# Chapter 4
# An Appraisal of the Financial Monetary System


The previous chapter traced how our financial monetary system has evolved since the nineteenth century. The financial system is crucial for the functioning of society, enabling households, businesses and other institutions to make payments, save money, obtain finance (through debt or equity), and insure themselves against unforeseen events. Payments, savings, finance and insurance are the four classical functions of the financial sector.[1] A sector that performs these functions well contributes to economic development and prosperity; a malfunctioning sector can cause a great deal of damage.

Trust is essential for the functioning of the system. Sobel defines this complicated concept as a person's willingness to let others make decisions that affect one's well-being.[2] Two dimensions of trust are central for our purposes. First, trust is earned through reliability – through the fulfilment of justified expectations. A second aspect of building or maintaining trust is the ability to express dissatisfaction. This is tied to the system's (perceived) legitimacy. This chapter assesses our financial monetary system on the basis of four characteristics: its economic contribution (Sect. 4.1); its stability (Sect. 4.2); its fairness in the distribution of benefits, costs and risks (Sect. 4.3); and its legitimacy (Sect. 4.4).

Based on this analysis, we highlight key problems in the current system. As many of these problems are also emphasized by the advocates of monetary reform, this raises the question whether they can be traced back to how money is created in the current system. Unfortunately, this is no easy question to answer. In our current system, money and debt are inextricably linked. Money largely consists of bank deposits and is thus linked to the functioning of banks. This interconnectedness means that problems resulting from the organization of payments, savings, lending and money creation in our society – and specifically the role banks play in these activities – cannot be readily separated. Moreover, problems such as high levels of

[1] The insurance function falls outside of the scope of this report.

[2] Sobel (2002)



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debt arise from many different factors. The problems discussed in this chapter therefore cannot be ascribed solely to how money is created. Chapters 5 and 6 will discuss to what extent these problems could be solved by transitioning to a different monetary system.

## 4.1 Economic Contribution

A well-functioning financial sector contributes to society, specifically to its economic development. In the wake of the financial crisis, many more people have been asking whether the financial sector is fulfilling this role. This section addresses this issue by first considering the functioning of the payment system. We then address concerns about high levels of debt and how far these can be reduced without causing economic damage.

### *4.1.1 The Payment System*

The payment system is crucial for society's functioning.[3] We evaluate the Dutch payment system using five criteria: its cost, accessibility, convenience, security and reliability. Studies have found that the total cost of the Dutch payment system (relative to GDP) is lower than that of most other countries. At approximately 0.92% of GDP, the Netherlands is just behind Denmark, Sweden and Finland – the top three in Europe – where costs amount to approximately 0.80% of GDP.[4] The cost of payments in the Netherlands is also declining. Although cash payments have become more expensive (from €0.30 per transaction in 2002 to €0.39 in 2009), the cost of giro payments has fallen sharply, from €0.49 to €0.33.[5] Given the shift from cash to giro/electronic payments – most payments in the Netherlands are now made with debit cards – the total social costs have most likely decreased even more.[6]

How are these costs allocated? Dutch consumers incur relatively few *direct* costs: they must often pay a fee to maintain a bank account, but pay little or nothing in the way of transaction charges. The direct costs are borne by businesses and banks. Businesses incur costs for both cash and electronic payments. For cash payments, these include the cost of transport, deposit and security systems; for electronic payments, charges levied by the bank. While banks incur costs to process payments, they also derive benefits from their position in the payment system, including the possibility to link services (such as loans and payment accounts), the relatively low

[3] The payment infrastructure has characteristics of a public good. We return to this in Chap. 7.

[4] Schmiedel et al. (2012: 40)

[5] Jonker (2013)

[6] Jonker et al. (2018)

interest paid on payment account balances and the government's implicit or explicit support of banks (see Sect. 4.3). Nevertheless, a study by McKinsey & Company on behalf of the Dutch Banking Association (NVB) and De Nederlandsche Bank (DNB) shows these benefits did not offset the costs banks incur when handling cash and electronic payments.[7]

The second factor is accessibility. Here, low payment account charges encourage the use of the electronic infrastructure. The NVB signed in 2001 a pledge with the Salvation Army and the Ministry of Finance that all permanent residents aged 18 and above with a valid identity card (or a postal address at a recognized welfare or government agency) have the right to a basic payment account.[8] Under European rules, there is now a statutory obligation for banks to provide people with a payment account (Section 4:71f of the Financial Supervision Act). All consumers lawfully resident in the EU must have access to a bank account with basic functions and reasonable charges.

The dominance of electronic payments raises concerns about the accessibility of the cash payment system.[9] While it is relatively easy to obtain cash – 99.65% of all Dutch residents live within five kilometres of an automated teller machine – some stores and municipalities no longer accept cash payments. It is particularly problematic in case of public bodies, as there is often no alternative.[10] Although most places still accept cash, DNB has raised concerns about its declining use.[11]

A third aspect concerns payment convenience. The payment system is an area of constant innovation. As discussed in the previous chapter, in the Netherlands it was mainly the public bodies – particularly the Postcheque en Girodienst and Gemeentegiro Amsterdam – that led with innovations such as ATMs and POS terminals and promoting giro transfers. Dutch consumers today enjoy a high level of convenience due to innovations such as internet banking and contactless payments. One issue of concern is the ease with which consumers can switch banks: although there is a switching service that eliminates some of the inconvenience, switching banks poses difficulties as account numbers are not portable.

A fourth factor is security. According to the National Forum on the Payment System, safety has been improving with declining incidences of bank card skimming and fraud in internet banking.[12] Whereas the damage caused by this type of fraud amounted to around €81 million in 2012, by 2016 it had fallen to €10 million. But despite improvements, there remain grounds for concern. Protecting people from online threats (cyber-crime) remains a constant challenge. The more we use internet banking and online payments, the more criminals will operate online.[13]

[7] McKinsey and Company (2006)
[8] Louisse (2013)
[9] MOB (2017b)
[10] Nationale Ombudsman (2017)
[11] Voormeulen cited in Bremmer (2018); DNB (2018a)
[12] MOB (2017a)
[13] CPB (2016); MOB (2017b)

Finally there is the issue of reliability, or disruptions to the system. Although the payment system is generally reliable, the 2008–2009 financial crisis revealed its dependence on the banks: large-scale government intervention was necessary to ensure that the banking sector and hence the payment infrastructure remained operational. Apart from financial instability, cyber problems appear to pose the main danger, with banks in recent years facing major DDoS (distributed denial of service) attacks that disrupted access to internet banking. The digital payment infrastructure also depends on other critical infrastructure such as telecoms and electricity. DNB recently cited increased digitization and cyber-attacks as risks that continue to grow with the shift from cash to electronic payments.[14]

### *4.1.2 The Volume of Debt*

Seen historically, global debt levels are exceptionally high.[15] According to BIS statistics, the total volume of private debt in the Netherlands (by consumers, businesses and other non-financial institutions) has risen from less than 40% of GDP in 1960 to over 250% today. This is high compared to other countries (see Fig. 4.1).

The sharp rise in private debt has many causes. Combined with financial liberalization and deregulation, the fact that banks can create money when granting loans implies that constraints on bank lending are limited. Financial innovations such as the securitization of loans have also contributed to high levels of private debt.[16] The deductibility of interest charges makes debt finance cheaper than equity finance. Another factor is compulsory saving through pension funds, meaning that first-time home buyers must borrow more.

Before the crisis, credit growth was largely seen as a positive development. Despite limited empirical evidence, economists broadly assumed that increased lending (as a percentage of GDP) was positively correlated with economic growth and even contributed to it.[17] Rising levels of individual indebtedness were also largely seen as positive, with economists framing it as the democratizing of financial services.[18]

There has been much more attention for the downsides of high private debt in the wake of the crisis. A new consensus holds that private debt can be excessive, with recent research showing an ‘inverted U’ relationship between lending and economic

[14]DNB (2018b)

[15]Buttiglione et al. (2014). This section focuses on private debt. We deal with public debt in Sect. 4.3.

[16]Securitization is the process whereby bank loans are ‘packaged’ and sold on to other financial players. This creates ‘space’ on banks’ balance sheets, enabling them to grant new loans.

