2/10/2016. *The wobbly banks and the financial system*

In the last week confidence has plummeted in the largest German bank, Deutsche Bank. Its shares have continued to decline sharply, and the German government has said that it will not bail it out if the bank becomes insolvent. (Berlin can't do that anyway under new EU legislation, but a blind eye might be turned, or a German bank merger forced.) The immediate problem is a fine levied by US regulators. That can be negotiated down at government level, but banks are heavily leveraged by design (as I'll explain), so that a fall of Deutsche Bank could lead to a chain reaction of failures through the world banking system. The Italian banks are virtually insolvent too, and dare not write off what everybody knows are bad debts on their balance sheets; there those debts fester. Whereas Greece had only a tiny economy relative to the Eurozone, Italy is large enough to bring the Euro down. Meanwhile, the world economy is still a long way from recovering from the 2008 crash; Washington, London, Tokyo and Brussels are all printing money to inject into the system and keep it oiled ('liquid'). They – or their central banks – do this 'quantitative easing' (QE) by buying financial assets on the open market via favoured brokers, typically investment banks which are the only institutions large enough to be able to offer assets in sufficient quantity. The assets purchased are generally government bonds, again because of the large amounts involved. Significant sellers include pension funds looking to rebalance their portfolio, again because of their large size. A further effect of QE is to weaken the currency of a nation, making its exports more competitive – although not if its trading partners do the same. Meanwhile, central bank interest rates are set at an extraordinary low in order to encourage businesses to borrow for growth. Yet the medicine is not working and, as I shall explain, is stoking worse trouble ahead. Is something fundamentally wrong with our banking system?

Yes, something is. We can learn what by looking at the laws God gave to ancient Israel and comparing with our system. God legislated against interest, but it isn't that. God forbade Jews only to lend at interest to other Jews, not to gentiles (Deuteronomy 23:19-20). If interest were intrinsically evil, God would not have permitted loans at interest to anybody. And in Jesus' parable of the talents (Matthew 25:14-30), one of the servants was told by his employer – who stands for God – that he should have banked the money at interest. Although compound interest can become a trap, our problem isn't with lending at interest.

Our problem is to do with the fair weights and measures legislation, which is set out in Deuteronomy 25:13-16. When a man came to market and precious metal changed hands – gold or silver – the receiver of the metal verified its weight using his own set of weights. (He might even assay the metal as well.) If he did not find that the amount of metal weighed what had been agreed then the deal was off. A dishonest man might carry a false set of weights in a different pocket from his genuine set. The law prohibited unfair weights, and Proverbs 11:1 calls their use an abomination.

How does this relate to the banking system? The government can mint coins of precious metal, stamping the weight on them, and because everybody trusts the government's stamp this saves people the trouble of carrying their own weights. But the government can then yield to temptation, and start to mix base metal into those coins and demand by law – by fiat – that the adulterated coins ('fiat currency') be accepted as equivalent to unadulterated ones. In other words, the coin is enforced by law to have greater value in exchange than it would have in a free market, in which the people decide freely what to exchange for it. The government, to inject its debased coins into circulation, may pay its armed forces and civil servants with them. That is fraud enforced by law, and is contrary to God's fair weights and measures legislation. The law applied equally to the king in ancient Israel, and this practice is condemned in Isaiah 1:22 – "your silver is turned to dross; your wine is diluted with water." (Since pure silver cannot be turned to dross, this is clearly an example of 'Hebrew parallelism.') More blatantly, the government might continue to manufacture coins of precious metal, but make them lighter while stamping them the same as before, then enforce the lighter coins as equivalent legal tender. (That is essentially how the pound coin became decoupled from the pound weight of silver, a long time ago.) People then preferentially offer the debased or lighter coinage, in order to get rid of it, and hoard undebased coins – 'bad money driving out good' (Gresham's law). Precious metals are the people's free choice of exchange medium in markets, whereas debased coins are the government's choice, forced upon the people. I said that this was fraud, and the government gains from it, obviously. But who is the fraud against? Who loses? Goods are generally worth a fixed amount of precious metal, so more coins are needed to buy them. All of the people lose. This scheme for transferring wealth from the people is more subtle than the government taxing them!

