MAIN BODY

What would be your radical plan to force a step change in the quality and quantity of the UK's economic growth?

ART OF BANKING
-
THE INVISIBLE HAND

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'The difficulty lies not so much in developing new ideas as escaping from old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.'[1]

John Maynard Keynes

Part 1 – Neoclassical Economics

In a world where a small number of firms and large-scale shareholders maintain a dominant position, and where the neoclassical agenda has severely limited the restraints that governments can place on corporations, the problem of preserving democracy against the force of vested interests, 'buying' politicians' election campaigns and threats exists:

> *"Our society will always remain an unstable and explosive compound as long as political power is vested in the masses and economic power in the classes. In the end one of these powers will rule. Either the plutocracy will buy up the democracy or the democracy will vote away the plutocracy. In the meantime the corrupt politician will thrive as a concealed broker between the two."* [2]

Institutional investors prefer to talk to strategists rather than economists, and we must question why. In common with campus academics and students, investors have lost interest in neoclassical economics, as they recognise it has become divorced from reality. While high hopes reigned throughout the last century about the ability of mathematical models to forecast economic developments, the business world does not place store by economic forecasters.

The implicit assumption is that credit flows to the real (productive) economy.

However a significant proportion of bank credit flows into existing financial assets, for example, land, property or financial commodities. The influence of credit flows on economic growth is at best indirect, since they result in asset price inflation rather than new GDP-transactions. Fisher[3] recognized this distinction, and later Keynes, who regarded that while income transactions might be closely related to GDP, asset transactions:

> *"...need not be, and are not, governed by the volume of current output. The pace at which a circle of financiers, speculators and investors hand round to one another particular pieces of wealth, or title to such, which they are neither producing nor consuming but merely exchanging, bears no definite relation to the rate of current production..."*[4]

Today, the status quo for economist, politician, and journalist alike is to talk about *competition* as a key mechanism and at the same time not address the reality that most mature industries are highly concentrated and dominated by a small and ever-shrinking number of firms.[5] Some of these firms have become highly influential, and it is not clear that the pursuit of profit has increased overall prosperity in their influence spheres. The time has come for a new kind of economics.

Part 2 – Ministry of Finance

My Radical Plan to transform the UK economy centres on the creation of a new Ministry of Finance (MoF) and overseeing the setup of 50 small banks of two varieties. This department would deal with the responsibility of a 'credit guidance' monetary policy. It would also implement monetary tools pertinent to credit guidance that has led to economic growth in 'miracle' countries where loan quotas are implemented.

By growing the number of small banks, the banking sector would evolve a small amount to look more like the German banking sector which comprises 1500 small-cap banks (accounting for about 70% of deposits, providing 90% of lending[6]). Today 4 UK banks quartered in London account for 77% of UK deposits.[7] Of the other 151 UK registered banks, only 65 make their headquarters the UK.[8] The London banks' business would not be directly affected by competition; we should also forget the past global outlook of British banks. UK banks are no longer global players. In 2018 only HSBC and Barclays scrape into the top 20 largest world banks.

Loan targets and quotas by the MoF will be set internally and loans allocated in market segments. The established smaller banks will chase successful small businesses to invest in their regions or industry segments, consequently investing in the real economy (C_R) from the bottom up. Loans will not be made for speculative credit creation (C_F) as happens with existing banks by their daily trading assisted by QE. Quotas will be measured and not expanded too rapidly in areas like manufacturing to limit non-performing loans.

An institution that seeks to oversee a regimen of credit guidance should be accountable and transparent. One department set up to monitor credit guidance must be precisely that. This monetary tool would be more potent in growing the UK economy than interest rates or their adjustment. As I show and has been empirically proven they do not generate growth.[9]

Credit guidance should be set up under the control of a new department in the form of the Ministry of Finance, allowing full accountability to a separate specific institution. The Central Bank must assume a smaller role, re-addressing its' monetary policy tools through which it means to stimulate the economy, and working with the new MoF.

The UK Economics profession must address its years of international recognition and achievement by way of ten Nobel laureates and great economic figureheads matched against a track record of decline since the end of WW2.

NON-TECHNICAL SUMMARY

It always bears mention that the politics of currency and money is not an exact science, but an applied art. Naturally, every technique has its handicraft. Dealing with money, as in banking, is a handicraft whose rules must be mastered. Economic processes, credit creation and last but not least the strength of character to resist interventions by political force - are part and parcel of monetary and currency policy.