[17]Levine (1997); Bijlsma and Dubovik (2014: 2)

[18]Debelle (2004); Rajan and Zingales (2004)

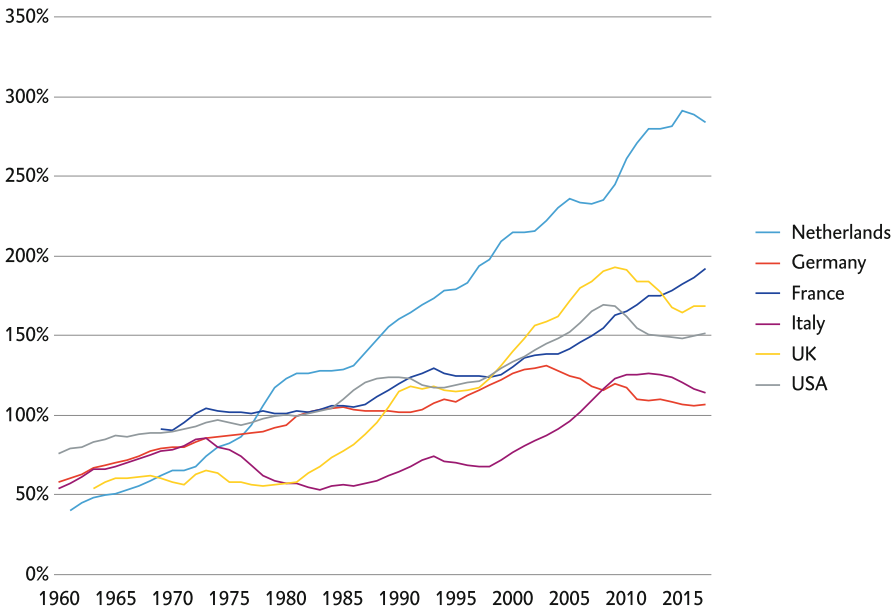


**Fig. 4.1 Volume of outstanding private debt relative to GDP**
Source: BIS statistics. Private debt defined as the debt of households and businesses, excluding financial firms. Figures differ depending on the source. For 2016, for example, debt relative to GDP ranges between 206% (World Bank), 231% (IMF), 262% (Eurostat), 264% (Statistics Netherlands) and 289% (BIS) of GDP. Business loans are not consolidated in the BIS data, so intragroup loans are included in the calculation. We use BIS figures in this report as they are the longest-running consistent and internationally comparative series. Despite the differences, all sources reveal the same upward trend.

growth.[19] This implies that although financially underdeveloped countries may benefit from increased lending, this does not apply to financially developed countries where lending above a certain limit may constrain economic growth.[20] Although the precise turning point remains elusive, the OECD concludes that most OECD countries – including the Netherlands – will not benefit from any further rise in private debt.[21]

Nevertheless, many economists still argue that high debt levels – given the low incidence of default – do not pose a problem for the Netherlands. Although it is true that Dutch banks' loan losses have been limited, high debt levels can still create macroeconomic problems. First of all, high levels of debt entail stability risks. A crisis is often preceded by strong credit growth,[22] while high debt levels can

[19] Arcand et al. (2015); OECD (2015); Cecchetti and Kharroubi (2012, 2015)
[20] Rousseau and Wachtel (2011); Arcand et al. (2015)
[21] OECD (2015); WRR (2016: 50–51)
[22] Borio (2012); Schularick and Taylor (2012); Drehmann et al. (2011)

constrain recovery after a financial crisis.[23] High debt levels also make spending more volatile. Dutch household consumption is highly volatile compared to that of other countries.[24] Due to high private debt and savings tied up in pensions, consumption patterns in the Netherlands are heavily influenced by house prices and interest rate fluctuations. In principle this works in both directions: with rising property prices homeowners feel wealthier and spend more; with downward movements the reverse occurs. This fuels pro-cyclical trends in the economy, the overall effects of which are negative.[25] The same phenomenon occurs in business. When debt levels are high relative to equity, business viability will more likely be threatened by a cyclical downturn. Debts must always be paid, whereas equity can be used to absorb losses.

High debt levels in society are therefore detrimental to economic development. Many authors point out that the allocation of credit also matters a lot (see Box 4.1).

**Box 4.1 Allocation of Credit**

While high private debt is a problem, it is not the only issue: we also need to consider who has access to credit and at what price.[26] We can distinguish between lending to households, businesses, public institutions and financial institutions. Figure 4.2 shows that the proportion of loans to businesses and public institutions in the total bank balance sheet has declined in recent decades while that of loans to households and financial institutions has increased sharply. This is tied to the growth of mortgage lending and changes in the financial system.

A number of economists argue that these trends in lending negatively impact economic development.[27] Clearly, the focus on mortgage finance and lending to other financial institutions has its downsides. Lending patterns and the price of assets such as houses and financial instruments become mutually reinforcing, exerting pro-cyclical effects on the banking sector and the economy at large.[28]

This, however, does not mean that banks are granting insufficient credit to businesses. If we look at loan volumes in terms of GDP, banks in recent decades have not reduced lending to businesses (on the basis of DNB Table 5.2.1). Moreover, bank credit is not the only source of (debt) finance for firms, with large companies having access to capital markets. There are nevertheless problems in business lending, primarily to smaller and medium

(continued)

[23]Mian and Sufi (2010); IMF (2012: 96–100); IMF (2016); Liu and Rosenberg (2013)

[24]Lukkezen and Elbourne (2015: 10)

[25]SER (2013); WRR (2016)

[26]Arcand et al. (2015); Beck et al. (2012); Cecchetti and Kharroubi (2012, 2015); Bezemer (2017)

[27]See e.g. Turner (2015) for the UK; Bezemer and Muysken (2015); Jordá et al. (2014)

[28]WRR (2016)

**Box 4.1** (continued)
sized enterprises (SMEs). The past decades saw a shift from relationship to transactional banking, with bankers increasingly basing lending decisions on standardized criteria rather than on personal knowledge of the customer or sector.[29] While standardization has positive effects, it biases decisions towards measurable factors. This can negatively impact access to credit for small businesses and entrepreneurs, who already have less access to alternative financing. For example, SME loans, due to problems of scale, remain unattractive for pension funds.[30]

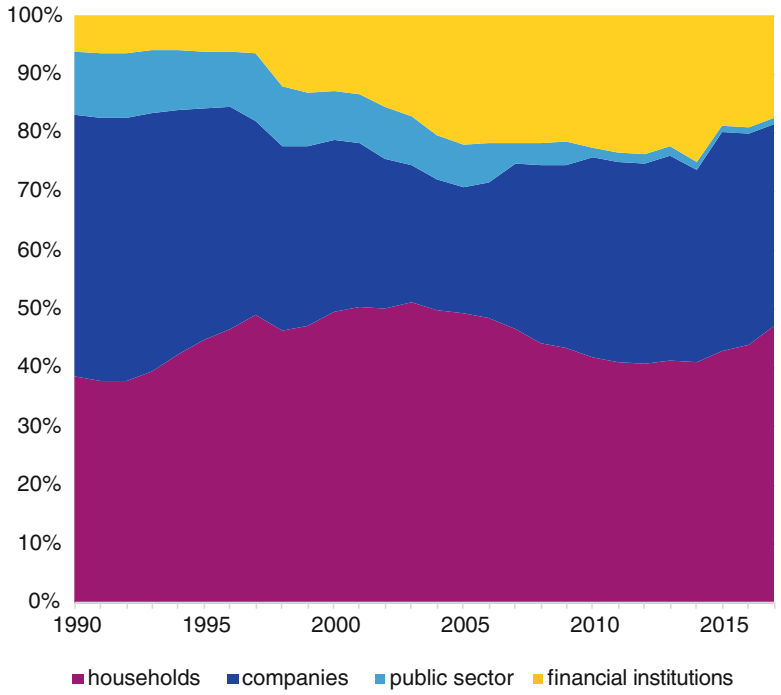


**Fig. 4.2 Allocation of bank loans**
*Relative share of credit categories in total bank loans*
Source: Compiled on basis of DNB Table 5.2.1

[29]Boot and Ratnovski (2016)
[30]SER (2013); European Commission (2013)

