Against usury: Solving the financial and economic crisis

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IN ECONOMIC AND POLITICAL MATTERS, CHRISTIANS OFTEN FIND THEMSELVES ADOPTING THE VIEWS OF SECULAR THINKERS AND CAMPAIGNERS, USUALLY LEFT-OF-CENTRE IN THEIR BIAS.

Yet prior to the seventeenth century Christians had their own distinct economic outlook, arising from the Bible. They believed that usury was the fundamental cause of economic crises and injustices, and that its prohibition, or at least reduction, was the only means to sustainable prosperity for all.

In fact, usury is the underlying cause of the financial and economic crisis that has gripped the world since the autumn of 2007; and, unless we root out usury from our financial system, the world will condemn itself to continuing crises. Moreover, while the crisis has its origins in the contractual arrangements made by wealthy bankers and financiers, the main victims are the poor. Unemployment, especially amongst the young, is growing, and governments will have to cut back on social welfare. Worse still, investment in the poorer countries of the world is contracting, as the banks scramble to repair their balance sheets. Meanwhile, governments continue to pay out vast sums to subsidise certain banks, while bankers' and financiers' incomes remain virtually unscathed.

Usury prohibited

The Bible defines usury as the charging of interest on loans. Both the Old and New Testament condemn usury among God's people. Thus, God said to the Hebrew people, 'If you lend money to my people, to the poor among you, you shall not deal with them as a creditor; you shall not exact interest from them' (Ex 22.25, NRSV). By the time of Jesus, financial arrangements had become more sophisticated. In the parable of the talents, Jesus acknowledged the existence of interest paid and charged by banks (Lk 19.23). However, he also reinforces the ancient law, 'But love your enemies, do good, and lend, expecting nothing in return' (Lk 6.35).

As the Church grew, it simply took for granted that usury was sinful and various Christian councils echoed the biblical condemnation. Moreover, in Christian literature and art usurers were typically portrayed as cruel and heartless, exploiting the misfortunes of others. In Dante's *The Divine Comedy* (1308–21) usurers occupy the inner ring of the seventh circle of hell, along with blasphemers. However, as trade between regions and countries began to expand through the medieval period, there was growing pressure on the Church to modify its attitude and lift its ban on usury. Merchants needed working capital to finance the transport of goods from one place to another; and their huge profits enabled them to offer substantial returns. At the same time, landowners were eager to enjoy these returns, rather than let their profits from agriculture lie idle.

Aware of this pressure, theologians from Thomas Aquinas onwards tried to work out exactly how and why usury was wrong. On the one hand, it was self-evident that personal loans, helping a family beset by illness or some other misfortune, should be interest-free, so that the lender in effect gives the borrower the use of his money as an act of charity. On the other hand, it seemed reasonable that a person providing finance for a commercial activity should share some of the profits, since they were giving up the profits that they could gain from that money – *lucrum cessens*.

The Church finally resolved this paradox at the Fifth Lateran Council in 1512, which defined usury as the unequal sharing of risk. The underlying proposition was that human beings cannot know the future, and, more importantly, cannot accurately assess the probability of any future event, since the future is never a simple extrapolation of the past. Thus, any commercial or economic activity is beset by risks that cannot be quantified. As a result, all the participants should share the risks in proportion to their involvement. It follows that charging interest on commercial loans is wrong because the lenders enjoy certainty – they will receive interest fixed at the outset and the return of the loan itself – while the borrower carries disproportionate risk. Instead, those providing finance should become partners, receiving a slice of any profits, or bearing part of the losses.

Sadly, in the maelstrom of the Reformation and its aftermath Protestants and Catholics alike forgot this profound insight. Indeed, only three decades later the great reformer John Calvin fell into the trap of ignoring the risks inherent in all economic activity[1] – a trap into which Christian commentators on economic affairs still often fall. Calvin thus confused lending at interest with acquiring a share in a business; and on the basis of *lucrum cessens*, he authorised usury. In due course, Catholic teaching followed suit, so that by the following century the churches had become virtually irrelevant to the development of capitalism.

