

Marketplace



Tim Congdon

'Under my proposal well-behaved banks would have a strong interest in preventing their risk-prone rivals from ruining the system'

Willem Buiter, chief economist of Citigroup, is one of the liveliest contributors to current debates on economic policy. On May 23 he gave particularly stimulating evidence to the Treasury Committee of the House of Commons, in its inquiry into the powers of the Bank of England. As is well-known, the early phase of the financial crisis saw intense efforts to recapitalise Britain's banks. Because private shareholders were reluctant to participate, much of the new capital came from the state, and the government now has large stakes in RBS and Lloyds. The Bank of England and the Treasury worked together in the recapitalisation, but only the Treasury—acting on behalf of the taxpayer—could inject equity capital on a large scale.

According to Buiter, one clear lesson from these events is that in future a "recapitaliser" of last resort is needed, as well as the "lender of last resort". The recapitaliser must be the government, with the key decisions taken by the Treasury. In Buiter's view, the existing reform proposals "leave the Treasury out of the core" which is "a big mistake". Instead he would reduce the Bank of England's responsibilities. Buiter believes the Bank and the Treasury should share the task of maintaining financial stability (i.e., ensuring that bank deposits can always be paid out 100 per cent in cash).

But, as the World Bank has shown in several studies, nationalised and semi-nationalised banks are less efficient than their wholly privately-owned competitors. By implication, constant Treasury involvement in banking supervision would be a mistake.

Is there a way out? First, Buiter needs to remember a key feature of the existing structure of institutions in this field of public policy. Yes, the central bank is supposed only to extend loans that are to be repaid in full with interest. It is not meant to be a risk-taking equity investor. But—as Buiter must be aware—central bank loans are meant to be available only to solvent, well-capitalised banks. The assessment of UK commercial banks' capital strength ought therefore to rest with the Bank of England. To involve the Treasury would complicate matters and lead to turf fights of the kind that were so embarrassing in 2007 and 2008.

Secondly, in the UK—as in most countries—an important state-backed institution is semi-autonomous from both the cen-

tral bank and the finance ministry. This is the deposit insurance agency (known here as the Financial Services Compensation Scheme), which is another buffer to protect depositors from bank failure. If banks have heavy losses that wipe out their equity capital, the first line of defence for retail depositors is not capital injections from the state, but transfers from the FSCS. Further, if FSCS's own assets are depleted, it has the power to impose a levy on the banking industry to rebuild the fund.

Suppose that banks are short of capital because of bad asset selection and heavy losses, and that there is a risk of deposits not being covered by banks' remaining assets—the situation allegedly facing Britain's banks and economy in late 2008. Surely everyone ought to agree that, ideally, the job of replenishing banks' capital should fall on the private sector, not the state, and that as far as possible accountability must lie in only one place. How might that be achieved?

I propose a structure which is almost the polar opposite of Buiter's. In a 2009 monograph, *Central Banking in a Free Society*, I argued that the capital of the Bank of England should be provided by the leading banks, and that the functions of the central bank and deposit insurance agency should be amalgamated. Whereas Buiter wants, in effect, to nationalise the arrangements (and the costs) of cleaning up a banking system fiasco, I would privatise them.

My proposal is much less radical than it may seem. Recall that at present the banking industry as a whole can in fact be levied by the FSCS if its funds are exhausted as a result of losses at one or a handful of banks. So, making the commercial banks the shareholders in the central bank and giving the central bank an explicit responsibility to protect deposits, has two consequences. First, the central bank would extend loans only if confident they would be repaid. The well-behaved, risk-avoiding and profitable banks have a strong interest in preventing their risk-prone competitors from incurring losses and ruining the system. Secondly, if the system nevertheless ran into trouble, the first line of defence would lie in the private sector, via the capital-levying power of the Bank of England. If the government did have to come in, it would be only after the bankers had decided that they could not help themselves. It would indeed be a last resort.