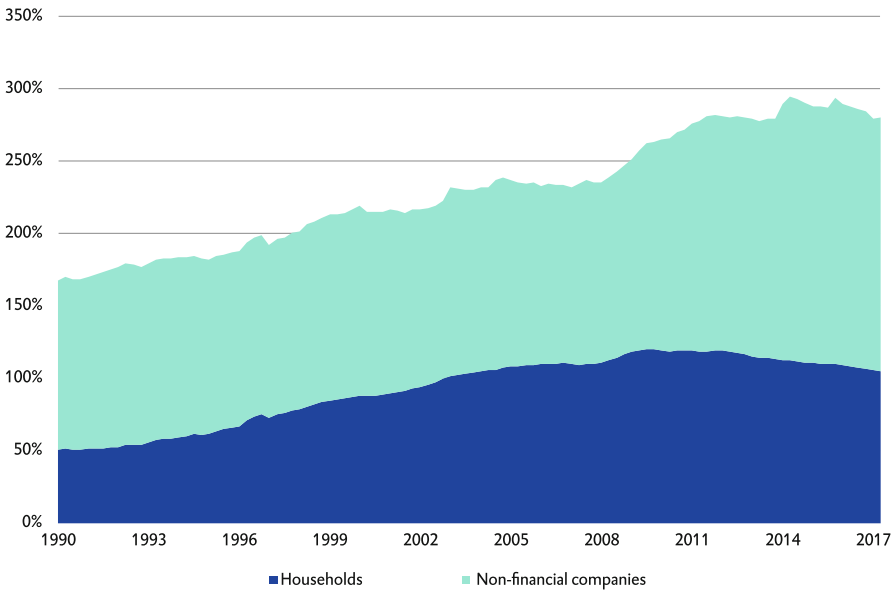


**Fig. 4.3 Volume of debt in the Netherlands**
*Private sector debt as a percentage of GDP*
Source: BIS

### *4.1.3 Reducing Debt Levels*

Current levels of private debt increase the risk of financial instability and may well be constraining economic growth. Reducing outstanding debt – referred to in the jargon as deleveraging – may seem the obvious solution. How to accomplish this is far from self-evident, however. Total private debt in the Netherlands now exceeds pre-crisis levels in both absolute and relative terms. In absolute terms, it has risen from €1400 billion just before the credit crisis to €1600 billion in 2016 (BIS statistics). As a percentage of GDP, it has risen over the same period from around 230% to around 280% (see Fig. 4.3). Despite increased awareness of the risks, private debt is currently no lower than before the crisis.

Reducing debt levels in the wake of crises is no easy task. When households and businesses pay down their debts, their scope for spending shrinks, slowing economic growth, triggering unemployment and paradoxically increasing the volume of private debt as a percentage of GDP. There may also be deflationary (price-reducing) effects, further impeding economic growth. In short, although debt repayment can have economic advantages by increasing stability, it can cause short-term economic damage.[31] Still, there are ways to reduce debt levels without undermining

[31]Lo and Rogoff (2015); Mian and Sufi (2014); Pontuch (2014); Turner (2015). Economists refer to 'the paradox of thrift', popularized by the works of John Maynard Keynes and Irving Fisher.

consumption. For example, if debt is repaid through a transfer of wealth from parents to children, the negative effects on consumer spending are less severe.

While repayment is not the only way to reduce debt, alternative methods have shortcomings or may not be feasible in the current system. After a crisis one could restructure problematic household and business debt. Depending on the method, private debt levels could be reduced without directly leading to deflation and lower economic growth. While such debt reduction could stimulate consumption and investment, it would create losses for lenders (in particular banks) and could lead to financial instability.[32] One option would be for the government to play an active role in the restructuring. Either way, it would have distributive effects, with debtors receiving preferential treatment over non-debtors and lenders. It is also questionable whether this strategy would be feasible in our internationally interconnected financial system. Restructuring between debtors and creditors within a single legal system is already difficult[33]; spread across countries, the task becomes even more onerous.

We can also aim to reduce debt in relative rather than in absolute terms. If the economy grows but outstanding debt does not, debt levels decrease as a percentage of GDP. This can happen when growth is financed through equity and the broad money supply grows more slowly than the economy (because money creation always involves debt creation). The relative debt burden can also decrease due to inflation. In the long run, however, inflation implies a larger money supply. In our current system, where money creation takes place largely through lending, it is generally accompanied by increasing debt (regardless of whether monetary growth is caused by bank lending or quantitative easing).

There are ways to stimulate demand without rising private debt levels. It can be done through greater government spending (which would increase public debt) or through the monetary financing of government spending and 'helicopter money' (which would not). Monetary financing means that government spending is financed directly by the central bank, currently prohibited under Article 123 of the Treaty on the Functioning of the European Union. In the case of 'helicopter money', the central bank directly credits household accounts with new money. It is unclear whether this would also fall within the prohibition on monetary financing. Either way, these options raise issues that we only address later (in Sect. 7.1.3). What is clear is that reducing the debt burden following a crisis is a complex affair, made no easier by international interdependencies. In a system where money and debt creation are inextricably linked, it is even more difficult.

[32]Demertzis and Lehmann (2017)

[33]Reinhart et al. (2015: 2)

## 4.2 Stability

The second goal of any financial monetary system is stability. Financial instability has grave consequences for society. When a bank fails, account holders lose their money; if their deposits are insured, they temporarily lose access to their money. Although the latter may not sound dramatic, 90% to 95% of our money supply is made up of deposit money; a crisis in a large bank could make it impossible for millions of people and businesses to make payments, disrupting day-to-day business. Holders of the bank's bonds, shares and subordinated deposits[34] would lose their investments while bank lending would grind to a halt.

Instability of the entire financial system has much wider effects on society. In addition to direct costs such as bank bailouts, crises undermine economic growth, business investment, accumulated wealth and trust. Unemployment often sky-rockets. Long-term unemployment entails the loss of knowledge and expertise, reinforcing negative economic outcomes and potentially leading to structurally higher unemployment.[35] Crises also undermine public finances (we return to this in Sect. 4.3). Even in the absence of a crisis, financial instability can have detrimental consequences for the real economy: when private assets (such as homes) plummet in value while liabilities (debts) remain unchanged, economic growth is constrained.[36]

We first examine the stability of individual banks and subsequently the stability of the system as a whole. The two are of course intimately linked: the instability of a systemic bank can cause the whole system to falter, while system instability threatens individual banks. Note that financial stability does not require the absolute stability of every individual institution; for systemic stability, it is important that institutions can be restructured or can be allowed to fail.

### *4.2.1 Stability of Individual Banks*

The fragility of individual banks is primarily linked to the maturity transformation and risk transformation that take place within a bank. While both can positively affect the availability of finance and the return generated on savings deposits, they also make banks inherently unstable.

Maturity transformation means that the terms of a bank's assets differ from those of its liabilities. While mortgages may have a 30-year maturity, money market loans to the bank may mature after a day and deposit money can be withdrawn at any time. These term differences between the bank's assets and liabilities generate liquidity risks: the bank must be able to immediately repay account holders while other

[34] If a bank fails, the balances on these savings accounts are only repaid once all other creditors have been paid.

[35] WRR (2016: 160–1); Layard et al. (1991)

[36] Borio (2012); Turner (2014)

parties' debts to the bank have longer durations. When problems arise, the first to withdraw their deposits have the greatest chance of seeing their money again. If a bank's creditors (account holders and providers of short-term loans) withdraw their funds *en masse*, the bank will have insufficient central bank reserves or other liquid assets to meet these requests. This is the risk of a bank run.

The bank will then have to sell some of its assets or borrow (against collateral) from the central bank.[37] Whether the bank succeeds depends on the extent of the withdrawals, whether it is able to borrow from other parties and whether it has sufficient assets to sell. Selling assets will be less problematic in normal times than during a crisis. In a crisis many markets dry up, meaning that either there are no buyers or a bank can only sell its assets at prices far below their book value.

There are various ways to discourage runs on a bank. Central banks can provide emergency liquidity, while deposit insurance schemes guarantee account holders' deposits (in Europe currently up to €100,000).[38] But deposit guarantee schemes often only guarantee certain types of deposits and only up to a certain amount; they thus cover only part of a bank's liabilities.[39] The large sums managed by professional parties are generally not covered by deposit insurance and are often the first to be withdrawn. The risk of a bank run therefore remains.

The maturity mismatch between banks' assets and liabilities widened in the years preceding the crisis as banks increasingly financed their activities through short-term borrowing in money and capital markets. Confident that they could always obtain new funds, individual banks felt protected against liquidity risks. But the crisis revealed that these funding markets can dry up.[40] While this risk has received more attention since the crisis, Dutch banks still depend fairly heavily on market finance and are therefore vulnerable to turbulence in financial markets.[41]

Risk transformation means that one side of a bank's balance sheet contains risky assets that can fluctuate in value while the other side has debts of fixed amounts. While a bank can make losses on its loan book and financial assets, it has promised its creditors to repay debts in full. A bank with an account on its books with a balance of €1000 must always be able to pay out €1000, plus any interest.