Economics should now be about economic reality; and demonstrably relevant to it. Money and banking must become a part of economic models; a new school of economics cannot be based on the deductive approach.

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Monetary Policy Reality vs Theory

Heterodox ideas in monetary policy throughout the last century have been proposed by men of great intellect, only to be misinterpreted by mainstream policymakers and commentators; implemented contrary to their intentions.[10]

The most obvious example of this can be found in ‘Quantitive Easing' (QE) - First proposed as the ‘Quantity Theory of Credit'[11] by Richard Werner.[12] His original theory of credit proposed in 1993 at York bore no resemblance to QE; lost in translation to Japanese. ‘Quantitive Easing' came to be defined as an expansion in bank reserves and then put into practice by the Bank of Japan, despite Werner's opposition.

Werner and others drew attention to QE already going under various pseudonyms over the history of monetary policy, thus needing no further names; only to no avail (Including reserve expansion, M0 expansion, High powered money expansion, Monetary base expansion).

As stated in the *prosperity report*, QE has failed[13] and should have been dropped in other countries; such as in Japan 2006.[14] It is a great blunder that the government did not enact the original Quantity Theory of Credit (QTC) policy by Werner.

My proposals by suggesting ‘credit guidance' bring a monetary topic to the discussion which is (by great misfortune) taboo in mainstream economic thought, especially to neoclassical economics. As such, I label ‘credit guidance' and related policies (QTC, window guidance and more) the ‘Invisible Arts.'

‘Visible and ‘Invisible’ Hand of Monetary Economics

Existing economic controls for the economy base themselves on the theoretical neo-classical school. Regulating boards such as the BofE's Monetary Policy committee work on paradigms of Neo-Classical Economic thought. Basel III

was founded on those theories; still, also the way banks are viewed as 'credit intermediaries' in textbook theory is an example I mean to show as the danger of neoclassical thought.

Policies that regulate the sector base themselves on the same theories economists have used to expand it. The expansion of finance for asset speculation under the guise of free markets, by extension, stock markets, derivatives, options and more, must be slowed. This visible hand of economic policy must be examined for the health of the economy.

Four Axioms of Neo-Classical Economic Theory that do not serve reality.

1. All money is used for GDP transactions.

The standard 'equation of exchange'

(1) $PY=MV$

Is a special case of:

(2) $PQ=MV$ Fisher, 1911[15]

Implicit assumption:

(3) $PY=PQ$ (That all transactions are part of GDP)

Incorrect: asset transactions are not part of GDP. The traditional approach ignores financial transactions, often more significant than real economy transactions.

How to Measure Money, M?

Standard measures of money are widely agreed upon as unstable and unreliable. Textbooks rely upon deposit aggregates M1, M2, M3 or M4, but admit they are not useful measures of the money supply. These deposit aggregates only measure savings not the amount of money that enters circulation and may affect GDP. [16]

The M measures are not in a stable or reliable relationship to economic

activity, mostly not concerning economists:

The M measures are not in a stable or reliable relationship to economic activity, largely not concerning economists:

"Once viewed as a pillar of macroeconomic models" it "*is now one of the weakest stones in the foundation.*"[17]

How do we separate money, M into two or more streams in practice? Fisher, Keynes, and Friedman tried, but failed to disaggregate money.

The majority of transactions take place without cash as book-entries in the banking system. For growth, we see an increase in transactions, resulting in more purchasing power/money that must have been created. The common sense equation of exchange says that:

'The money used for transactions must be equal to
the value of these transactions.'

In our financial system, this is conceivable only via credit creation as I will show. Thus the correct measure of 'money' in the equation of exchange is credit/credit creation. We can now explain significant macroeconomics puzzles such as:

1. The irregularity of the ineffectiveness of interest rate policy
2. The characteristic of the recurring banking crises
3. The nature of the velocity decline.
4. The inconsistency in the inability to measure money.
5. The peculiarity of asset price determination.
6. The singularity of the ineffectiveness of fiscal policy.

$$M = M_R + M_F$$

Money in GDP transactions, used for the 'real economy' ('real circulation') (M_R)