As people tend to think that gold is for the rich only, I must justify the statement that precious metals are the people's choice of exchange medium. The statement is true – it's just that most of us can't afford very much gold. Here is how it came about. Our society evolved from an agrarian economy. When items come to market, there are exchange rates between pairs of goods, including grain, cabbages, meat, shoes and so on. (A single exchange rate exists between any two goods because word spreads rapidly among buyers of which seller is offering the best rate.) But grain is acceptable in exchange for all the others, whereas the converse is not true. Why is that? Grain is easily weighed and divided, cannot be counterfeited, and can be stored such that it does not degenerate rapidly. Further, grain is grown as a staple for everybody, and everybody knows that everybody needs food every day. People therefore know that they will be able to pass grain on, and are consequently willing to accept more of it than they need for personal consumption: they have immediate *confidence* in it as an exchange medium. Persons who bring other goods to market can barter them for grain, then barter grain they do not need to eat themselves for other goods they want (or store it).

Among the goods that came to market were gold and silver. Precious metals share with grainseed the properties necessary for exchange, storage and accounting: durability, distinctiveness, divisibility and portability. In fact they are more readily portable than grain, and they can be hidden more easily. They can also be crafted for ornamentation, and the wealthy, who could afford objects of beauty but no practical use, would exchange grain for them; the exchange rate was set by their scarcity (and grain's!) Once people saw precious metals being accepted in markets for more and more goods, they gained confidence in them as a currency. That confidence would falter if circumstances caused precious metals to be no longer exchangeable for food staples, but such circumstances are extraordinary. This is why gold and silver are the people's choice of exchange medium; there has been a world currency for many centuries! Government fiat currency, in contrast, represents the nationalisation of money. Exchange rates arise between fiat currencies according to the amounts of precious metal in the coins of the two currencies. Government attempts to fix rates differently within their jurisdiction are further violations of divine principles of fair weights and measures, and lead to a black market in which private bargaining between consenting individuals is criminalised.

Governmental abuse worsens when we move from coins to paper money. Paper money started as receipts for fixed amounts of precious metals in the government's vaults, which anybody can swap by presenting the note at the vault door. But again the government yields to temptation – under the pressure of financing a war or a Welfare State, and with votes to win and taxation unpopular. Left-wing or Right-wing regardless, it soon starts printing more notes than it holds as precious metal, crossing its fingers that not everybody will wish to redeem all of the notes in circulation at once (a 'run' on its own central bank). After the notes have been in circulation for a while, and people have got used to them as an exchange medium, the wording of the notes as a receipt is quietly dropped. In the short term this doesn't matter, but governments get greedy and then print more and more notes. Few paper currencies that aren't receipts for precious metal survive longer than a lifetime before the resulting inflation destroys them and a reset takes place. (During out-of-control inflation a government might try to fix prices of goods in order to prevent this, but the need for food ultimately overcomes fear of breaking such laws as a clandestine free market develops.) When it is understood that a 'dollar bill' (or some other currency) is just something that can be exchanged in markets for something else, it is obvious that exchange rates vary not only with the seasonal availability (say) of the goods you want to come away with, but also with the abundance of dollar bills.

This cycle, in which the government debases its currency ever further until popular trust in it breaks down and a reset occurs, can be seen in milder form in the 'business cycle' of unsustainable boom and socially distressing bust. The business cycle has exactly the same root cause, in central bank manipulation of fiat currency. (Not many economists understand that!)