Losses can be absorbed by the bank's equity; when equity is wiped out, the bank is bankrupt. The bank's solvency determines whether it has sufficient equity to absorb shocks in the value of its assets. The risks of insolvency and illiquidity are

[37] Bank of England (2013)

[38] Deposit guarantee schemes were institutionalized in Europe fairly late: in Germany in 1977, in France and the Netherlands in 1979, in the UK in 1982, and in Belgium in 1985. The United States is the pioneer, having introduced a guarantee system in 1933 during the Great Depression (Baltensperger and Dermine 1986: 14).

[39] Cannas et al. (2014)

[40] Brunnermeier et al. (2009)

[41] DNB (2017: 17)

intimately linked. In times of crisis, liquidity problems can rapidly turn into solvency problems and vice versa.[42]

Banks' equity levels declined sharply in the decades before the crisis as growing bank balance sheets were financed mainly through additional debt. In other words, the share of equity relative to the total balance sheet (the leverage ratio) declined. Low leverage ratios make banks more susceptible to shocks and fuel pro-cyclical behaviour. When ratios are low, relatively small losses (or gains) translate into major reductions (or increases) on the balance sheet.[43] Since the crisis, we have seen efforts to increase banks' equity, with Dutch banks' leverage ratios rising from around 3% in 2007 to around 6% today.[44] Elsewhere in Europe it is not much better.[45] Improvements notwithstanding, bank equity levels remain low, especially when compared to non-financial companies: around 33% for SMEs and around 48% for large firms.[46]

### *4.2.2 Systemic Instability*

As we saw during the 2007–2009 crisis, systemic stability is not simply the aggregate of the stability of individual banks. The financial system must also contend with systemic risks, "a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and that has the potential to have serious negative consequences for the real economy".[47] The literature usually distinguishes between vulnerabilities resulting from: (1) the build-up of large imbalances, such as high debts and the development of bubbles; and (2) the structure of the sector, including interdependencies and financial institutions being too big to fail.[48]

Economic and financial cycles are accompanied by periods of collective optimism and pessimism. As Rien Nagel, former director of Rabobank, puts it: "As a bank we're part of the herd. You can linger on the edge of the herd, but if you move too far away you won't survive. So if favourable economic developments suddenly lead everyone to grant mortgage loans of five times annual salary, instead of the maximum of three times, you're bound to go with the herd".[49] Market players' expectations crucially affect the functioning of financial systems, both in the run-up

[42]Goodhart (2007)

[43]Schoenmaker and Wierts (2015)

[44]DNB Table 10.1. Based on data gathered for the IMF *Coordinated Compilation Exercise on Financial Soundness Indicators*.

[45]WRR (2016)

[46]Verhoeven et al. (2010)

[47]FSB, IMF and BIS (2009: 2)

[48]DNB (2016); IMF-FSB-BIS (2016); Stellinga (2020)

[49]Cited in Keuning (2017). Our translation.

to crises and during their aftermath.[50] Banks grant loans with expectations about future income streams and the value of collateral, while the price of other financial instruments also depends on future expectations. Shares drop in value when profit outlooks are adjusted downwards; bonds fall in value when the future looks less rosy.[51] These forecasts are not only based on calculations of known risks. The financial world is beset by uncertainty; decisions are often based on intuition, narratives and social norms. Changing expectations or declining trust can lead to very different judgements, affecting people's willingness to purchase financial assets.[52]

Changing expectations about the future fuel the pro-cyclicality of the financial system. In times of confidence, estimates of future incomes are positive, loans are readily granted and financial assets are highly valued. Rosy expectations also mean that households and businesses are willing to incur greater debt. This can inflate the value of assets such as houses and shares, reinforcing the optimism and increasing the value of collateral. Rising house prices and credit growth are thus mutually reinforcing. All this contributes to higher profits and growth, further reinforcing the overall trend. A financial boom is born, fuelled by strong credit growth.

Relatively minor, unexpected changes such as disappointing profits can undermine general confidence. This can cut into the value of banks' financial assets, leading to a disruption of financial markets, thereby reinforcing banks' problems. Doubting their investments, financial actors will try to sell them off. Panic can ensue. Previously positive, self-reinforcing effects now operate in reverse, only more strongly as asset values collapse and market liquidity dries up.[53] Financial institutions lose access to funding, with accompanying doubts about their solvency. As the boom turns into a crisis, banks become less willing to grant loans. Households and businesses become reluctant to take on more debt or attempt to pay down what they have already borrowed. Homeowners see a collapse in housing prices while their mortgages are fixed. They feel compelled to consume less, often with further negative effects on the economy. The financial crisis turns into economic turmoil.[54]

Alternating waves of collective optimism and pessimism recur in history. Although designing a crisis-proof financial system may be unrealistic, the system should be able to absorb moderate shocks. But this has become less and less the case over the past decades as imbalances have accumulated, the probability of shocks has grown and shock-absorbing capacities have declined. After decades of relative calm,

[50] Stellinga and Mügge (2017); Stellinga (2018, 2019)

[51] Bonds issued by governments deemed reliable are exceptions. Safe havens in times of crisis, they can rise in value.

[52] King (2016: 150)

[53] Adrian and Shin (2008). This means there are no further buyers; there is no longer a 'market' where these products can be traded.

[54] Borio (2012); King (2016). This dynamic was already recognized in the works of economists such as Kindleberger (1978) and Minsky (1986).

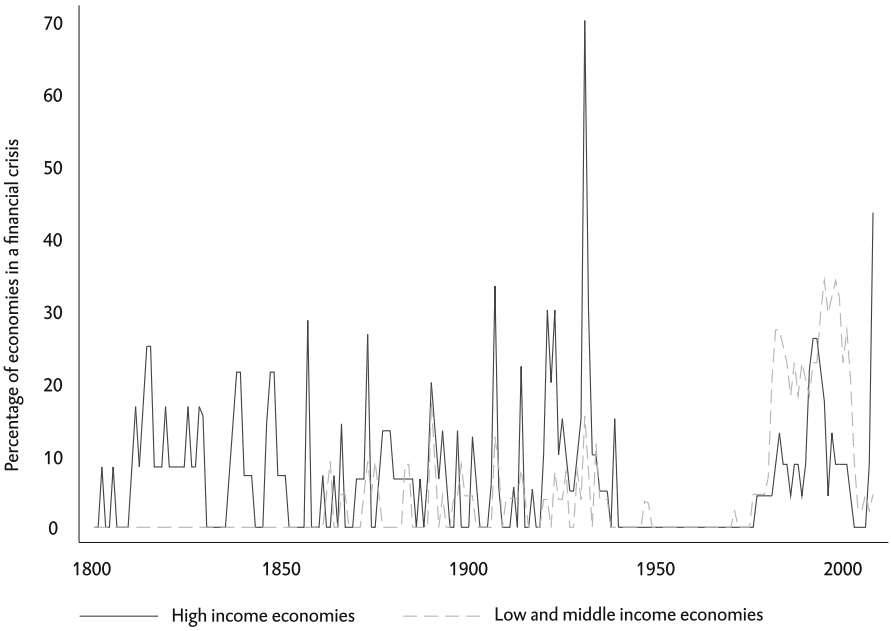


**Fig. 4.4** The frequency of banking crises since 1800

financial instability has returned since the 1970s as a structural problem (see Fig. 4.4).[55]

Imbalances in our current system are evident in the financial and non-financial private sectors' ballooning levels of debt. Private debt is at historic highs. Limited equity relative to this debt means that all actors have less scope to absorb shocks. We observed that despite post-crisis improvements, banks still have little equity, while corporate and household debt-to-equity levels have also risen in recent decades.[56] Small economic fluctuations can thus rapidly create problems for financial institutions, businesses and households. A society in which all economic actors are highly indebted is more sensitive to systemic shocks.[57]

Systemic fragility has also been fuelled by structural changes in financial markets. Financial globalization, the blurring of boundaries between financial institutions, and the growing uniformity of major banks have changed financial sectors markedly. Previously national financial systems have been internationalized with the liberalization of capital flows and the dismantling of other barriers. Although financial globalization has some major benefits, it allows local problems to spread rapidly to the global level and vice versa. Financial activities have also become interwoven. Whereas financial systems in the post-war period remained segmented, the lines

[55]Taylor (2012); WRR (2016: 70–71);

[56]Schularick and Taylor (2012); WRR (2016)

[57]Bezemer and Muysken (2015); WRR (2016)

between different types of financial institutions have been blurred. Banks today combine a wide range of financial activities; although this may bolster the ability of individual banks to absorb shocks, the system as a whole is more susceptible to instability.[58] Day-to-day movements in banks' share prices are more interrelated than those of businesses in other sectors, indicating that investors are aware of these systemic risks.[59] Banks have become intertwined not only with other banks but with other financial institutions (see Box 4.2). Finally, we see the emergence of institutions that are so big or important for the system – institutions that are too-big-to-fail – that their problems can threaten the entire system.

