repay their bank loans, the newly created money is 'destroyed' after one step. Just as money is created when banks grant loans, money is destroyed when borrowers repay the bank loans.

The second limiting factor concerns the balance sheet risks banks face when making loans and creating money. Banks run the risk that borrowers will be unable to repay their loans. A bank must ensure it has sufficient equity capital to absorb losses. All other things being equal, extending more credit increases the risk of loan losses, potentially endangering the bank's financial health. Creating money also increases liquidity risk, because a bank deposit is a debt owed by the bank to the account holder. Citizens and businesses can convert bank deposits into cash or transfer them to another bank. In such cases banks must have sufficient cash and central bank reserves. These risks act as a constraint on money creation. Since the viability of banks is of key importance for financial stability, there are also legal requirements in this domain (capital and liquidity requirements) that have a constraining effect.

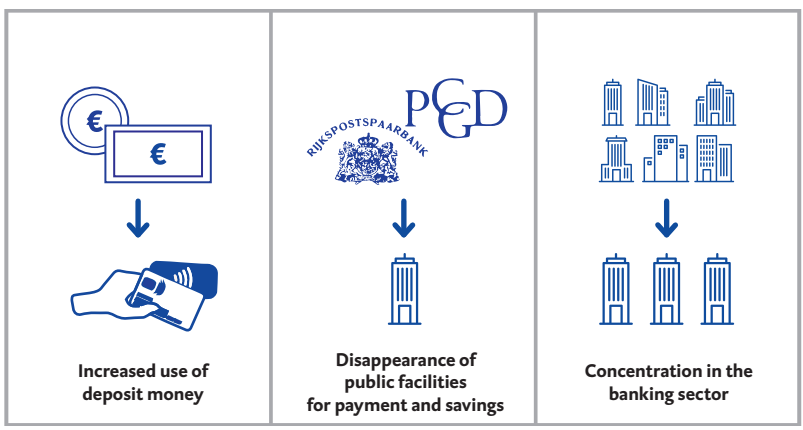
The third factor is that monetary policy influences money creation. The interest rates set by the central bank have a major influence on other interest rates, exchange rates and stock and bond prices. These all affect demand for loans and banks' willingness to grant these. In the wake of the financial crisis, many central banks also engaged in large-scale asset purchases ('quantitative easing'). This lowers interest rates and potentially increases demand for credit. Insofar as quantitative easing involves purchases of assets of non-bank institutions, it also increases the money supply.

MONEY CREATION IN A CHANGED ENVIRONMENT

Banks' ability to create money by making loans has existed for a long time. What has changed, however, is the context in which this money creation takes place.

The Dutch monetary system has changed remarkably over the past decades (see Figure 2). First, there has been a shift from cash to deposit money. In the 1950s, bank deposits accounted for just over 50 percent of the money supply. Today the figure is more than 90 percent. Second, public payment and savings facilities have all but disappeared. Before the 1990s, many citizens and businesses had deposit and savings accounts with public facilities (the *Postcheque- en Girodienst* and the *Rijkspostspaarbank*, which later merged into the *Postbank*). But in the 1990s, public authorities privatized the *Postbank*, which thus became part of the bank-insurance company ING. Third, the Dutch banking sector became much more concentrated and homogenous. A diverse banking landscape with several different types of banks slowly changed into a landscape with three large and very similar banks.

Figure 2 **Changed circumstances: three key developments**



The changed circumstances are important because they have changed the risks for banks associated with money creation. The risk that money creation leads to a *net* outflow of funds, either because it is converted into cash or transferred to other banks, has declined considerably, along with the need to maintain a high level of reserves and readily saleable assets. The large banks' systemic relevance also means that these have an implicit government bail-out guarantee, reducing the risk of failure. This means that constraints on money creation are less strong.