Modern banking and interest payments

The authorisation of usury led in turn to the development of modern banking, which soon became the main conduit of usurious transactions. The original banks had simply provided a place where people could safely deposit their gold and silver, issuing paper notes in exchange; and these paper notes came to be used as money. However, from the seventeenth century onwards banks practiced what is known technically as 'maturity transformation', and although the introduction of paper money, cash, issued by the central bank changed the form that this took, the essence has remained the same to this day.

The nature of maturity transformation is embodied in a bank's balance sheet. Its primary liabilities are the funds deposited by the public that can be withdrawn at will or very short notice; these in effect are loans to the bank. The bank's primary assets are loans at interest, often to be repaid over several years or, in the case of loans for property, two or three decades. Thus, in the old phrase, banks borrow short and lend long. In the process, banks act as mediators of risk, transferring risk from their depositors to their borrowers. On the one hand, the depositors carry no risk at all. On the other hand, the borrowers carry the risk that the assets purchased by their loans, or the businesses financed by them, rise or fall in value.

There are two manifest dangers in maturity transformation. The first is that the bank does not have sufficient cash to meet depositors' demand for withdrawal. However, in normal times these demands are quite predictable, so the banks can survive with only quite modest stocks of cash. The second is that borrowers default on their interest or capital payments. But, again, in normal times the rate of default by different types of borrower is quite predictable; so banks charge higher interest to riskier borrowers, to offset the losses from defaulters. Indeed, in recent years bankers have developed highly sophisticated formulae for assessing risk, so the higher interest payments act as an insurance premium.

The effect of the banks' guarantee to depositors of instant withdrawal is that bank deposits function as money, by means of cheques, debit cards, bank transfers and the like. Indeed, they are by far the main form of money in the modern economy, dwarfing the notes and coins issued by the central bank. As a result, the banking system is as essential to the day-to-day functioning of the modern economy as the electricity and water supply. If the banking system suddenly collapsed, the results would be as catastrophic as all the power stations suddenly breaking down.

Crisis and reform

Until about a quarter of a century ago, banks were mainly national in that they operated primarily within national boundaries. More importantly, banking itself was largely local, in that the local branch managers had personal knowledge of both their depositors and their borrowers. However, with astonishing speed banking has become global, with banks across the world lending to one another, so that money deposited in one place may ultimately finance a loan thousands of miles away.

It was the globalisation of banking, and hence the globalisation of risk, that enabled the long boom from 1990s – which in turn led to the great crash of 2008.

As China and other Asian economies began to grow rapidly, people there typically saved almost half their incomes, placing it in local banks. So the banks in Asia found themselves flooded with money, which they offered at low interest to banks in America and Europe. The Western banks then urged their customers to borrow this money at slightly higher interest to buy houses and to finance consumption. As house prices shot up, many homeowners borrowed more than they could reasonably afford and did not save any money. Many of the goods purchased by these loans came from China and the rest of Asia, boosting their economies still further; so in effect Asia was lending the West the money to buy Asian goods. Meanwhile, the banks were happy to lend up to 100 per cent or more of the value of people's property, convinced that prices would continue rising.

The banks, of course, were wrong. At some point, this usurious merry-go-round was bound to slow down, causing house prices to stabilise. Since rising house prices were both the cause and the security for the borrowing, the merry-go-round was bound to judder quickly to a halt. The first sign of the impending crisis, at least within Britain, was the collapse of Northern Rock in 2007. Northern Rock had become almost wholly reliant on loans from other banks to finance its own mortgage lending. When, in response to stabilising house prices, other banks stopped lending, Northern Rock found itself insolvent. A year later, the entire global banking system became insolvent.

At the time, there was huge confusion as to how this could have occurred. However, in retrospect, while commentators may describe it in different terms, the role of banks as mediators of usury is now widely held responsible. In particular, the formulae for quantifying risk assumed that the economic and financial system was essentially stable, but once the system began to seize up in 2007–8, causing huge numbers of borrowers to default, the formulae proved worthless – as medieval theologians would have warned. Therefore, the banks had no choice but to transfer risk back to their depositors, threatening to default on their guarantee.