**Box 4.2 The Shadow Banking System**

The 2007–2009 crisis revealed that the source of systemic instability can lie outside of the formal banking system. Many argue that the crisis was largely a 'shadow banking crisis' where problems arose in institutions that were not strictly speaking banks (they had no banking licences) and only later spread to banks. Although this framing suggests that the shadow banking system is a separate segment of the financial sector, it is closely intertwined with banking, either because banks had granted these institutions loans and guarantees or because banks were financed by them. Many shadow banks that experienced difficulties had been set up by banks to circumvent laws and regulations.

There are competing definitions of the shadow banking system. Broadly defined, it comprises all financial institutions that are not banks, pension funds or insurance companies.[60] The weakness of this definition is that it lumps together disparate institutions that differ greatly in their activities and stability risks. The FSB therefore uses a narrower definition, including only institutions that pursue activities and incur risks that closely resemble those of banks (such as lending based on short-term debt).[61] Examples of shadow banks in this narrower definition include institutions involved in securitization, 'open-ended' investment funds and broker dealers.

How one defines shadow banking affects estimates of its size. Broadly defined, the Dutch shadow banking system had a total balance sheet of €5552

(continued)

[58]Haldane (2009). Holding similar types of financial assets as well as pursuing similar strategies can increase systemic instability. In the stock market crash of 1987, all large institutional investors in the United States were using the same risk management system and received automatically generated advice to sell.

[59]De Vries (2005); Muns and Bijlsma (2015). Hartmann et al. (2004) show that stock prices in the EU and US react more to movements in an index of bank shares than movements in the broader market index. Muns and Bijlsma (2015) compare linkages between bank share prices and linkages in other sectors and find banking to have the highest systemic risk. De Vries (2005) traces this to the high probability of large outliers, coupled with banks pursuing the same activities.

[60]See for example ESRB (2018)

[61]FSB (2015)

**Box 4.2** (continued)
billion (826% of GDP) in 2014; according to the narrow definition it was €207 billion (31% of GDP) (see Van der Veer et al. 2015). The difference is mostly due to the many 'special financial institutions' registered in the Netherlands – institutions set up by multinationals to take advantage of the flexible tax regime – which do not fall within the narrow definition of shadow banking and are not directly linked to banks.

For financial stability, three questions follow: (1) what are the vulnerabilities within the shadow banking system? (2) how do they impact society (possibly through regular banking)? and (3) what policies are required to eliminate these vulnerabilities? Although policymakers have devoted much attention to these matters following the crisis, issues remain. Many institutions still fall outside the scope of policy and supervision. We still know little about how different types of shadow banks may contribute to future financial instability. While growth in non-bank financial intermediation can contribute to financial stability and economic growth, the potential risks cannot be underestimated.

Financial instability may also be caused by very different factors, such as cyber-attacks on crucial parts of the system. These are occurring with increasing frequency and are becoming more dangerous. Cyber security is now a top priority for banks. Cyber risks can threaten the overall system and, like financial risks, are exacerbated by high levels of interconnectedness in the financial system.[62]

## 4.3 Fairness

An important requirement of the financial monetary system is that it is fair in the allocation of costs, benefits and risks. Financial crises are a key problem in this respect, as they entail high public costs. These include *direct* costs (for example the costs of bailing out financial institutions) and *indirect* costs (such as unemployment and the deterioration of public finances). Another question concerns the financial benefits that banks enjoy as a result of implicit or explicit government guarantees, the position they occupy in the payments system and through competitive distortions. Finally, there are questions about the allocation of costs, benefits and risks from higher private debt levels.

[62] BIS (2014: 1); Bank of England (2015)

### 4.3.1 The Public Costs of a Crisis

Profits before the crisis went to the bank whereas the costs were borne by the government and the general public – this is what many said in the wake of the crisis.[63] How valid is this statement? We first consider the costs of a financial crisis before discussing the allocation of benefits in the pre-crisis period.

Financial crises have major economic and social consequences. These include the evaporation of wealth, business bankruptcies, increasing unemployment and house evictions. To stop further deterioration and prevent systemic collapse, public authorities (governments and central banks) normally intervene in various ways – through liquidity or capital injections, taking over problematic loans, issuing guarantees or even nationalizing financial institutions.

While the idea that public authorities must intervene during a crisis is far from new, the size of implicit or explicit public guarantees has mushroomed in recent decades. This is largely due to the greater size of banks relative to GDP,[64] while the growth of the shadow banking system and its interconnectedness with banks means that central banks must also worry about the stability of financial institutions that are not strictly speaking banks. The collapse of Lehman Brothers in September 2008 triggered a global crisis. Since then, no government has seriously considered allowing a major financial institution to fail.[65]

The enormity of public guarantees became evident during the crisis as public authorities had practically no choice but to provide financial support. Support to banks from the Dutch state – in the form of capital injections, acquisitions of problematic financial assets and guarantees – amounted to 27.3% of GDP or approximately €174 billion.[66] Providing support does not immediately imply *losses* for the government: if a government purchases bank shares or takes over problematic loans, it obtains financial assets that may ultimately generate value. The Dutch government, for example, benefitted from its guarantee for ING.[67] Moreover, guarantees do not always have to be called on.

Still, the *net costs* of support are often substantial.[68] This was certainly true for the 2007–2008 crisis. Between 2008 and 2014, the *direct* losses borne by euro area governments for supporting financial institutions amounted to 4.7% of GDP or roughly €470 billion. There were substantial differences between countries, with the outliers being Ireland (30% of GDP), Greece (22% of GDP) and Cyprus (19% of

[63] See e.g. https://www.nemokennislink.nl/publicaties/winst-is-voor-de-bank-verlies-voor-de-burger/

[64] ESRB ASC (2014: 7)

[65] DNB (2015: 35) argues that if guarantees are given to other financial players, they should also be more tightly regulated.

[66] DNB (2011)

[67] Netherlands Court of Audit (2016)

[68] IMF (2015)

GDP). The Netherlands, with losses of 4.8% of GDP, was close to the average.[69] Direct government support led to the deterioration of government finances, rapidly rising public debt and often to austerity.

Alongside the *direct* costs, a crisis also entails *indirect* costs for the government. Recessions, bankruptcies and unemployment cause government finances to deteriorate due to both lost tax revenues and higher social security expenditures. During recessions households and companies decrease spending and investment, often encouraging governments to stimulate the economy through greater spending, thereby impairing public finances (in any case in the short term).

Although the direct costs of a bailout are highly visible, the indirect costs are generally much higher.[70] Unemployment in the Netherlands doubled from 3.7% before the crisis to 7.4% in 2014 (Statistics Netherlands). Dutch government debt rose from €260 billion in 2006 to €450 billion in 2014 (Statistics Netherlands). For all euro area countries together, government debt as a percentage of GDP rose by 27 percentage points, with only 4.7 percentage points resulting from the *direct* costs.[71] The total growth of government debt in the Netherlands (25 percentage points) was around the average, with Ireland (86 percentage points), Greece (73 percentage points), Spain (62 percentage points) and Cyprus (53 percentage points) being the negative outliers.[72] Figure 4.5 shows the growing post-crisis government debt for selected EU countries.

Social discontent with the enormity of the crisis' costs was – and remains – high. Discontent was also fuelled by the broadly shared sentiment that the boom's benefits accrued disproportionately to a select group of employees, managers and shareholders in the financial sector. But bankers were not the only ones to benefit from the preceding boom: governments, businesses and households did so as well.[73] Who benefits from a boom is difficult to calculate with any precision. For governments, it is clear that the negative effects of a financial crisis exceed the preceding *positive* effects of a boom on government finances. Overall, the cycle of boom and bust leaves countries worse off.[74]

Before the crisis, employees in the financial sector earned substantially more than those in other sectors (even when controlling for education). This certainly applied to executive remuneration.[75] Bank shareholders also enjoyed golden times, rapidly

[69]ECB (2015)

[70]Turner (2015: 82); WRR (2016: 160); ECB (2015)

[71]This represents the difference between the initial (debt of $x$% of GDP) and post-crisis situations (debt of $x$ + 27% of GDP). As debts are expressed as a percentage of GDP, the crisis-induced shrinking of GDP raises this percentage.