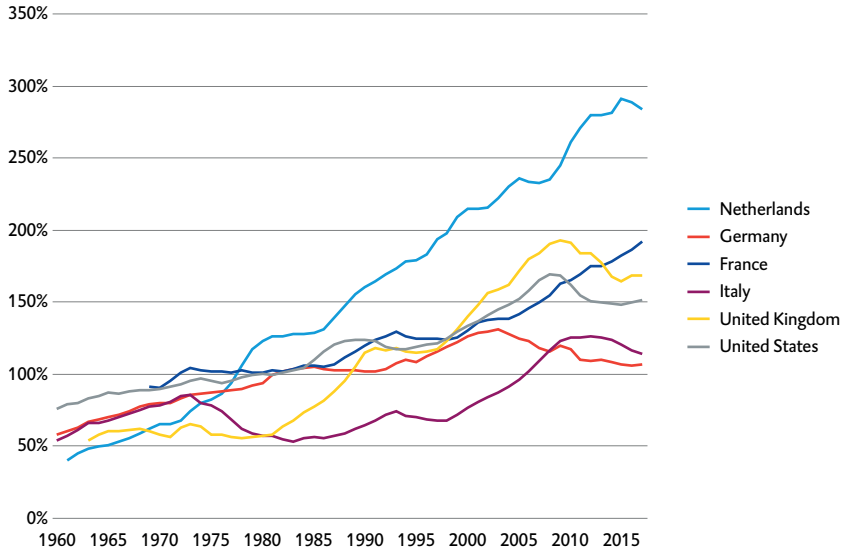
The history of monetary systems shows a permanent need to balance stringency and flexibility. Too many constraints can ultimately prove problematic for economic growth, and exacerbate crises. Too much flexibility creates credit and asset bubbles, increases the risk of crises or fuels inflation. The changed environment, along with financial liberalization and central banks discarding more direct policy tools (such as reserve requirements and credit ceilings), has significantly reduced the constraints on money creation and lending that existed in the decades after the Second World War. The balance has shifted too far towards flexibility.

TWO CORE PROBLEMS

The WRR identifies two core problems in our current system: the high level of debt and the imbalance between public and private interests. The level of private debt is historically unprecedented. While private debt has also risen sharply in other countries, the Netherlands is exceptional (see Figure 3). In addition to the aforementioned flexibility in the monetary system, various other factors play a role. These include the debt bias in taxation, indirect government support for banks, and housing market and pension policies. People commonly assume that high debts pose no problem as long as there are sufficient matching assets and the debts are fully repaid in a timely manner. But even then, high debt levels can create problems. High debt levels contribute to financial instability, longer recovery after a crisis and increased economic volatility.

The second problem is the imbalance between public and private interests in the banking sector. Over the past 50 years an ever larger part of the banking sector has started operating as purely commercial institutions. At the same time, the public role of banks has grown considerably. The growing importance of bank deposit money, the disappearance of public payment and savings facilities, and concentration in the banking sector have led to a limited number of banks becoming essential for key public services, such as the payment infrastructure, lending and financial stability. Simultaneously, public authorities have become ever more involved in the functioning of the banking sector. Banks' size and the important role they play in payments and lending mean that the implicit and explicit government guarantees have increased – witness the numerous and substantial bank bailouts during the last crisis. Banks have thus become *de facto* semi-public institutions. There is a need to restore the balance between public and private interests.

Figure 3 Private debt as a percentage of GDP



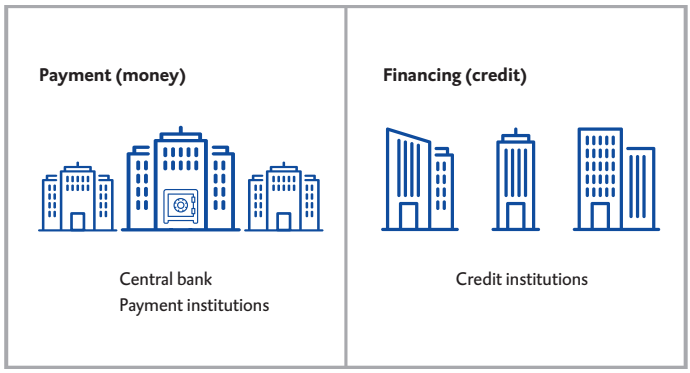
Source: BIS total credit statistics

THE 'SOVEREIGN MONEY SYSTEM' AS THE SOLUTION?

In several countries, including the Netherlands, there is an active debate as to whether a so-called 'sovereign money system' could solve the problems of our current system. These debates are inspired by a plan developed in the 1930s in the United States, known as the Chicago Plan. In the Netherlands, the citizens' initiative '*Ons Geld*' proposes a shift to such a sovereign money system. Similar proposals are also being discussed in other countries, such as Iceland, the United Kingdom (*Sovereign Money*) and Switzerland (*Vollgeld*).