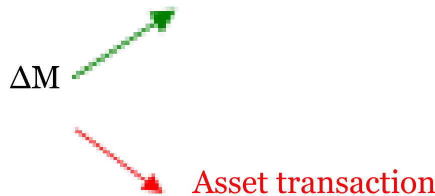
M

Money used in non-GDP transactions ('financial circulation') (M_F)

Considering Growth:

nGDP growth = proportional to growth in 'real circulation money'

$$\Delta(P_R Y) = V_R \, \Delta M_R$$



Asset transaction

Growth = proportional to 'financial circulation money'

$$\Delta(P_F Q_F) = V_F \Delta M_F$$

This explains many puzzles in economics such as: velocity decline; asset prices; the 'Great Moderation'; Why interest rate and fiscal policy have been ineffective; Why banking crises recur.

The conventional theory that all money is used for GDP transactions must be false. The only way for the future of economic growth is for economists to recognise bank credit can be used for two types of circulation, namely for GDP transactions and non-GDP, asset transactions. Financial bank credit creation is everywhere unsustainable. The gains achieved to service and repay loans are capital gains, driven by credit creation.

Types of Speculative Credit Creation (C_F) by Banks

1. Margin loans (credit for financial speculation)
2. Loans to non-bank financial institutions
3. Lending for real estate speculation:

    To Construction companies

    Mortgages, buy-to-let mortgages

Real-estate investment funds, other financial investors

4. Loans to structured investment vehicles

5. Loans to Hedge funds

6. Loans for M&A

7. Loans to Private Equity

8. Direct financial investments by banks.

–Examples of banking crises due to speculative credit creation included in the Appendix.

Result

C_F then must be understood as a bind to economic growth. Anyone wishing to change the quality and quantity of the UK's economic growth must set out to reduce C_F and comprehend: the regulatory, lobbying and policy apparatuses that accompany the banking system do not control C_F adequately. If credit creation is to be private, then it must be done for the public good. The responsibility of C_F lies squarely with banks who invest for short-term profit. Recriminations during and after financial crises are no resolution.

What is required is transparent quantitative and qualitative regulation of credit creation.

2. GDP growth by any Government credit creation may only lead to inflation - despite evidence.

'Inflation is always and everywhere a monetary phenomenon' [18]

Good and Bad Credit

The Good - Bank credit extends to productive investments alone, which expand the amount or value of goods and services, resulting in sustainable and inflation-free growth. Bank credit expands the money supply, matched by an increase in the cost of goods and services, avoiding inflationary pressure. Income services then repays the original loans.

The Bad - Bank credit extends to unproductive transactions, credit from primarily financial speculation C_F results in inflation of two sorts:

1. Credit for consumption leads to consumer price inflation. The amount of

money supplied is increased, as well as the demand for goods and services, but there is no accompanying increase.

2. Credit created for transactions that don't commit to GDP, C_F, principally asset or financial transactions, tending to push up asset prices that do not generate income, merely capital gains, beginning a business cycle that disguises actual GDP growth.

3. Central Bank interest rate changes have failed to affect GDP in an economy.

Neo-classical economists and policy makers must ask the question of themselves: "Why have successive interest rate reductions failed to stimulate the economy?"

The theory:	Low rates lead to high growth;
	High rates lead to low growth.
The fact:	High growth leads to high rates;
	Low growth leads to low rates.

1. Fiscal policy has not been as effective as the IS-LM explanation claims. [19]
2. The puzzle of ineffectiveness of falling rates – which contradicts the New Consensus approach[20]– remains unexplained in the theory.

Interest Rates - What are the empirical facts?

Rates are not negatively correlated to growth, but positively.

Interest rates don't lead economic growth – they follow it.

True for long, short, nominal and real rates – and in almost all countries.

Nominal GDP growth in the economy is determined by credit creation used for GDP-based transactions. Interest rates do not enter the equation. An inspection of the link between credit growth and interest rates shows that there is not a robust

negative correlation between the two.[21 22]

In other words, raising interest rates should not slow the economy, if credit creation for GDP transactions (C_F) continues to grow, and lower interest rates will not at times be able to stimulate the economy banks, burdened by high debts, have become highly risk-averse.

4. Existing capital is the financial tool that drives the economy.

'Capitalism without Capital' summarises the traditional school of thought succinctly:

'Investment occupies a central place in much economic thought. Investment is what builds up capital, which together with labour, constitutes the two measured inputs to production that power the economy. The sinews and joints that make the economy work.'

