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It’s not about rate cuts, it’s about how the money is used

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The European Central Bank is well intentioned. The idea of lowering interest rates to encourage additional economic activity is sound and proven. Sadly, the banks are not singing from the same hymn book and refusing to direct the money to initiatives that could push the European economy in the right direction.

Adding money to the economy is only helpful if that money is used to get more people into work, yet most banks insist on lending for the purpose of getting people fired.

Banks have been lending, some at record levels yet the economy appears to be getting worse not better. This is counterintuitive, yet when you look at how the banks lend, it makes sense.

Businesses are finding it easy to get loans if those loans are for new equipment or to automate a facility. These are loans that are by their very nature collateralised. In other words, companies are buying new things that have value and banks use that value to make sure they get their money back.

The problem is that the majority of loans are going towards efficiency improvements, which by their very nature displace people. Therefore, by giving more money to the banks, but not changing the lending priorities, what the central banks are doing is adding to unemployment levels and making the economy worse.

What Europe needs is for banks to lend without collateral. This would be money targeted at hiring new people, marketing new products or exploring new markets. This is the type of lending that has no material assets and is thus much riskier for banks, but much better for the economy.

Banks are like beggars on the street. Most decent people do not have an issue with giving a few pounds or euros for someone in need of food. However, most do not give because the never know whether the money is making their lives better. The answer is to give beggars food instead of money. Why can’t central banks do the same thing? Don’t give banks money, but give it directly to the businesses that are going to put that money to good use.

While that is a great idea, we have become so overly reliant on banks that governments have no mechanism to direct funds. The failure to build an alternative to the banking industry must be considered the biggest failing since the financial crisis.

The other challenge to banks is capital reserves. Many banks are choosing not to lend. Instead, they are taking central bank money and reinvesting in the capital markets for profit. Money under a mattress just ruins your sleep.

The answer is not more money into the hands of banks, it is forcing the money that already exists to the areas that are going to help the economy, not just the profitability of banks. That is the challenge of central banks; they have all the money in the world but no power to dictate its use.