[72]ECB (2015)

[73]This does not mean that good times for the financial sector are automatically good times for the country as a whole. Although the financial sector is crucial for economic growth, its further growth given current debt levels may well have a dampening effect on GDP – even without considering the effects of the financial crisis (Cournède and Denk 2015).

[74]IMF (2015: 13–15)

[75]Philippon and Reshef (2012); Denk (2015)

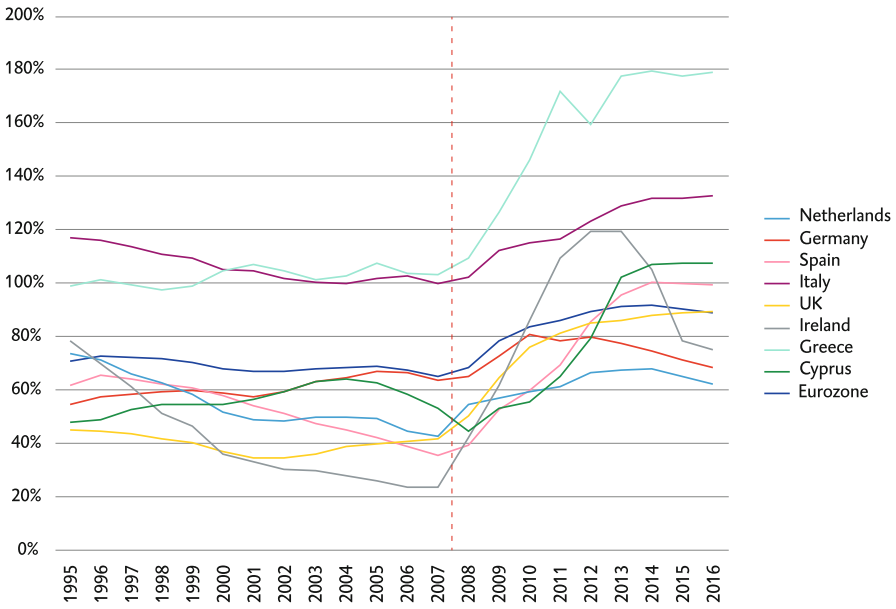


**Fig. 4.5 Government debt of EU countries**
*Percentage of GDP*
Source: Eurostat data (2018)

earning large sums from profit distributions and share repurchases.[76] Nevertheless, the claim that profits are private and losses are public is overly simplistic: the benefits of the pre-crisis boom spread beyond the banking sector, while those directly involved in finance also suffered losses. Still, there is truth to the notion that the benefits disproportionately accrued to the financial sector while the costs were borne more widely.[77]

Measures taken following the crisis sought to address this problem, including the European *Bank Recovery and Resolution Directive* (BRRD) which aimed to reduce the *direct* public costs of crises by making shareholders, bondholders and large savers responsible for the cost of future bank bailouts; public support should only be a last resort. While an important step, the BRRD has yet to prove itself in practice (see Chap. 7).

[76] Haldane et al. (2010)
[77] WRR (2016)

### 4.3.2 *Financial Benefits for Banks*

The financial sector enjoys financial advantages that are not available to other sectors. According to DNB, Dutch banks benefit "from an abundance of [...] subsidies, arising largely from tax regulations".[78] DNB argues that such subsidies "stimulate oversupply and lead to lower welfare" since "activities need only be subsidized if they would otherwise be less available than is socially desirable". These advantages for banks can lead to a financial sector that, from a societal perspective, is larger than optimal.

What benefits do banks enjoy? Since banks rely heavily on debt finance – the payment and savings account deposits of private individuals and businesses as well as other debts – they benefit from the tax deductibility of interest expenses more than ordinary businesses. Moreover, business and household demand for loans is greater than it would be without such interest deductibility, while mortgage interest deductions enable people to borrow more than they could otherwise afford. All this provides indirect support to the sector. The value added tax exemption enjoyed by the financial sector means that demand for bank services is higher than it would otherwise be.[79] Tax-friendly savings, government guarantees for SME loans, the national mortgage guarantee and first-time buyer schemes are other forms of indirect support for the banking sector.[80]

Banks also receive government support because of their social and economic importance. With crucial functions in the field of payments, finance and insurance, some banks are simply too big to fail and will always be supported in case of problems. Account holders' deposits are also guaranteed up to a certain level.[81] These implicit and explicit public guarantees mean that individuals and companies are prepared to accept lower interest rates on their bank accounts than if they incurred greater risks.[82] This latter point bears on the broader issue of financial benefits for commercial banks given their role as money-creating institutions (see Box 4.3).

[78]DNB (2015: 31)

[79]Bettendorf and Cnossen (2014). Other sectors enjoying this exemption are education and healthcare. Exemptions for financial services are described in the Turnover Tax Act 1968, Article 11(1)(i-k), pursuant to Article 135(1) of the European VAT Directive. Difficulties calculating VAT on bank services stem from whether they are end- or intermediate use.

[80]DNB (2015: 31–33)

[81]While the deposit insurance scheme is officially a guarantee between banks, the state is expected to act as the ultimate guarantor.

[82]OECD (2012)

**Box 4.3 Seigniorage for Banks?**

The House of Representatives motion requesting the WRR to study money creation called for an examination of "the extent of seigniorage".[83] Seigniorage is traditionally seen as the difference between the production cost of money and its purchasing power. If the government produces a €10 note and the production cost is 10 cents, the seigniorage when it is spent amounts to €9.90. Of course, this is far from the full story. The cost of generating the social trust required to allow a piece of paper to serve as money is much greater than just the production cost. Money depends on numerous institutions including an effective legal system and a central bank.[84]

More importantly, this traditional perspective provides scant insight into the financial advantages and disadvantages of money creation in our current system. After all, it concerns a form of money creation – the government prints money and spends it itself – that is prohibited in the EU and most other countries. In our current system, money is created by commercial and central banks when they grant loans or purchase financial assets, the lion's share by commercial banks. Banks do not spend this money themselves but make it available to the borrower in the form of bank deposits.

The academic literature focuses mainly on revenue from seigniorage for public institutions (central banks), not on gains accruing to private institutions (commercial banks). According to economists at the New Economics Foundation and Copenhagen Business School, private seigniorage consists of the funding advantages banks enjoy as a result of being able to create deposit money.[85] They calculate this advantage by comparing the interest banks pay on deposits and the interest they would have to pay if they had to finance themselves by other means (the 'alternative cost method').

While this is a rather straightforward methodology to calculate private banks' seigniorage, it has three shortcomings. First, it is far from obvious how to determine the interest rate that banks 'would otherwise have to pay'. Should we use the rates that banks pay on other debts? Those paid by other (financial or even non-financial) institutions? What about terms of maturity? Second, the method takes scant account of the real costs, for example that banks must maintain a payment infrastructure to finance themselves through bank deposits. The provision of bank accounts is also so intertwined with other

(continued)

[83] Kamerstukken II, 2015–2016, 34346, no. 19

[84] Giannini (2011: 14–15)

[85] Bjerg et al. (2017); Macfarlane et al. (2017)

**Box 4.3** (continued)
bank activities that it is difficult to allocate costs.[86] Finally, the financing benefit says nothing about who enjoys it: is it the bank's borrowers (with lower interest on bank loans), employees (with higher pay) or shareholders (with higher dividends)?

This does not mean that banks do not derive financial benefits from their status as money creating institutions. But for society, the crucial question is not which part of bank income can be seen as 'seigniorage', but the extent to which banks' indispensable role in the payment system and the sector's concentration is giving banks an excessive piece of the pie. As various studies have concluded, competition in Dutch banking leaves much to be desired.[87] DNB points to "high market concentration, entry barriers, and products that are difficult to compare with each other" while banks benefit from various implicit and explicit government guarantees.[88] All point to excessive bank profits.[89] Focussing on these excess profits seems more promising than figuring out the level of private seigniorage.

The 'alternative cost method' is generally not used to determine gains from public money creation (the issuing of bank notes and central bank reserves). The euro area uses the concept of 'monetary income': the interest income that national central banks earn by implementing monetary policy. To calculate it, expenditure on debts is deducted from income on assets. The assets include loans to commercial banks and securities such as bonds purchased as part of quantitative easing; the debts are central bank reserves and cash. The monetary income of all national central banks is pooled and then allocated to the central banks, using an allocation key. For DNB the monetary income over the period 2002–2017 averaged €770 million per year (an average of approximately 0.12% of GDP).[90] This monetary income, together with income on other assets, makes up DNB's total income. After the deduction of various costs and provisions, the profit is paid to the Dutch government.

