What Trudeau should know about money and banking

Recently, Justin Trudeau has been criticized for his statement “When I think about the biggest, most important economic policy this government, if re-elected, would move forward, you’ll forgive me if I don’t think about monetary policy. You’ll understand that I think about families.”

While this statement is probably good politics (as talking about families is much more likely to win a politician empathy points with voters than talking about boring things like interest rates and bank regulations), it is terrible leadership, as wrong-headed choices about money and especially banking have crippled our economy for 50 years.

So, in the interest of better governance, this article will attempt to explain to Mr. Trudeau (and perhaps the other party leaders) how improved banking could transform Canada into a more productive, more prosperous and more egalitarian country.

The economist Richard Werner has spent a lifetime studying money and banking. The ideas that follow are his, not mine, and I would encourage you to look up his interviews and articles.

Werner’s first insight is that, while it is commonly thought that neither individual banks nor the banking system create money, it is in fact true that individual banks create new money whenever they grant loans.

Werner actually looked into a bank’s internal accounting during the lending process and realized that the money being lent was neither someone else’s deposit (the financial intermediary theory of banking), nor a multiple of someone else’s deposit (the fractional reserve theory of banking). Instead, at the moment a loan is granted, the bank simultaneously records the sum in its loan book (where it is considered a bank asset - money you owe the bank) and your bank account (where it is considered a bank liability - money the bank owes to you). From an accounting perspective, then, the granting of the loan created the bank deposit. Money was *created* through lending (the credit creation theory of banking).

This ability to create money from nothing gives individual banks and the banking system as a whole tremendous power. Werner’s second insight concerns how to best utilize this power. If bank lending is directed towards consumption, more money will be available to purchase a fixed quantity of goods and services. The result will be consumer price inflation. This has probably never happened directly, but it has happened and is perhaps happening now indirectly, as governments borrow money to send to individuals in the form of CERB and other benefits.

If bank lending is directed towards the purchase of existing assets (such as homes, or shares on the stock exchange) the result will be asset price inflation. Our current affordability crisis and the widening gap between the rich (who are often older and were therefore able to buy homes and other assets before they became unaffordable) and the poor (who are often young and find it impossible to purchase assets like homes at today’s sky-high prices) are direct consequences of decades of such lending.

The other alternative is for bank lending to be directed towards productive investment. Small and medium enterprises, which are unable to raise funds on the stock market, can still improve their technology, buy new equipment and fund expansion if given access to bank credit. The result is higher productivity, more employment and rising incomes without inflation, as the increases in income are matched by increases in output.

The one country where the banking system prioritizes lending to businesses, Germany, is a manufacturing powerhouse. Thousands of German small and medium enterprises are globally competitive, often holding 70% or more of the global market share in their business niche. Astonishingly, Germany, a country of just 83 million people, has over 3 times as many such "hidden champion' firms as the United States, with its population of almost 330 million.

Werner's third insight was to see how the size of banks influences lending priorities. Seventy percent of German banking is conducted by roughly 1700 local cooperative and savings banks. These smaller banks have strong, long-standing relationships with local businesses and are well-equipped to be partners in their growth in a way that larger banks headquartered in distant cities are not. Tellingly, when Deng Xiaoping modernized China in the 1980s, he used the German banking system as a model and created hundreds of small regional banks to direct lending to businesses which, like their German counterparts, are now also major exporters.

Taking these insights together, the future direction of money and banking in Canada is clear. The "Big 5" banks in Canada should be broken up and replaced by smaller, regional banks. Further, these new banks should be explicitly chartered to provide loans to businesses and barred from lending for property and other forms of speculation. The power to create money from nothing is an awesome one that should be used to bolster the prospects of small and medium enterprises operating in the real economy, workers, and their families.