These proposals vary in some ways, but essentially propose separating the payment and credit roles of banks (see Figure 4). The banking sector would be split into two parts: one for payments, the other for financing. In the payment part, money is either held in accounts directly at the central bank or in accounts at payment institutions that are fully backed with central bank reserves. These payment institutions would therefore be 'full reserve banks'. In this system, new money can only be created by the central bank. Newly created money enters the economy through government spending, loans or possibly direct transfers to citizens. The new money can also be used to reduce taxes or repay government debt. In the financing part, credit institutions must first raise money before they can grant loans. This means that these institutions cannot create new money. People who lend money to these credit institutions may suffer losses and cannot demand instantaneous repayment of their loans.

Figure 4 **A sovereign money system**



While the wish to separate money and credit is understandable, it would bring many new uncertainties. If money creation is the sole preserve of the central bank, the central bank could, in theory, ensure the money supply does not get out of hand. The opposite is also conceivable. Without adequate checks and balances, centralizing the power to create new money could lead to excessive money creation. Another issue is whether there would still be enough credit available to facilitate the growth of the economy. How likely is it that money-like instruments (shadow money) would develop in the financing part, which would make the new system rather similar to our current system? What happens when there is a crisis in the financing part? Is it realistic to completely rule out public support for financial institutions in trouble?

The monetary system is ultimately not a technical but a social system. The behaviour of citizens, businesses, banks, politicians and policymakers is of fundamental importance. It cannot entirely be predicted or steered. What works well on the drawing board may therefore turn out to be very different in practice. Furthermore, a sovereign money system as envisaged by its proponents has never been implemented. This means it is impossible to determine conclusively whether the intended system will perform better than our current system.

Finally, transition risks and the international context are major barriers to its introduction. Because of the uncertainties faced by citizens, businesses and banks, it is impossible to rule out a crisis during the transition. It is also unclear how the system would operate in a context of major international interdependencies, such as the Dutch membership of the eurozone. Given the fundamental importance of our monetary system, the WRR considers a transition to a sovereign money system to be a risky experiment with the backbone of the economy.

Proposals for a sovereign money system, however, are worth studying for several reasons. These plans enable us to reflect on our current system from a different perspective, reveal a number of major problems therein and may act as a source of inspiration for fundamental reforms.

RECOMMENDATIONS

To achieve more sustainable debt levels and to restore the balance between public and private interests, our financial system needs to change in several important ways. The WRR makes four recommendations:

- Promote diversity in the financial sector
- Curb the excessive growth of debt
- Be better prepared for the next crisis
- Safeguard the public responsibilities of the banking sector

Promote diversity in the financial sector

Diversity in the financial sector is important for a number of reasons. These reasons go beyond increasing consumer choice or reducing prices. Diversity in the financial sector is even more important than in other sectors, because it is essential for financial stability and is a prerequisite for a more balanced development of money and credit. Although there has been considerable debate about the need for more diversity in banking sectors, post-crisis reforms have not achieved the desired results. On the contrary, in terms of balance sheet size the three large Dutch banks' share increased from 71 percent in 2006 to 75 percent in 2016.

To genuinely increase diversity in the banking sector, the WRR proposes the introduction of an alternative payment and savings option, alongside the existing banks. This could take the form of a public or private full reserve bank (a payment institution). A more ambitious reform would be the introduction of a central bank digital currency, the electronic equivalent of cash. Such an alternative payment and savings option would definitely require changes in how commercial banks operate, for example in how they are financed. We can expect the mere existence of such an alternative to have a disciplining effect on the other banks, thereby reducing their dominance.

The government should also take more direct action to reduce the dominance of the systemically important banks. These banks enjoy several implicit or explicit government subsidies, giving them an unwarranted competitive edge over smaller institutions and newcomers. Taxing systemic risk more heavily is a way to discourage systemic importance. Public authorities could also actively encourage challengers, for example by having different regulatory regimes for different types of banks, as was the case up until the 1980s.

Curb excessive debt growth

Lower debt levels are important for greater stability, a faster recovery after the next crisis and more balanced economic development. Although public authorities have taken several measures to curb excessive debt growth, total private debt is now higher than before the crisis. Additional efforts are therefore required.

An important step in this regard is aligning the tax treatment of debt and equity. This can be achieved by limiting the tax deductibility of debt interest payments. Another strategy is to make equity more attractive by allowing a fictitious return deduction on equity, while simultaneously increasing corporate tax levels slightly to ensure budget neutrality.

Curbing excessive debt growth also requires strengthening existing macroprudential policy frameworks, which specifically target systemic risks. This also requires more attention to be devoted to policy coherence. Macroprudential policy ultimately has a limited effect if other policy areas, such as monetary policy, bank supervision and socioeconomic policies, encourage credit growth. It is therefore important that public authorities pay sufficient attention to other policy domains' impact on debt levels.

