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WHY THE BANKING SYSTEM SHOULD BE REGULATED*

Sheila C. Dow

It has long been taken for granted that the financial system should be regulated. That this should now be open to question is to be welcomed. It is important in general to question assumptions, but it is particularly important to do so in the case of a sector which has undergone such major change over the last few decades. It is necessary therefore to go back to first principles and examine the implications of these principles in the current environment. The outcome outlined here is a renewed case for regulation, but one which takes account of the changing nature and role of banks. Historical evidence aids our understanding of these changes, but historical evidence must be used with care; the advocates of free banking misinterpret and misuse this evidence to support their position.

The case for regulation rests on the very special economic role of money and the uncertainty associated with it. This uncertainty in turn renders free banking unworkable since the proposal requires the non-bank public to assess the expected value of the portfolios of the issuers of money. Adequate knowledge could only be generated if money-issuing were concentrated in a dominant institution, or set of institutions, which operated like a central bank. This outcome would only occur, and be socially acceptable, given a high degree of social cohesion. Rather than eradicating regulation on the grounds that it is flawed, and risking financial chaos, the more appropriate response is to consider how to improve regulation.

I. BANKS AS PRODUCERS OF MONEY

Because banks' liabilities are used as money, their redeposit ratios are sufficiently high to allow them to hold longer-term assets without fear of illiquidity. The primary purpose of prudential regulation has been to ensure that banks' assets retain sufficient liquidity to meet any reduction in redeposits, and to discourage such a reduction in the first place. Regulation is warranted because the moneyness of bank liabilities is a public good: moneyness (rather than any particular money asset) satisfies the conditions of non-rivalry-in-consumption and non-excludability-in-exchange. The state produces moneyness by inspiring confidence in money's capacity to retain value. This confidence underpins the performance of money's role as means of payment and store of value. But most of all it underpins money's role as unit of account and thus denominator of contracts, which are central to the functioning of modern economies (see Davidson, 1978; Heinsohn and Steiger, 1989).

The context of this latter argument is that the functioning of economies is fundamentally conditioned by uncertainty. The term uncertainty is not used

here in the sense of a learning gap which in principle can be closed. Rather it refers to unquantifiable risk—a learning gap which can never, even in principle, be closed. Uncertainty in this sense pervades the economic process, colouring the decisions to consume, invest, supply labour and allocate wealth. In order for the economic process to proceed in spite of uncertainty, society adopts conventions as a basis for expectation formation, and, supported by the state, creates elements of stability to aid decision-making (see Hodgson, 1988). The legal system supports the establishment of contracts, while the provision of outside money and bank regulation and supervision supports the evolution of a banking system which produces money as an asset to hold in times of particular uncertainty. Just as money's role is integral to the economic process, so the state's role is integral to the evolution of private sector institutions and conventions. While it is conceivable that the private sector could evolve such institutions and conventions without state support, and indeed can be said to have done so in particular historical instances, there is no guarantee that it would do so.

Money is the ultimate object of liquidity preference. Understood in flow as well as stock terms (see Dow, 1993, pp. 165–8), liquidity preference operates simultaneously on both sides of the banks' balance sheet. In addition to influencing the demand for bank deposits, liquidity preference also influences the expenditure and borrowing plans of the non-bank sector, as well as the willingness of banks to extend credit. A generalised increase in liquidity preference thus creates a paradox of liquidity (see Dow, 1993, pp. 146–52): just when the demand for bank deposits rises because of increased uncertainty about asset values, their supply may be curtailed by a credit crunch. The financial system thus exacerbates the downturn phase of the business cycle. Similarly, the reverse process exacerbates the expansion in output in upturns: banks are most willing to expand credit just when demand for holding liquid assets is at its lowest.

The reserve ratio in many countries no longer acts as an effective constraint on credit, due largely to the priority given to promoting confidence in the financial system through the lender-of-last-resort facility. Central banks can use this facility to prevent an undue credit crunch when bank expectations turn out to have been over-optimistic. The UK banking system has probably gone furthest down the road of reducing required cash ratios: it is now almost entirely an inside money system. The outsideness underpinning the banking system is no longer a tangible metal, or even tangible liabilities of the public sector, but the experience of bank regulation and supervision. The public's concern, insofar as it exists, is that deposits might not be accepted as a means of payment because of concerns over the banks' actual or perceived solvency; a problem only of illiquidity, and perceived as such, can always be resolved by interbank lending, or lending by the central bank. That the UK public is not in general concerned about retail banks' insolvency, is a product of a long history of bank regulation and supervision and the absence in recent history of retail bank failures.