Banks and bank services receive implicit or explicit support through a number of channels. This, however, does not determine who benefits. Benefits may be passed on to bank customers through the interest rates they pay and receive. But given the concentration of the financial sector, it is doubtful that banks pass on these advantages to customers in full. The OECD states that high implicit support contributes to

[86]How do accounting methods recognize joint production costs? While a number of methods are available, these remain arbitrary as the costs incurred do not specifically concern individual products in the joint production process.

[87]DNB (2015); ACM (2014)

[88]DNB (2015: 41); see also ESRB ASC (2014); OECD (2015)

[89]WRR (2016: 39)

[90]DNB reports this amount in its annual reports.

the "financial sector wage premia", with employees of financial institutions earning substantially more than employees of non-financial institutions with comparable profiles in age, education, etc.[91]

Benefits are also unevenly distributed *within* the financial sector, with funding advantages mainly accruing to systemically important banks. Since the government has no choice but to bail out banks that are vital to the system, these banks are not allowed to fail. This is the too-big-to-fail problem. CPB, the Netherlands Bureau for Economic Policy Analysis, estimates that this advantage for the systemic banks amounts to 0.4% of GDP, or approximately €2.5 billion annually. The OECD puts this number higher at around 0.5% of GDP.[92] The advantage for systemic institutions derives from credit rating agencies taking into account implicit government support. This leads to lower interest costs and hence a funding advantage.[93] Given that large banks know that they will receive public support, also means that they incur more risks by providing riskier loans and operating with lower equity buffers. This can have self-reinforcing effects, making these crucial institutions ever larger.[94]

Policymakers have sought to address the too-big-to-fail problem since the crisis, opting for a strategy of dissuasion by imposing levies or taxes on systemic relevance. European bank regulation allows regulators to impose higher capital requirements on systemically relevant institutions. The idea is that banks see this as a 'tax' on systemic relevance while higher requirements reduce risks of failure. Policymakers have thus far avoided more direct approaches such as splitting banks into different units, while a European plan to 'ring-fence' their crucial parts to make it easier to save them has been shelved. Instead, regulators are drawing up bank resolution plans to facilitate their winding up in crises or to keep their vital parts in operation. The too-big-to-fail problem has been addressed but has not disappeared. Then G30 Executive Director Mackintosh describes the situation as follows: "If a major international bank once again teeters on the brink of collapse, no one in finance believes they would be allowed to fail."[95] The ECB's recently expressed preference to create even larger banks is of no help in this respect.[96]

### *4.3.3 Benefits and Costs of Increased Indebtedness*

How are the benefits, costs and risks of increased private indebtedness allocated? Theoretically, rising debt levels could be pointing to a 'democratization of financial services' as less prosperous people can now obtain funding and shape their lives as

[91] OECD (2015)

[92] Bijlsma and Mocking (2013); OECD (2012)

[93] DNB (2018c: 47)

[94] Adfonso et al. (2014); Carney (2014: 9); Liikanen Report (2012: 23)

[95] Mackintosh (2014: 410)

[96] Nouy (2018)

they wish.[97] While few would argue against broader access to secure and affordable financial products, this 'financialization' of society has its associated risks. Various studies have suggested that the financialization of society can contribute to increasing economic inequality and that economic inequality and people's reliance on financial services are mutually reinforcing.[98] People with higher incomes and more assets benefit more from the ability to make lucrative investments and obtain cheap finance.[99] People with lower incomes and fewer assets often have higher interest expenses (in relation to their income), have to go take on relatively higher debts and are often the first to lose their jobs in a downturn. If people have problems to pay interest and must borrow more to make ends meet, the problem gets worse.[100] Indebtedness causes stress, affecting people's ability to perform well, exacerbating the debt problem. While access to credit can help households shape their lives, problematic debt makes it more difficult.[101]

These problems appear to be especially severe in countries such as the United Kingdom and the United States where many people borrow for private consumption and where social security benefits are modest.[102] But in the Netherlands as well, a growing number of households – currently more than one million – have problematic debt, although these more often concern payday loans, debt collector's fees and taxes than bank debt. People regularly fall below the subsistence minimum due to problematic debt, while applications for debt assistance continue to rise (see Fig. 4.6).[103] This brings to the fore the issue of rights and obligations of creditors and debtors. Debtors have a relatively weak position vis-à-vis creditors in case of difficulties in redeeming loans.

Mortgage debt likewise raises questions about the distribution of risk between creditors and debtors. This is an important issue in the Netherlands. Fitch Ratings describes the Netherlands (alongside the UK) as the European country with the "*the most lender-friendly legal system*".[104] This means that mortgage borrowers must do their utmost to meet their obligations. Should they fail to do so, the bank can sell their home while any residual debt is still owed and the bank has a claim on the debtor's income for years to come. The debtor can only escape payment obligations by filing for personal bankruptcy.[105]

It goes without saying that debtors must fulfil their obligations and should only be able to escape them in exceptional circumstances. But this statement requires qualification. Financial products such as mortgages are long-term products with

[97]Beck (2011)
[98]Turner (2015: 119–124); OECD (2015)
[99]OECD (2015: 24)
[100]Turner (2015: 123)
[101]Tiemeijer (2016); WRR (2017)
[102]Mian and Sufi (2014)
[103]Tiemeijer (2016)
[104]Fitch Ratings (2012); cited in De Ruijter (2012)
[105]NVB (2014)

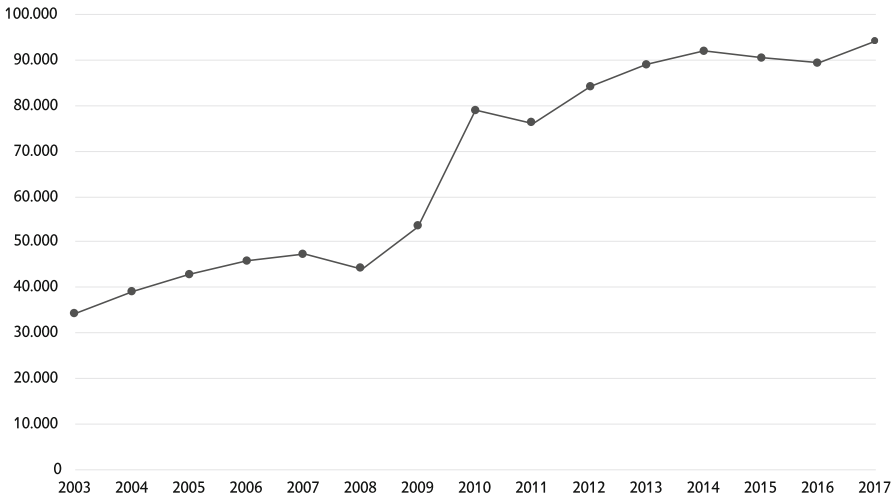


**Fig. 4.6 Applications for debt assistance in the Netherlands** (The NVVK is the sector organization for debt assistance and social banking)
Source: NVVK

which the customer has only occasional experience. The borrower thus has a major disadvantage in information and experience, while the risks can have far-reaching consequences.[106] For mortgage debt there is an additional factor: the uncertainty surrounding house prices over time. The dynamics of the housing market reflect the combined actions of a large number of players: consumers, estate agents, mortgage lenders and policymakers. When a homeowner is left with residual debt after being forced to sell her home, it is doubtful whether this is entirely her own fault. Measures since the crisis have reduced these risks by limiting the value of loans relative to that of the home and through financing rules that consider the ratio of income to mortgage expenses.

## 4.4 Legitimacy and Influence

Public trust in the financial monetary system requires justified expectations to be met and opportunities to express dissatisfaction and exert influence. Problems here are rife. The public-private character of banks muddies what can be expected of them while options for democratic control have been curtailed in recent decades. The ability of households to exert direct influence on banks is limited.

