Central Banking in a Free Society

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THE AUTHOR

Tim Congdon is an economist and businessman who has for over thirty years been a strong advocate of sound money and free markets in the UK's public policy debates. Between 1992 and 1997 he was a member of the Treasury Panel of Independent Forecasters (the so-called 'wise men'), which advised the Chancellor of the Exchequer on economic policy. He founded Lombard Street Research, one of the City of London's leading economic research consultancies, in 1989, and was its managing director from 1989 to 2001 and its chief economist from 2001 to 2005. He has been a visiting professor at the Cardiff Business School and the City University Business School (now the Sir John Cass Business School). He was awarded the CBE for services to economic debate in 1997. His latest book, a collection of papers on *Keynes, the Keynesians and Monetarism*, was published in September 2007.

FOREWORD

The decision to give the Bank of England operational independence to control monetary policy in 1997 was widely regarded as an important step forward in ensuring that the UK had a credible monetary policy regime capable of keeping inflation under control. Gordon Brown's reforms of the Bank of England, however, involved two other aspects that have been given much less coverage. The first was to remove from the Bank responsibility for the supervision of the banking system and to hand it to the soon-to-be-formed Financial Services Authority. The second was to create a new agency of the Treasury to manage the national debt. In this monograph Tim Congdon argues that these two 'minor' reforms of the Bank of England had catastrophic effects in the financial market crisis of 2007 and 2008.

The author begins the monograph by discussing the Bank of England's role and purpose within a historical context. He rejects the arguments of the free-banking school, and argues that a central bank evolves naturally in a financial system where private agents are motivated by profit maximisation. If clearing banks are to economise on cash reserves, and make loans efficiently and cheaply, then, the author suggests, they need an institution that performs the functions of a modern-day central bank. Central banking allows banks to reduce their ratios of cash and capital to assets and the result is a reduction in loan margins and an increase in the flexibility of loan facilities, which benefits banks' customers.

These basic propositions will be controversial among some supporters of the free market who have accepted the arguments of Hayek, among others, for the denationalisation of money. The author's contribution to our understanding of the role of central banking in a market economy is, however, important. He is able to demonstrate how a coherent set of regulatory and monetary institutions can operate in a free society, even if the case for the denationalisation of the currency is not accepted.

The author accepts the argument that banking systems need regulation because the failure of one bank will have systemic effects on the payments system. Indeed, the failure of one bank can potentially bring the whole financial system down. The question then arises, 'Who should regulate the banking system?' Before extending a lender-of-last-resort loan the central bank must be able to distinguish between a bank that has liquidity problems and one that is genuinely insolvent. It must therefore have detailed information about the assets and liabilities of banks to which it may have to provide a last-resort loan. This establishes a prima facie case for banking regulation in the UK to be returned to the Bank of England. Lender-of-last-resort facilities and supervision of the banking system are complementary activities.

But would this not simply replace one state institution that regulates banking with another? Not necessarily. It is interesting that, as well as not questioning most aspects of Gordon Brown's dismembering of the Bank of England, few commentators question the ownership of the Bank. In fact, it has been nationalised only since 1946. From 1694 to 1946, the Bank of England was in private hands and did an extremely good job of maintaining financial stability. Why is it that no political party ever discusses the privatisation of the Bank of England, despite the fact that it was only nationalised by a radical government that was determined to take the 'commanding heights' of British industry under government control?

Privatising the Bank of England and ensuring that its capital is provided by commercial banks neatly square the circle. The lender-of-last-resort facility is a form of collective good, which all banks need to function efficiently, and which can be provided by an institution that is owned by and accountable to the banks that use the facility. The systemic effects of a bank failure on the rest of the banking system mean that regulation is another collective good which can be provided by the central bank for the mutual benefit of all banks in the system. If the Bank of England regulates banks too lightly, then there will be costs imposed on the central bank, which is owned by all other banks, as a result of the behaviour of bad banks. If the Bank of England regulates too heavily, then the banking system will be inefficient and banks will also suffer. A privately owned central bank is therefore subject to checks and balances. Regulation, under these proposals, would be provided by a market institution, not by a government body, and the degree and form of regulation will emerge from market processes. If a bank does not like the regulation imposed on it by the central bank, then that is no problem. It could simply operate outside the system and forgo liquidity support from the Bank of England. Indeed, it could seek such support elsewhere if it chose to do so and if another central bank wished to provide it. All its counterparties, however, would know the risks of dealing with a bank that chose not to be regulated by the Bank of England.

These proposals – returning banking regulation to the Bank of England, privatising the Bank, and ensuring that it uses its lender-of-last-resort powers efficiently and generously – are self-consistent. They will not satisfy the free-banking school. They would, however, be a decisive step in a more liberal direction compared with our current position. The author argues that experience in the UK, over several decades, suggested that the proposed institutional structure can be effective in delivering the stability of the banking system. On the other hand, within little more than a decade Gordon Brown's reforms to the Bank of England led to the biggest bank run for well over a century.

