Free Banking, Central Banking and Banksterism

By

Kevin Dowd
Durham University

Presentation to Oxford University Mises Society

1 June 2022

Overview

Free banking

Central banking

Socially destructive ‘bankster social contract’

Global Financial Crisis

Suggested solutions

Free Banking ('Once Upon a Time')

FB – a banking system in which banks issue their own currencies on a commodity standard and there is no central bank or monopoly issue

Excess note issues are disciplined by a law of reflux

Bank competition – 'good banks vs bad bank' model:

- In good times, bad bank takes excessive risks, makes easy profits but when downturn occurs, bad bank gets run out of business
- Good i.e. prudent banks win out in the end – a race to quality, not a race to the bottom

Bank run serves the useful purpose of eliminating cowboy banks

- Bank runs are good!

No central bank lender of last resort, no bailout

Role of 'banking clubs' e.g. clearinghouse associations

The Experience of Free Banking

You should always ask economists to provide evidence for their claims!

FB is **not** an untried theory

There are many historical experiences of FB

- See, ahem, my forthcoming edited book, *The Experience of Free Banking, 2nd ed*

Well over 60 historical cases of free or nearly free banking!

Most famously, Scotland (early 18th century to 1844), Canada (early 19th century to 1914)

Plus Australia, Belgium, Chile, China, Colombia, France, Ireland, Italy, New Zealand, Peru, Sweden, Switzerland, antebellum U.S.

- Mostly 19th century

Historical FB was highly stable (but did experience occasional crises) and efficient but was eventually superceded by central banking via state intervention for fiscal, political and ideological reasons, **not** because it 'failed'

Central Banking

Now introduce a CB – a bank with monopoly note issue and obligation to provide LOLR to banks in difficulties.

- CB creates moral hazard – incentive to take excessive risks subsided by others

In practice, CBs always threaten not to support badly run banks if they get into difficulties, but they almost always panic when push comes to shove

- E.g. they bailed out Northern Rock in 2007, which posed no systemic risk to UK banking system at all
- They should have let it fail!

Such threats have no credibility

The bankers know this and exploit the prospect of CB support to make it the central principle of their business model

Bankers wish to maximise the value of the LOLR subsidy – to do that they increase risk-taking and maximise leverage to maximise ROE

- Leverage = assets/equity

The higher the leverage (and risk-taking), the higher the ROE – if the market is doing well
But if the market goes down, higher risk-taking and higher leverage lead to higher losses

Central Banking, cont.

With the CB/state support, bankers get bailed out by CB and implicitly the taxpayer, so pass on their losses to others

Hence the **Bankster Social Contract**: privatised gains (when things go well), socialised losses (when they do not)

Thus, there is a built-in incentive towards subsidised ergo excessive risk-taking

This BSC is the **No. 1 Problem** in the political economy of banking

- It is getting worse but few people discuss it openly

Thus, CB/LOLR creates a race to the bottom – weakening capital standards, system becomes less stable, cycle of ever worsening crises

CB/LoLR captured by the banksters – ‘regulatory capture’

Situation reminiscent of the trade unions before Mrs. T sorted them out

Global Financial Crisis and Aftermath

Short version: Banks compliant with capital regulations (new Basel II system just implemented in UK) but in reality banks were heavily leveraged

September 2007: run on Northern Rock signals impending problems

BoE in denial – 'it's just a liquidity crisis, not a capital crisis'

Banking system collapses and is bailed out

The losses incurred by the banks from the GFC were > £500 billion

The banks' GFC losses **more than wiped out the capital of the banking system several times over**

Subsequent reforms (Basel III etc.) papered over the cracks but U.K. banks now are even more leveraged than they were before the GFC (e.g. average TA/MC = 8.9 end 2006 but 21.5 end 2019)

Evidence of Bank Weakness

Can evaluate bank strength via PtB ratio – ratio of mkt value to book value

A PtB value indicates that bank is in very poor shape, e.g., Merton Miller on a 50% PtB ratio: “That’s just the market’s way of saying: look at these guys; you give them a dollar and they’ll manage to turn it into fifty cents.”

Table Four: Big Five Banks’ Price to Book Ratios: End-2006 and End-2019

Bank	Price to Book Ratios	
	Dec 31st 2006	Dec 31st 2019
Barclays PLC	232%	48%
HSBC Holdings PLC	181%	81%
Lloyds Banking Group PLC	139%	92%
Royal Bank of Scotland Group PLC	413%	64%
Standard Chartered PLC	176%	55%
Weighted average	**255%**	**71%**

Notes: As per Table Three.

