

BANKING AS A PUBLIC FRANCHISE



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Introduction

The most common view of banks is that banks act as financial intermediaries. The bank accepts scarce capital from private savers as deposits and pays them an interest as an incentive to save, and also a form of compensation for not spending money. Subsequently banks lend these private savings to borrowers for various economic activities, charging them an interest for the borrowed capital. The myth behind the orthodoxy story of capital is limited, scarce and financial capital first get accumulated in private hands. Then banking act as financial intermediaries channeling this private capital towards both private and public borrowers. The state is depicted to be a regulator and as a supporting arm to the privately owned and operated financial capital. State presence in financial markets through various financial instruments is considered as a competition to private borrowers by orthodoxy crowding out economic theory. When governments borrow, they compete with the private sector who wants to borrow the limited private capital available in the economy as per the orthodoxy theory. The purpose of this article is to unravel the orthodoxy myth of finance as intermediary, scarce and private capital. In modern economy, financial capital is not scarce, in fact it is unlimited and it is neither provided through private savings nor do the banks act as financial intermediaries. Finance capital being labelled as scarce and privately-owned makes resource allocation for the public significant in private hands.

Money Capital is not a commodity, instead money is a credit issued by the state (state liability). However, not all money capital being circulated presently is created by central banks. In modern economy, majority of the money capital is created by the banking system. When banks lend or extend loans, they simply credit the borrower's account. These bank credits (bank private liabilities) function as money, simply because they are convertible to government money (public liability).

In summary, financial capital is not scarce and not limited to privately owned savings, technically it is a creature of sovereign states and there is no limit for the ability to create capital. However, there can be real resource constraints. The modern financial system works as a public-private partnership, which the sovereign public as the franchisor and the banking system works as franchisees, since, private liabilities of the bank are convertible to public liabilities of the state. This process is called public accommodation and monetization of private liabilities. Further, banking system creates the majority of the capital in the economy in contrast to the orthodoxy intermediary belief.

The Three Theories of Modern Finance System

- **One-to-one, credit intermediary model:** Accumulated limited private capital of savers flows through to borrowers via the banking system.
- **One-to-many model:** The banking system lends out multiple amounts of what they receive from the savers as deposits, known as fractional reserve banking theory. However, the amount of lending is constrained by the deposited monetary base.
- **None-to-many, credit creation model:** The banks create new money by creating credit and new bank deposits for borrowers. In this model as well as in reality, new credit creation (new deposits) is not constrained by the deposited monetary base (privately accumulated savings).

Bank Credit Creation

In this way, banks expand its balance sheet recording house hold 1's mortgage note as an asset and simultaneously creating house hold 1's bank account as a liability. In modern banking systems, loans create deposits, not the other way around as depicted in orthodoxy loanable funds theory (deposits create loans). In a way of extending loans, banks have created a form of credit money out of thin air. Similarly, households have bank accounts with commercial banks, the bank themselves have bank accounts with the central bank called reserves. Just as households maintain enough balance to clear all of their payments, banks must maintain enough reserve balances with the central bank reserve account in order to enable payments to other banks requested by customers. There are many ways to obtain reserves for commercial banks. Simply, banks can sell their securities to obtain reserves. Banks can borrow excess reserves from other commercial banks. Banks also can borrow reserves from the central bank to finance its reserves. However, interbank settlement occurs in aggregate level. At the end of each day, banks will figure out through their settlement account, who owes whom. Final payable amount will be deducted from the reserves of the debtor bank and it will be added to the reserves of the creditor bank via the reserves held at the central bank. We call this type of money, bank reserves. Together with currency in the form of notes and coins which is circulating outside the banking system, makes up high powered money also known as base money, monetary base.

The Role of Government Liabilities in Financial Markets.

Government, as the issuer of the securities, also provides the necessary liquidity for the financial markets. Treasury securities function as the safest investment for financial markets. Risk-free government securities provide a benchmark for reliable pricing for privately issued securities as well. Treasury securities function as base money in shadow banking, since, it serves as an extremely reliable and most liquid collateral for the sector. As the issuer of the necessary securities for markets to function, the government involvement is quite different to the commonly labelled role as the regulator. In a nut shell, the government liability works as a safe asset for the private sector. When various private debt issuances in financial markets are purchased by extending bank credit, the public accommodation and monetization of private debt occurs. The same can be stated when the government provides guarantees for various debt instruments in financial markets.

Thus far, the majority of public accommodation and monetization of private credit generation has ended up in financial markets, creating a capital glut while creating chronic shortages in the real economy for full utilization of the productive capacity of the economy. The underlying cause for this failure is the lack of effective public control over the performance of the franchisee by the franchisor.

Conclusion

The financial system operates as a franchise arrangement, where the public sector which accommodate and monetize private credit creation as the franchisor, while the private credit creating institutions works as its franchisees. Therefore, this debunks the private capital intermediary myth in the financial system. Hence, it destroys the orthodoxy narrative scarce private capital which hinders stable economic development. Rather, it establishes the fundamental need of active public sector participation in controlling and allocating private credit creation to ensure sufficient flow of credits to productive purposes.

References

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