The IEA commends this publication as an important contribution to our understanding of the role of a central bank in a free society.

The views expressed in this monograph are, as in all IEA publications, those of the authors and not those of the Institute (which has no corporate view), its managing trustees, Academic Advisory Council Members or senior staff.

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January 2009

SUMMARY

- Central banks are an essential component of a free and efficient banking system. They evolve naturally in a market economy and enable banks to economise on cash.
- Over time banks have reduced both liquidity and capital to what, at the time of the difficulties at Northern Rock, were historically low levels. This has allowed businesses and households to enjoy considerably reduced costs of borrowing from banks.
- The lender-of-last-resort role is a crucial function of central banks. The facility should be provided liberally to a bank in need of liquidity, just as was described by Bagehot in the nineteenth century.
- Very occasionally the central bank may wish to provide facilities to organisations outside the clearing bank system (such as AIG in the recent episode of financial instability), but this should always be done with a view to protecting the banking payments system.
- It is sometimes difficult to distinguish between banks that are insolvent and banks that are simply illiquid. Only the latter are entitled to lender-of-last-resort facilities as of right.
- Those responsible for making decisions about providing lender-of-last-resort facilities need to have experience of the banking system, and to have been involved with

the regulation and supervision of banks. Officialdom's performance in the Northern Rock affair suffered from lack of clarity about the respective roles of the Bank of England and the Financial Services Authority.

- This confusion about their roles was largely the result of Gordon Brown's dismemberment of the Bank of England in 1997. During the Northern Rock affair the Bank of England did not act promptly and efficiently as a banker to the banking system, as it had done in previous financial crises.
- Banks have to pay a penalty rate for, and to provide good-quality collateral against, lender-of-last-resort facilities.
  The claim by the present Governor of the Bank of England, Mervyn King, that last-resort assistance leads to moral hazard is overstated. By contrast, deposit insurance systems do create moral hazard. Such systems should be limited in scope and do not need to be pre-funded.
- The Bank of England needs to be active in providing lender-of-last-resort funds when necessary and should make this clear in contracts with clearing banks; it should be privatised and have its capital provided by clearing banks; and it should have returned to it the powers to regulate the banking system.
- This proposal would provide a stable set of incentives to keep regulation to the minimum necessary to maintain the stability of the banking system. Banks themselves, because they provide capital to the Bank of England, would suffer if one of their number were reckless and regulation too light. They would also suffer if there were over-regulation. The central bank, because it would be owned by the clearing banks, would have the right incentive structure to provide the appropriate degree of regulation.

TABLES AND FIGURES

AUTHOR'S PREFACE

This monograph is a response to very recent events, in particular the UK banking crisis that began in August 2007. However, some of the ideas – such as the argument that the evolution of central banks should be seen as the result of private agents' choices as they try to maximise profits – have been with me since the early 1980s. I am most grateful to the Institute of Economic Affairs for publishing the monograph since this argument is undoubtedly controversial in free-market circles. But one of my conclusions will, I expect, be welcome to economic liberals everywhere. This is that the central bank should be privatised and owned by the banking system, not by the state. I believe that central banks in private ownership would be subject to a better pattern of incentives, with checks and balances that would be more likely to keep them on the right course, than if they remain in the state's hands. More especially, my view is that the Bank of England's failure to act as a pre-emptive and efficient lender of last resort in the recent crisis can be blamed on the gradual erosion of its financial resources (i.e. its capital base), and of its powers and responsibilities, that occurred in the preceding six decades of public ownership. In my opinion the Bank's failure in this respect has had catastrophic consequences. It has both contributed to the severity of the latest cyclical downturn in demand, and caused long-term damage to the efficiency of our financial system and the international competitiveness of the City of London.

My main debt of gratitude is a negative one. I was dismayed in late 2007 and throughout 2008, first, by the volume of media commentary that was hostile to the British banking industry, and, second, to the assortment of wholly misguided policy prescriptions arising from this commentary. I suggest that the shambles of the British economy in early 2009 is – at least partly – the result of the translation of the commentariat's ideas into actual policy. (In qualification, I accept that blunders in financial policy have been made not just in the UK, but across the world.) So may I say 'thank you' to the various economic and financial journalists who made me so angry and spurred me into writing this work?

I am, as ever, grateful to Professor Charles Goodhart for his comments on an earlier version, and also to Professor Kevin Dowd and an anonymous referee for helpful criticisms. But I must emphasise that the views expressed here are very much my own.

I should declare a financial interest. I have owned shares in UK banks throughout the crisis and continue to do so, and am considerably poorer as a result. This preface was written in January 2009, but the text was finished in November 2008.