Once a banking system is in place – meaning banks that may loan money as well as just store it – there is a further way of inventing money from thin air. This is known as fractional reserve banking (FRB). Suppose I have 100g of gold and I deposit it in a bank. The bank gives me a receipt for it. Provided that people trust this bank, I can use that receipt to buy goods in markets as an equivalent to the gold, *i.e.* as money. But the bank might also lend money against part of that 100g (it must by law retain some of it) at interest to someone who wants a mortgage, or to an inventor who needs money to develop his idea. The bank does this

by opening an account in the inventor's name containing credit equivalent to (say) 90g of gold. If the innovator demands some money to pay his employees their first month's wages, the bank hands over banknotes (nowadays the central bank's notes, but formerly its own). Or it can transfer money to the employees' accounts; this and other credit arrangements, which do not involve banknotes, make it hard to know how much money actually exists in the system. (Other forms of credit worsen that problem, and bonds in particular throw repayment onto future taxpayers.) Notice now that the original money has been committed almost twice! Moreover, employees can deposit their wages in a bank, which can lend part of that… and so on. A bank serves a large number of depositors at once, reducing the probability that so many of them will randomly want their money back at the same time that the bank runs out of money. But if word spreads that the bank is in trouble then a queue quickly forms of depositors who want their money back before the bank runs out of money. This is known as a bank run, and it can bring a bank down as it obviously cannot pay off everybody at once. Central banks generally promise to bail out a local bank suffering a run, acting as 'lender of last resort' (a phrase that matches 'too big to [be let] fail'). Popular awareness of this promise often provides confidence enough by itself to prevent bank runs. But it also encourages reckless lending which can eventually cause the very problems it is meant to prevent. So never forget that a bank is different from a secure storage vault. You granted your bank permission to lend out your money when you opened your bank account. (Check the small print!) Admittedly that fact is hard to remember today, when banks charge you like vaults to store your money – even though, unlike vaults, they lend it out at interest. They then use your money to get other people in debt – but to them, not to you. Before we castigate bankers for these practices we should remember that we are nearly all complicit in this system, for we deposit our money in banks rather than in vaults in search of interest, and we accept loans in order to buy things we cannot afford on the spot. It is a characteristic of money that it raises mixed motives; no wonder Jesus preached more about it than any other subject than the Kingdom of God! What you do with your money reveals where your heart is (Matthew 6:21).

When a fiat currency crashes, wealth is not destroyed but redistributed. Persons storing wealth in the old currency lose it; persons with debts denominated in it gain; persons holding tangible assets such as property, or gold, ride it out. (Unhappily the government might confiscate citizens' gold, as President Roosevelt did in 1933 during the Great Depression; Washington paid the market rate, but Americans were deprived of their only simple hedge against Washington's anti-deflationary manipulation of the US dollar, which soon amounted to a 40% fall in value.) The principal reason why inflation gets out of control is that governments are large debtors and they engineer inflation to reduce the real value of their debts. But it eventually becomes increasingly difficult to prevent inflationary runaway. In fact there are three ways out of debt:

1. Make enough money to pay it off, and in a government's case hope that your citizens make enough money from economic growth to be taxed enough without electorally impossible tax increases and/or austerity programs. (Government spending in order to inject money into the economy has the effect of increasing government debt, or takes in taxation money that would have been available for bank loans to businesses; such spending only pays for itself via economic growth in specific circumstances, as Keynes understood but his followers have forgotten.)
2. Default (which prevents a government borrowing on the international markets for an extended period, as trust in it is lost).
3. Let inflation corrode it, as mentioned (although Western governments now have inflation-linked pension commitments, so this might no longer work very well). Inflation is corrosive to the biblical virtues of thrift and saving.