[106] European Parliament (2014)

### 4.4.1 The Public-Private Nature of Financial Institutions

Society needs an efficiently functioning financial monetary system. The Dutch Parliamentary Committee of Enquiry into the Financial System (the De Wit II Committee) that investigated the financial crisis for the House of Representatives formulated it as follows: "The financial sector is not an ordinary sector and banks are not ordinary companies. The economy depends greatly on the stability of the financial system. Payments, the development of personal reserves in the form of savings, pensions and insurance, the system of social services and lending to business rely on the financial sector. Hence there is a strong public interest in a stable financial sector".[107]

The discipline of economics has various criteria for designating something as a public interest. The existence of a public good or service is one criterion. This requires that two conditions are met: no one can be excluded and its use by one person does not prevent its use by someone else. An example are the dykes that protect everyone in the Netherlands from floods. The payment infrastructure likewise has the characteristics of a public good. No one can be excluded from the use of cash, and while exclusion would be possible from the electronic infrastructure, legislation requires that all people in principle have access to a bank account (Section 4:71f of the Financial Supervision Act). The use of the electronic or cash payment infrastructure by one party does not hinder its use by another, but rather promotes it. With the declining use of cash, the electronic infrastructure for payments has become crucial for the functioning of society.

A well-functioning system for credit provision is also in the public interest. Lending has far-reaching positive and negative external effects. It can contribute to economic development, but both excessive lending and the limited availability of credit can damage the economy. Precisely because of these external effects, an efficient lending system is vital.

The network effects between individual institutions distinguishes banking from other sectors. The functioning of bank A directly affects the functioning of bank B. This means that the actions of individual banks affect the banking system as a whole and hence its fulfilment of public interests: the bankruptcy of a systemic bank can threaten people's savings, the payment system and lending. In other sectors, the (impending) insolvency of a private company is generally less problematic for the system as a whole. The proper functioning of a bank thus concerns not only the bank and its direct stakeholders but has wider social implications.

Banks thus have two faces. On the one hand, a bank is an organization with public functions essential for society. There are sound reasons to regulate the sector and for the government to bail it out during crises. The bank resembles a public organization and is expected to operate in the public interest and not lavish upper management with exorbitant salaries and bonuses. On the other hand, a bank is a private organization driven by market forces and competition, and customers should make

[107] De Wit II Committee (2012: 540). Our translation.

informed decisions when buying financial products. The legal standards applying to public and private organizations also differ.[108] As these views are formulated in different contexts, it is understandable that expectations regarding bank actions at times clash.

### *4.4.2 Options for Democratic Control*

Public involvement in the financial monetary system is unavoidable given its importance. The government even has a constitutional duty to regulate the monetary system (Article 106).[109] That public interests are at stake does not mean that services should be in public hands. In the Netherlands, education and healthcare are also provided by private institutions, while there are major public interests at stake. It does mean, however, that the conditions and policy goals should ultimately be determined democratically. In particular we can expect the public institutions responsible for the development and implementation of financial monetary policy to act within a democratic mandate and to be democratically accountable. Several developments, however, have limited the scope for democratic oversight.

First, financial institutions increasingly operate internationally, aided by the deregulation of international capital flows. Much of the policy is developed on the European or global levels, with the Basel Committee playing a central role in banking regulation. While international policies are necessary to prevent a legislative race to the bottom, it also means that it is increasingly difficult for national governments to deviate from the international standard without facing a loss (or threatened loss) of financial activities.[110] This is partly due to a second trend: the sweeping liberalization of the financial sector since the 1980s. This included the abandoning of post-war policy instruments such as the separation of different banking activities, credit ceilings and restrictions on capital movements.

Third, technocratic decision making also limits democratic influence. Monetary and financial policy are complex issues, and policy development and implementation are increasingly outsourced to technocratic forums such as the Basel Committee. In such forums, trade-offs between political goals often disappear under a layer of expertise. Major financial players also have resources to influence policy developments at the supranational level, which is not the case for other stakeholders (smaller players, consumer organizations or NGOs).[111]

Finally, many rules are enshrined in the European treaties ("constitutionalization"). Agreements in monetary and financial policy are set out in the Treaty on the Functioning of the European Union, including the goal of monetary policy (Article

[108] Jak (2014)

[109] This article states: "The monetary system is governed by law." Our translation.

[110] Pettifor (2017)

[111] Pagliari (2012)

127(1) TFEU) and the prohibition of monetary financing (Article 123 TFEU). Changes can only take place with the consent of all EU member states. Governments have boxed themselves in to such an extent that they have limited scope to take different paths based on new insights or changing circumstances.[112]

Internationalization, liberalization, technocratic decision making and constitutionalization introduce specific problems for democratic accountability and control. Key institutions in the field of monetary and financial policy are remote from politics, while policy-making within central banks is hermetically isolated from parliamentary influence. This applies in particular to the European Central Bank, but also to national central banks. Although politics still influences central banks through appointments to governing boards and various accountability mechanisms, participation in economic and monetary union requires the central bank to be formally independent of day-to-day politics. A lot of financial sector policy is also developed within the same policy forums that are largely independent of national and European politics. The scope for political control and influence appears to be limited.[113]

A somewhat different problem is that changing laws and regulations can more rapidly create problems in contexts of high debt, limited equity and limited social capacity to absorb change. Policy adjustments must be made with great caution. For example, abolishing the tax advantages of debt may lead to long-term gains but also to greater short-term uncertainty and instability for highly leveraged households and institutions. For banks as well, improvements will be more difficult starting from low equity levels. High debt therefore also limits policy discretion.

### *4.4.3 Position of Citizens*

Finally, we need to consider people's ability to exert influence on the system. Consumers can reward or penalize specific banks by taking their business elsewhere. But the exit option in the financial sector is impeded by various factors. Switching from one bank to another poses administrative hurdles; especially the lack of account number portability makes it unattractive for many consumers to change banks. It is also almost impossible for uninitiated consumers to assess whether banks are behaving appropriately when it is already difficult for regulators and direct stakeholders to understand what banks are doing. Finally, the highly concentrated Dutch banking landscape offers consumers little in the way of alternatives.

People can also exert influence on the workings of the financial system by means of voice, for example when they organize into NGOs. But their resources and capabilities are dwarfed by the resources of large financial players to organize and exert influence on politics and policy. The fragmentation of policy across many

[112] Van der Sluis (2017)

[113] Stellinga (2015)

different forums is also advantageous for large players; they can be active in numerous areas, while counterforces with less capacity can only focus on a few.[114]

The limited scope for influence takes another dimension when we consider the gulf between the perceptions of citizens and banks. Haldane, Chief Economist at the Bank of England, calls it a "*Great Divide*".[115] Many bank and financial institution mangers perceive the post-crisis period as one in which they have been overwhelmed by new legislation and regulations, but are again on track to regain the trust of consumers. Many people, however, associate the period with the absence of fundamental change and the financial sector with greed and corruption. There is a gulf between how post-crisis developments have been perceived.[116]

## 4.5 Conclusion

The financial monetary system showcases deficiencies in all four areas: economic contribution, stability, fairness and legitimacy. Our analysis highlighted two underlying problems: (1) the unbalanced and uncontrolled growth of money and debt; and (2) a distorted balance between public and private interests.

The excessive growth of money and debt can undermine the economic contribution of our financial monetary system. Although efficient lending fuels economic development, there is a point at which more lending no longer contributes to economic growth. High debt levels also pose risks to stability. Crises are often preceded by debt accumulation while post-crisis recovery takes longer when debts are high. Excessive debt also raises issues of fairness, for example regarding the unequal distribution of the costs and benefits of booms and busts. The excessive growth of money and debt is also related to the system's legitimacy, as it limits politicians' ability to make policy adjustments when even small changes can have major economic consequences.

The second underlying problem is the balance between public and private interests. The financial sector fulfils crucial public functions, namely the facilitation of payments, savings, finance and insurance. Many of the problems we described in this chapter can be traced to the changing balance between private and public interests. With the growing use of deposit money and the disappearance of a public option for electronic payments, banks have become semi-public institutions – a transformation that has largely gone unnoticed. The current imbalance between private and public interests also undermines the system's contributions to the economy. In the run up to the credit crisis banks behaved as if they were purely private firms without a public role. This contributed to the instability and led to an unfair distribution of costs and benefits. Their actions also fuelled problems of

[114] Anheier (2013)
[115] Haldane (2016)
[116] Haldane (2016)

legitimacy, as it became less clear for politicians and citizens about precisely what they could expect from banks.

This does not mean that all of our problems can be traced to commercial banks creating our money. Nor is this what advocates of an alternative system are suggesting. What they do argue, however, is that a financial monetary system in which payments and financing are strictly separated – in which commercial banks no longer create money – will resolve or reduce many of the problems described in this chapter. We analyse this alternative system in the next two chapters. Chap. 5 outlines the potential design of an alternative system. Chap. 6 discusses its advantages and disadvantages.

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