The average PtB ratio was 255% at the end of 2006, which fell to 71% at the end of 2019.

http://eumaeus.org/wordp/index.php/2020/06/16/uk-banking-system-is-one-big-impaired-asset/

‘Great Capital Rebuild’

BoE position is what I call the ‘Great Capital Rebuild’ i.e., that UK banks are now so strongly recapitalised after the trauma of the GFC that they could go through a much worse than GFC event and still emerge in good shape. E.g.

“The resilience of the system during the past year in part reflects the consistent build-up of capital resources by banks since the global financial crisis. ... As a result the UK banking system is well placed to provide credit to households and businesses during periods of severe stress.” (Carney, 2016)

But the metrics and capital ratios the BoE uses are all highly gameable, e.g. rely on RWA metrics and dodgy models, which are easily gamed

- ➢ BoE metrics relate to a **Potemkin banking system**

GCR is as **factual as the Wizard of Oz** and flatly contradicted by the evidence set out above - **GCR is hogwash**

How to Counter the Destructive Bankster Social Contract?

Need to get rid of the CB/taxpayer subsidy to excessive risk-taking and excessive leverage

Four suggested solutions:

1. Reshuffle the regulatory pack aka more of the same

2. Free banking

3. Extended personal liability for senior bankers

4. Much higher minimum capital standards

Proposed Solution I: More Regulatory Reform

Meaning more tepid regulatory reform that the banks won't object to plus promises that the reforms will work the next time even though they never worked before

E.g., Basel II failed in spectacular fashion, so rush through a Basel III that has much the same fundamental design flaws

When that fails, we will do a Basel IV, etc.

Einstein's definition of insanity – doing the same thing over and over and expecting a different result next time

If this is what regulatory reform entails, there is no regulatory reform solution

Such reform doesn't work because the regulatory system itself is captured by the banking industry aka the banksters

Proposed Solution II: Free Banking

Can we solve this problem?

Yes, ‘first best’ solution is FB

We know from historical experience this **would** work, **but** the problem is political – FB is way outside the Overton Window

- no strong support, not even on most people’s radar system

We are then into ‘second best’ solutions

Proposed Solution III: Extended Personal Liability

Make decision makers personally and strictly liable for the decisions they make – if they make losses, all their personal wealth is first at risk to cover those losses

- Remove limited liability for bankers
- Strictly liable means no need to prove fault – if it happens on their watch, they are liable

Bankers will be far more careful with risk-taking and leverage if their wealth is on the line

In February 2012, Steve Baker MP introduced a private member's Bill, the Financial Institutions (Reform) Bill, which set out a programme of radical reforms to the banking system

- a free-market solution (of sorts) to the banking crisis

The underlying principle was to minimize moral hazards within banking, by making those who make or preside over risk-taking liable for the consequences of their risk-taking

Within this framework, bankers would be free to do as they wished

Unfortunately, the Bill got almost no political support in Parliament – < 12 MPs supported it and it didn't get past First Reading

Proposed Solution IV: Higher and Less Gameable Min Cap Standards

A final solution is **much higher** minimum capital requirements

- This solution has considerable support from financial economists albeit still a minority view
- This position has been derided as 'Capital Taliban' – bankers hate it, a good sign

If ratio of capital to assets is high enough, most of the incentive to excess risk-taking disappears – can achieve this outcome by sufficiently high minimum required C/A ratio

Famous 2010 FT letter by Prof. Anat Admati and other distinguished economists proposed a minimum required C/A ratio of **at least 15%** – much higher than under Basel III!

Needs implementation detail, my version:

- capital = market value shareholder equity
- assets = total assets
- give banks notice period to comply
- those that comply are relieved of all other prudential standards ('regulatory off ramp')
- after notice period expires, any banks not compliant are shut down

Conclusions

The biggest problem in the political economy of banking is how rein in banksterism

- ➢ Don't believe what the BoE tells you!
- ➢ Need to shift the Overton Window – spread the message!
- ➢ Need a new Mrs T to sort the banksters out

If we don't sort this problem out, we are condemned to a cycle of ever worsening financial crises which threaten the basis of (what is left) of the capitalist economy

Remember Kipling's 'Gods of the Copybook Headings':

'And that after this is accomplished, and the brave new world begins
When all men are paid for existing and no man must pay for his sins,
As surely as Water will wet us, as surely as Fire will burn,
The Gods of the Copybook Headings with terror and slaughter return!'

Thank You

Serfdom Sucks

Kevin.Dowd@outlook.com
Kevin.Dowd@durham.ac.uk