This axiom is echoed in *Prosperity Report* by through their implicit intention to raise capital for the NIB from existing sources.

Neo-Classical economics is a static discipline. It focuses on the conditions for an efficient allocation of *given* resources – how the income pie should efficiently be divided. This approach considers the given framework, political status quo of the day, and tries to optimize the allocation of given resources. Fundamentally, it takes a bottom-up approach, seeing the economy as an aggregation of individuals and then deduces all its economic principles from the actions of one individual or one company. In such a framework, virtually by definition, government intervention is unnecessary and inefficient.

Neo-Classical economics fails to ask who the creator of the money supply is and whether this has purpose. Today it has been proven banks create 97% of the money supply in the UK. [23]

Since the credit markets are supply determined, and banks entirely decide whether to lend, how much to lend, and who to, they perform a crucial public goods

function. They not only create most of the purchasing power in the economy, but they also decide who benefits from the money and to what purpose.

Central Planning

Sovereign examples of Good and Bad Government Credit Policy.

The success stories in East Asia and the EEC post WW2 empirically demonstrate state intervention has worked well. In Japan, South Korea, and Taiwan, the state played a vital role in a wide variety of ways creating rapid expansion[24]. The government 'guided' the market, instead of following a hands-off approach.

However, there are degrees to which state intervention lends a hand. Many of the far eastern economies are branded as 'free market' today, and trade on WTO terms.

Examination shows how newly industrialised countries are the rule not the exception when it comes to state intervention. The visible hand of the state is rife in protecting national interests across the western world. In the UK there are many examples of the government playing an influential role in promoting and supporting economic change, most commonly by preventing foreign-led M&As. [25] Alas, the British government has not exercised its' invisible hand to boost growth.

The most notable instance of GDP growth without relation to inflation to an economy was the 1920s and 1930s Germany under the tutelage of Reichsbank governor Hjalmar Schacht. Economist Joan Robinson best describes the turn-around of the said economy:

"Hitler had found a cure against unemployment before Keynes was finished explaining it" [26]

German economic thought could not be divorced from the following Nazi policies of virulent anti-Semitism, racism, and genocide, however. German economic theory from the '20s-'30s is therefore ignored on a systemic basis today regardless of whether the economists had political orientations or not.

The Japanese, who had modelled their economics on the German system in

the inter-war years achieved high growth from 1945 to 1989 with the result of Japan being the 2nd largest country by 1950 in GDP terms, without American aid; guided there by the unofficial monetary tool of 'window guidance.' Other East Asian countries followed its' example after WW2, some being former Japanese colonies like South Korea. The other instance of GDP growth without relation to inflation was the German 'Wirtschaftswunder' under the tutelage of Walter Eucken, another economist of the German school. These central planning these governments initiated whilst also encouraging free markets and free trade for the benefit of the economy needs further research.

A New Methodology for Economic Research.

Britain needs a new, radical plan to create economic growth. Equally, it needs a new economic methodology which does not generate theories alone. Examining how money, credit and banking work, but also the future of the internet and banking, are essential for future generations.

Milton Friedman was instrumental in establishing the neo-classical deductivist methodology which economists today still widely practice. His essay "The methodology of positive economics" [27] has had a profound and continuing influence on economists'. Now completely dismissive of methodological concerns, the theoretical thinking continues to dominate despite its deep flaws. Its' core premise is: "*Positive economics is in principle independent of any particular ethical position or normative judgments*...it deals with *"what is,"* and not with "*what ought to be*" (p.4). It continues:

"(T)he relevant question to ask about the "assumptions" of a theory is not whether they are descriptively "realistic," for they never are, but whether they are sufficiently good approximations for the purpose in hand. And this question can only be solved by seeing whether the theory works" [27] (p.15).

According to Friedman, a theory cannot be judged by the realism (or lack thereof) of its assumptions, rendering assumptions malleable, a free parameter to be constructed and modified so that the theory works.

Today the central bank and the treasury use methodologies that start with axioms not derived from empirical evidence. Then theoretical assumptions are added, and on the bases on which tools of logic (mathematics) are utilised to prove theoretical results.

