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Center for the Advancement of the Steady State Economy
4601 N. Fairfax Dr. Suite 1200 • Arlington, VA 22203 • USA • www.steadystate.org • info@steadystate.org

Banks in a Steady State Economy

Sound Byte

It is time for financial institutions to focus on the quality rather than the quantity of loans and seek stability rather than boom and bust cycles.

Banks and Economic Crisis

The function of a bank is to act as an intermediary between lenders and borrowers. Over time, banks have been allowed to take on additional activities, and they have devised many perplexing financial instruments. As a result, banks have grown immensely and generated outsized profits for stakeholders.

Since we live on a planet with limited resources, it's not possible for the economy, including the banking sector, to grow forever. The recent financial crisis is not due to a lack of liquidity in the economy; it is due to the unsustainable growth of financial assets that are not backed by real assets. What led to the crisis was an increase in paper money, created out of thin air, through convoluted financial instruments. Borrowers will be able to pay back the debt only if the real wealth in the economy can grow as fast as the debt.

In a growing economy with a growing financial sector, people have "more money" for consuming more things. However, beyond a certain point, it becomes impossible to consume more things. We can only produce and maintain so many real assets, such as roads, buildings, and our stocks of natural resources. Debt for financing these assets must be paid off either by the folks who borrowed the money, or by future generations who will inherit an economy and monetary system embedded in an Earth rife with environmental problems.

The financial crisis provides grounds for shifting to a new steady state banking model, in which financial institutions concentrate on strengthening their core function as an intermediary between lenders and borrowers.

Outside the Box Banking

Netherlands-based Triodos Bank has strictly adhered to sustainable banking principles since 1980. Triodos is highly selective in its lending and investment practices. It supports renewable energy, such as wind power, biomass, and solar energy projects. It invests venture capital and offers loans to manufacturers that develop technologies to reuse and recycle raw materials. Triodos also invests in organic farming and manufacturing that uses organic products as inputs.

By remaining an unlisted private company, it has avoided the focus on short-term profit maximization held by many other banks. The company's balance sheet grew by 25 percent to 2.4 billion euros in 2008, 10 percent over expectations. Net profits were 13 percent higher than in 2007, exceeding internal targets. Triodos joined ten other sustainable banks around the world—with a totals of ten billion dollars in assets—to create the Global Alliance for Banking on Values. Two other partners are BRAC Bank, the world's largest microfinance institution, and ShoreBank, a community bank based in Chicago.

Strategies for Steady State Banking

A steady state economy features a stable population and stable flows of energy and resources at sustainable levels. Just like banks in a growth economy are geared for growth, banks in a steady state economy can be geared for sustainability. Let's examine some strategies for better banking:

- Herman Daly says, “Every dollar loaned should be matched by a dollar previously saved elsewhere.” He recommends that we should move to 100 percent reserve requirements instead of fractional-reserve banking (the practice of a bank lending more money than it has on reserve). One hundred percent reserves would put control of the money supply back in the hands of the people rather than private banks, which have pursued growth beyond the point of usefulness.
- Banks should focus on strengthening their core function as an intermediary between lenders and borrowers, rather than creating money. Instead of creating money out of nothing and lending it at interest, commercial banks would earn income by charging fees for matching lenders and borrowers, and for providing desired services like management of checking accounts.
- Financial institutions should focus on the quality rather than the quantity of capital created. Peter Blom, CEO of Triodos Bank, says, “We have created too much capital and have come to think that there is value in its mere circulation.” Another approach to improve the quality of loans would be to loan savings to “green” and sustainable enterprises.
- To alleviate poverty and reduce the rich/poor income gap that has mushroomed in recent decades, fair distribution of wealth is a key feature of a steady state economy. A start to ensuring fair distribution is to place limits on the compensation that banking executives can receive.
- Income and expenditures are indicative of liquidation of natural resources. Creation of all economic value is dependent upon natural resources (remember that income generation in all sectors of the economy is possible only because there is surplus production in the agricultural sector, and production of all commodities and waste disposal require the use of natural resources). The value of total bank deposits, therefore, must not grow so high that society overconsumes natural resources and damages the regenerative capacity of ecosystems.

Benefits of Steady State Banking

The solution to our financial woes is for wealthy countries to change their goal from growth to stability, to recognize that a healthy economy can survive only on a healthy planet, and to disassociate a happy and healthy society from incessant consumption and production of commodities. A stable banking system can support a stable economy in which financial assets reflect real wealth, and creation of assets is not based on unsustainable levels of debt and environmental destruction.

As opposed to the enormous superstructure of finance built upon shaky expectations of growth, we could have a system with low interest rates, where investment would be mainly for replacement and qualitative improvement. There would be a beneficial shrinkage of the enormous heap of debt that balances atop the real economy and threatening to bankrupt future generations.

Under the existing fractional reserve system, the money supply expands during a boom and contracts during a slump, reinforcing the cyclical tendency of the economy. Raising the reserve requirement, a number manipulated by the central bank, gradually to 100 percent would result in better lending practices. Banks would lend only money that has been saved by someone. Enforcing the 100 percent requirement would re-establish the classical balance between abstinence and investment. This extra discipline in lending and borrowing would help prevent such debacles as the “sub-prime mortgage” crisis, stabilize the economy, and reduce Ponzi-like credit leveraging.

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