Today, a huge amount of money has been injected by government QE in order to prevent deflation, as deflation increases the real value of government (and other) debt. It is also liable to gum up an economy, because people hoard their money until it can buy more goods. (There is also 'good' deflation when, for instance, high-tech products get cheaper due to improved efficiency of production, but people generally want a computer *now*.) Furthermore, in a fractional reserve banking system, withdrawals reduce the amount of money in existence by a large multiple of the sum withdrawn, as explained above – furthering illiquidity. The money poured into the system by QE to prevent deflation is not being invested by businesses to promote taxable growth; rather it went to large concerns willing to sell bonds, such as pension funds, who re-invest it in the stock market and elsewhere but do not make it available for innovation. The stock market is where the inflation is today. When people eventually start to spend it, instead of hoarding it expecting deflation, there

is risk of an inflationary avalanche. Raising central bank interest rates to damp that down would apply the brakes too slowly to stop it. And central banks will someday raise their interest rates. These rates have been dropped almost to zero to encourage businesses to borrow money for investment in growth, and to keep property prices up as property is the main collateral for everything else, so that a fall in property values – amplified by FRB – leads to a wider collapse. (This policy makes life much harder for first-time property buyers.) The longer this 'temporary measure' goes on, though, the longer that central banks lack this same weapon of interest rate reduction to use against stagnation in the future. And if interest rates are ever raised in order to fight inflation – which would necessitate the end of QE, since bond purchases by governments/central banks have the effect of reducing interest rates – then servicing of the amount of debt that has been encouraged by prolonged low rates will become impossible and trigger a chain reaction of defaults. (Bond purchases reduce interest rates because demand for bonds goes up, so their price goes up, so new bonds offered by the government carry lower interest rates in order to save government money while keeping new bond issues competitive with older ones offered secondhand; the value of a bond, meaning the return it gives a buyer, increases with both the interest rate it specifies and its spot price.)

It is possible in a fractional reserve banking system involving fiat currency for *everybody* to be in debt to 'the system,' making the men who run it extremely powerful. Wall Street dominates Washington. The interests of the financial system and the people are not the same (war may be good for business!) Wall Street grew huge in the 1980s and 1990s because it knew that Washington was determined to stamp on inflation, thereby making government bonds increasingly attractive; the banks could buy bonds in exaggerated numbers via leverage, and sell them at a guaranteed profit. A spin-off enterprise called Long Term Capital Management, based on complex mathematical ways of pricing financial products known as derivatives (which package good and bad credit risks together in opaque ways), failed in 1998, taking down Nobel prizewinners in Economics and their work. LTCM was bailed out by banks which had large investments in it, in order to keep their leveraged balance sheets secure. Then in the 2008 crisis those same banks claimed that they were too big to be let fail, because the consequences of a crash might take down the entire financial system. Washington, cowed, bailed them out. Since then they have exploited the security provided by government by continuing to gamble, thereby putting at risk the underlying collateral in wealth-creating enterprises – which the bankers would snap up in a collapse – and even the stability of society. Attempts at regulation have been compromised.

I suspect that our present monetary system is fairly near to collapse. There is too much debt in both the USA and China, the key economies whose relationship dominates the world economy, for growth to overcome these problems. It is an open secret that central bankers are now making up their monetary policy on the hoof, and we shall eventually fall off the tightrope in one of the ways I have described. I doubt that the US dollar will continue to act indefinitely as the world's 'reserve' currency, in which most international business deals are denominated. I cannot say when the system will crash, though – nobody knows that.

To repeat: in a crash of the monetary system, wealth is redistributed, not destroyed. All of the houses in the country stay standing, although they might change owner. But there is still the question of what happens during the breakdown. In that time no generally agreed exchange medium is available. This is not a big problem in a simple agrarian society in which people grow their own food. But in a complex society, with a greater division of labour, most people need an exchange medium in order to buy vitals, and the transition is more traumatic. There was serious social unrest during the German hyperinflation after World War I (Hitler exploited the resulting disillusion), and modern society has grown considerably more complex since then. Will law and order break down? What can you use to buy food? I believe people would do well to keep a hideable cache of tinned food. Never forget: this is all due to fiat currency, a type of fraud that God outlawed in the only code of law he has ever given.