An alternative approach for future consideration examines reality, identifies facts and patterns, then attempts to explain them, using logic in combination with theories. These theories then undergo testing and are modified as needed, to be most consistent with the facts of reality. This method is inductivism. All the natural sciences and most scientific disciplines use this approach. Inductivism also describes how we learned as infants in the world; when we touched a stinging nettle in long grass, we learned inductively not to do it again.

Neoclassical economics turns out to be one of the very few intellectual disciplines in any area of academia that rejects the inductive approach and prefers deductivism, used by theorists or ideologists. Unhindered by economic reality, deductive economists will start with any preferred axioms, which do not need to be supported by facts – such as the tautology that persons only care about the maximisation of their individual material benefit. Theories, which are specific to a hypothetical environment created by the assumptions, are then used to advance policy recommendations.

An alarming jump from theoretical and hypothetical models to actual, supposedly useful and functional policy advice is not usually explained, but can and will occur. It is striking how seamlessly neoclassical economists have bridged the gap from their wholly fictional world of unrealistic models to recommendations of policies that actual politicians are supposed to implement in reality - and indeed do.

Radical Economic Plan
A Plan to Realise Growth in the UK Economy.

Growth in the UK economy is currently exercised by the visible hand. Institutions implement policies from Whitehall, fiscal policy is decided upon by slicing up the income pie, monetary by adjusting interest rates, which has no economic significance anywhere beyond stock markets. Both work on the assumption that the amount of money in the economy is static; banks are believed to operate as intermediaries. Thus, the economy is going nowhere.

The prosperity report's proposed National Investment Bank (NIB) and the recently operational Funding for lending (FLS) scheme both accept the neo-classical axioms and therefore do not address the root problem of the UK's Growth, that is, credit created for financial speculation. Creating a separate public project or 'scheme' that invests existing credit, existing purchasing power when banks create new loans at higher speed is a false economy.

The government must create a scheme where it may harness this bank purchasing power. Credit must be directed to the real economy by banks in the form of loans.

Guided credit creation fulfills the crucial function of organising inputs to enable the production of new products, at the same time creating the income to allow consumers to buy the product.

The 50 MoF banks must meet the loan quotas set for them in their targeted market segments. All research indicates that the size of bank customers is proportional to the size of the bank itself. Large banks loan to large customers or sovereign nations, they do not chase small SME's. Small banks chase small customers, which in the long run benefit individuals.

The solution to grow and improve British investment in SME's is to grow and protect Britain's small banking sector.

This would achieve the goal of any good economist -to foster the connection

between science and business, this connection being a key driver of the national economy. The catalyst for this is the unused 'invisible hand' of government: credit guidance, that is, allocating to banks loan quotas.

Ministry of Finance & Small Banking Sector Setup

1. Creating 50 New Small Banks.

A new Ministry of Finance (MoF) should be set up to oversee the initiation of approximately 50 small banks focused on lending to SME's. As new start-up banks such as Starling and Tide show, the future of banking is online, their banking operations will reflect this. These small banks may be separated into two categories:

- Regional community banks – centred in a county or metropolitan area and giving loans only to companies in that area
- Industry-specific banks – banks that limited to courting companies specifically in the market segment that the MoF and specifically the government wish to expand. As the largest bank in the world demonstrates (Agricultural Bank of China) this has merit.

2. Loan Categories A, B and C

The MoF must separate all loans that these newly created banks will give out into loan categories. Any speculative loans that could contribute to asset inflation and might not contribute productively to the real economy (CF) will not be allowed.
Category A – For high tech goods, cutting-edge technologies, value-added products, medical, engineering of most varieties and radical innovations.
Category B – Incremental innovations, light industry, automobile, existing profitable market segments, agriculture, beverages, other identifiable growth segments, luxury items
Category C – Wholesale, retail, hotels, restaurants, tourism, manufactured goods for domestic consumption.

3. Operation - Front end, Back end, MoF Oversight.

MoF banks will have separate front and back office departments, discouraging corruption of banking officials by local stakeholders. Front-office bank staff will be responsible for seeking out new business concerning smaller or medium-sized companies in pre-selected market segments. Back office staff will approve the loans, dependent solely on financials; never meeting customers or local interest groups. When the front and back office staff cannot agree on loan issuance, bank managers may pass the loans onto the MoF for final approval.

The MoF must have transparency so that interest groups can see how many loans are approved by the MoF and that there is no corruption at any step, as it is an easily corruptible process, however one that produces results.