The subsequent events, however, proved even more inequitable than even the gloomiest of medieval theologians could have anticipated. The centrality of banks to daily economic activity forced governments to provide as much money to the banks as they needed to honour their guarantees to depositors, amounting to hundreds of billions of dollars, pounds and Euros. Thus, the ultimate holders of risk in our financial system turned out to be not the borrowers or even the lenders, but innocent taxpayers.

Over the past year, there have been various suggestions for reforming the banking system to prevent future crises, while leaving its essential structure intact. These include raising 'capital ratios' – the amount of cash banks must keep to pay depositors – and banning bonuses. However, diligent readers of the financial press will be aware of growing pessimism. It is not merely that politicians may feel unable to resist the bankers' intensive lobbying against reform; most commentators feel that such reforms simply would not work. On the contrary, by propping up the banking system at such huge costs, governments have actually increased the possibility of future crises. Banks know that they can continue lending recklessly, enjoying the interest they earn during the good times, in the knowledge that governments will cover their losses during bad times – the problem quaintly known as 'moral hazard'.

But the banking crisis has exposed an even deeper and more intractable problem. By providing the means for Asians to save a very high proportion of their incomes, the banks have in effect allowed Westerners to consume too much. Now, however,
Westerners are cutting back their consumption, while Asians are not increasing theirs. Thus, we are suffering the 'paradox of thrift', analysed 70 years ago by John Maynard Keynes, in which excessive savings plunge the economy into chronic depression. At present, governments are disguising this paradox by running huge fiscal deficits, replacing private borrowing with public borrowing, but, like the merry-go-round of the long boom, this cannot continue indefinitely. Once governments are forced to cut back their borrowing, global demand is likely to slump. Indeed, this is by far the greatest horror of our usurious financial system, in which the poorest and weakest will be hit the hardest.

To recognise usury as the ultimate cause of our financial and economic crisis is to point towards its solution. Quite simply, banks must stop being usurious. In particular, banks must be required to divide themselves into two. First, there should be deposit banks that fulfil their ancient role of protecting people's money and administering payments; and, far from paying interest, they should if necessary charge a fee for their service. Second, there should be capital banks in which people invest their money for profit. The investment banks should offer no guarantee of withdrawal, and should pay returns on the basis of the returns they have received from the businesses in which they invest and the houses for which they provide finance – so they act as large-scale investment funds.

Happily, this kind of radical division of banking is beginning to find favour, with John Kay and Samuel Brittan of the *Financial Times* supporting it. Their grounds are largely pragmatic; but their colleague Martin Wolf has even described the essence of modern banking as 'fraudulent' – so the moral grounds for reform seem implicit. The most obvious effect is that the deposit banks would be free of risk, while in the capital banks the depositors would share risk and, at the same time, taxpayers would cease to be ultimate holders of risk. Thus, risk would be shared in an equitable fashion.

If this division of banking were replicated across the world, it would go a considerable way to resolving the global paradox of thrift. Individuals and businesses would become reluctant to accumulate their money in deposit banks, since, far from earning any return, it would lose value both through inflation and through the banks' fees. Instead, their best means of accumulating wealth would be to invest in businesses, either directly, or through capital banks and other such institutions, where it would put to use, employing people to produce goods and services. Of course, achieving international agreement on such a division of banking might be hard; but there are various means – tariffs being the most extreme – by which any country reforming its banks could protect itself from the ill effects of countries not dividing its banks.

There would also be an important – and perhaps world-saving – side effect. It is now three decades since we began to become aware of the dangers of climate change. Yet over that time investment in developing clean energy technology has been meagre, and the results pitiful. A major reason is that banks seek borrowers whom they regard as safe, while researching new technology is inevitably very risky. If households could no longer accumulate wealth without risk through the banks, they would have to embrace risk, which would boost the funds available for research into clean energy – as well as other new technologies. Governments in turn might be emboldened to impose a far tighter timetable for the replacement of dirty energy generation, just as two decades ago they successfully forced the abandonment of CFCs. This in turn would greatly increase the prospective returns on successful research, boosting investment still further. So outlawing usury in the financial system may save both the economy and the planet.

Notes

1. In De Usuris Responsum, 1545.