Be better prepared for the next crisis

The financial system is inherently unstable. The post-war stability was probably an exceptional period that will not return in the near future. It is important to be better prepared for the next crisis. This is because crises generally require far-reaching policy steps that would not take place under normal circumstances. It is better to anticipate possible unconventional policy measures before these are tabled.

In the first place it is important in a crisis to take losses in a timely manner, thereby creating better circumstances for recovery. If problematic financial positions are not tackled, the aftermath of a crisis can be long drawn out. In the Netherlands, almost all of the credit risk is borne by the debtor. Both from the perspective of fairness and with a view to rapid recovery after the crisis, it is important to consider a more balanced allocation of credit-related risks. We also recommend a law that enables a mandatory general recapitalization of banks after a crisis, even if some of these banks have not encountered severe problems themselves. The post-crisis recovery experiences of the United States and Europe show that a swift bank recapitalization is essential for a rapid recovery.

It is also important to be well prepared for the fact that far-reaching measures may be proposed during the next crisis. Typical instruments that central banks use to tackle crises, such as cutting interest rates and buying up bonds, have already been deployed to a large extent. It is not inconceivable, therefore, that more controversial measures, such as the option of monetary financing of government

expenditures, will be proposed during the next crisis. The time available to take decisions during a crisis is fairly limited. It is therefore essential to think through and prepare for various unconventional measures in advance, for example by means of scenario analysis.

Safeguard the public responsibilities of the banking sector

The growing importance of deposit money, the disappearance of public payment and savings facilities, and concentration in the banking sector mean that banks are indispensable for key public functions. The combination of private activities and public functions causes permanent tensions. While these tensions are to a certain extent unavoidable, we argue that the public dimension of the banking sector must be better safeguarded.

First of all, this requires changes in the organization of banks. Societal interests must be better incorporated in banks' activities. This could be achieved, for example, by requiring banks to set up an advisory council, comparable to the client boards that are common in Dutch healthcare institutions. Other business models – such as the cooperative model – could also contribute to strengthening banks' focus on their societal roles. It is therefore important that centralization of European regulation and supervision (the Single Rulebook and Banking Union) allows for sufficient variety in banks' business models.

Increasing banks' sensitivity to their public responsibilities also requires strengthening the position of citizens. One way to do so would be by increasing their 'exit options', by making it easier for account holders to switch to a different bank, and by providing an alternative payment and saving option (referred to earlier). But it is also important to improve their 'voice options', by ensuring that both banks and supervisors pay more attention to citizens' ideas and expectations.

CONCLUSION

Money and debt are of fundamental importance to society. In the current system these are to a large extent two sides of the same coin. In an expansion, money and credit can drive the economy to great heights, but in a recession the combined collapse of credit and money causes harm to society. The proper functioning of our monetary system is therefore a permanent challenge. Too much flexibility, and credit and money creation get out of hand. But an approach that is too stringent also causes harm. The way in which our monetary system functions depends on the rules, institutions, technological developments and behavioural responses in society. Regulatory frameworks must keep credit and money creation in check, but should also leave sufficient room for facilitating economic development and manoeuvring during adverse economic developments. They must also ensure that public and private interests are well balanced. The economy is never at rest; new challenges arise all the time. The rulebooks and institutions should therefore

strike a proper balance between stringency and flexibility, to be able to face the new developments. With this report the WRR hopes to contribute to the ongoing debate on how to strike a balance between public and private interests in our financial-monetary system, and to achieve prudent growth of money and debt.

Money and Debt: The public role of banks

Money and debt are of fundamental importance to our society, but difficult to understand. In *Money and Debt: The public role of banks*, the Netherlands Scientific Council for Government Policy (WRR) analyzes how money creation works and why money and debt are closely interrelated. It discusses the main problems and possible solutions.

In our monetary system banks create deposit money whenever a loan is granted. This form of money creation has long since existed. The context in which money creation takes place, however, has changed slowly but fundamentally in recent decades. The shift from cash to deposit money, the disappearance of public payment and savings facilities, and the concentration and increased uniformity in banking have resulted in a situation in which money and debt creation can more easily get out of hand. It has also led to an imbalance between public and private interests.

To address these issues, the WRR recommends to promote greater diversity in the financial sector, to curb excessive growth of debt, to be better prepared for the next crisis and to safeguard the public responsibilities of the banking sector.

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