4. Which Market Segment?

Economic policy makers are obligated to cater for and consider all aspects of economic life. A central bank in its decisions must find the best wishes of all its' citizens. The Ministry of Finance, exercising monetary tools more powerful than the bank of England must assess possible implications from its' actions. Every decision by the board of the MoF on must be reached unanimously by vote.
The prioritization of specific market segments for growth lends itself to existing stakeholders and sharp entrepreneurs to make fortunes. South Korea is an economy that has gone from being a third world, recently freed colony post WW2, for years with 'junk' credit rating, to today having an AA credit rating, same as the UK, and is one of the few fully industrialised developed free markets.

In South Korea though, credit guidance saw families close to government form chaebols, who made billions of Won in ship-building, telecoms, technology markets and more. The men who were making the decisions in government, and decided where the banks should allocate credit to, were frequently given back-handers from their new successful friends in trade. Careful steps must be taken to avoid similar possible collusion; however, our existing British legal system should provide security.

Conclusion

Modern economics aims to enhance the agenda of international free trade, globalisation and WTO trade laws. It may have noble roots. Unfortunately, beliefs in the critical tenets of privatisation, deregulation, and liberalisation that constitute the neo-classical mantra also extend fluidly into banking and the stock market sector. The two schools are now difficult to separate, and it is now detrimental to economics and creating real economic growth.

Harnessing credit creation directly allows for the implementation of research and development, which results in the invention of innovation and new technologies. New technologies, recipes to combine inputs in a new way into a product highly valued, enhances total productivity. Credit also enables entrepreneurs and firms to implement new technologies. Since the credit market is always rationed and supply-determined, banks are already engaged as allocators.

Banks have the power to discriminate, which the UK must harness to benefit economic growth and justice simultaneously. The banks that already exist should not have loan quotas set upon them. Such a radical new proposition to the entrenched financial cluster of the City of London is a more significant burden than it can be expected to bear. The success of a small number of banks under credit guidance may be the thin end of the edge, however.

The scheme should prove to the public and policymakers alike that harnessing banks grow the economy as successfully as East Asian miracle economies have, ending the balance sheet recession, austerity, and recurring banking crises. The time is now ripe for the purchasing power of banks to be harnessed for the good of the British public whom they serve.

The UK will face obstacles more significant than any Western economy in embracing a new economic system. It has championed the classical and neoclassical schools and produced great heroes in those fields. Confusingly, the UK's economic

standing in the world, GDP, income distribution and more have collapsed calamitously in 100 years, yet it represents more Nobel laureates than any country except the USA. No country from China or Japan, and more high-growth countries have had any famous economists win such a reward. British economists must look beyond personal achievement however and become more ambitious for the nation. Its heroes must be those economists not who improve the 'free markets' or in actuality, free up the stock markets, but those who improve the lives of the citizens they represent.

The economy cannot be managed solely through mechanical activity, nor can it be shaped according to fixed rules and regulations.

It demands a feeling of responsibility for the economic health of the country. Prudent, responsible economic practice requires the capacity for making decisions, and courage, therefore.

Economics is entirely a human-made philosophy. It is a study of human-made phenomena; it is an art. An exacting librarian would label most economic books in the fictional section of his library for that is where all economic theories are. Relying alone upon theory to make policy affecting millions is a frightening folly, and a daily reality.

The easiest policy option of the UK is to copy successful macroeconomic paradigms of foreign high-growth economies, which cause little harm to the average native citizen, such as South Korea. The argument that developed nations must become fully deindustrialized because they are rich does not hold for a younger, globalized generation that can see Eastern nations with as-good-as, and soon a better quality of life, operating with fully employed manufacturing market sectors. For Britain’s leadership though, its’ numbers of intelligentsia may need considerable time and effort to be persuaded from their intelligent theories.

Appendix

Past Banking Crises and their Cause.

USA 1920s (Margin Loans):	Speculative Credit Creation
Scandinavia in the 1980s:	Speculative Credit Creation
Japan in the 1980s:	Speculative Credit Creation
Asian Crisis, 1990s:	Speculative Credit Creation
UK property bubble until 2007:	Speculative Credit Creation
US property bubble until 2006:	Speculative Credit Creation
Irish property bubble until 2007:	Speculative Credit Creation
Spanish property bubble until 2007:	Speculative Credit Creation

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