Regulation and confidence in supervision have acted as elements of stability

in a system which provides the vehicle, money, for the economic process, in a sector where expectations of asset prices are crucial and yet not covered by quantifiable risk. The structure of the financial system has been undergoing major change, which certainly invites a major rethink about regulation. But money itself is a convention, the product of centuries of experience. To propose to remove these elements of stability and introduce a new convention is bold to say the least; the confidence arising from many years' experience is not to be dismissed lightly, nor can the behavioural effects of changing conventions be predicted easily.

II. CRITIQUE OF FREE BANKING PROPOSALS

The proposal to free the banking system from regulation rests on a very different view of money from that outlined above (see Smithin, 1994, chapter 2; Dow and Smithin, 1994): one which presumes that uncertainty is eliminable. It follows first that there is no need for a perfectly liquid asset as a means of payment; bank liabilities of diversely varying value will do. Secondly, it follows that financial assets can be valued in the same way as goods, so that there is no reason for banks to be regulated differently from other producers. Third, there is no connection in their view between credit creation and the demand for money (other than the increase in transactions demand which may follow from a credit-financed increase in expenditure), with no consequent risk of instability. Instability is therefore seen in micro terms as the result of unwise portfolio decisions taken by individual banks, or imperfect information about individual banks. While the law of reflux does not protect against a generalised expansion, Dowd (1993, pp. 212–7) argues that the risk of adverse clearing without a lender-of-last-resort would be enough to encourage individual banks to buck the trend. But it is the presumed absence of uncertainty which allows Dowd (1996) to argue that banks can actually detect overvaluation of assets (implying, for example, that banks in recent years knowingly entered into the situation which generated bad debts).

Ignoring true uncertainty has pervasive importance, not just for the nature of the demand for money and the propensity for systemic instability, but also for the operational feasibility of a free banking system. Free banking proposals rest crucially on the market's capacity to value bank assets. In the absence of state regulation and supervision, it is the market which is to discipline banks into adopting prudent portfolios. Yet free bankers have not demonstrated that the market can actually generate the knowledge by which to assess bank risk; the word 'knowledge' is used advisedly – it is not a matter of complete or incomplete information, but rather a matter of the ability or otherwise to predict market values correctly, even within a probability distribution, and even in principle. Free banking would certainly provide the incentive to depositors to acquire more information about banks, but the question is whether even complete information is adequate for correctly assessing risk with respect to asset values.

The contrary argument is not that asset values can never be predicted, but

that these valuations are contingent on a range of unknowns. There is accordingly no sense in which one can talk in general of the 'true' value of a bank's assets. Keynes (1937) outlined the conventions employed in practice under uncertainty: giving undue weight to current trends, and relying on conventional judgements and on the judgements of experts. A conventional view might emerge, through the pronouncements of pundits for example, that a bank's portfolio is unbalanced, with the effect of encouraging a run on the bank. But, as Davis (1992) points out, it is extraordinarily difficult even for central bank supervisors of banks (whose *raison d'être* it is) to determine whether a bank has a liquidity problem or a solvency problem. That is why prudential regulation needs to be backed up by the lender-of-last-resort facility. Goodhart (1993) argues in similar vein that private sector deposit insurers would face insurmountable difficulties in gathering adequate knowledge. It would be even more difficult for small deposit holders, and it is for this reason (without considering its wider implications) that Kaufman (1991) advocates deposit insurance to reassure small depositors.

Recognising that unwarranted runs might occur, Dowd (1989, pp. 27–31) proposes, in the absence of an insolvency problem, that option clauses be invoked when bank reserves are reduced. Banks would retain the option not to redeem their liabilities, with some compensation if the option were taken up. Dowd (1995) takes convertibility as an institutional given, necessary for stability at the level of individual banks and as a source of general price stability. This would certainly be a reversal of recent banking history, in which the notion of an outside medium of redemption has become progressively less important. But if he is right that such a reversal is required, and if the public are not assured of redemption on demand, it is not clear how much confidence would be generated by the expectation that redemption would only *normally* be forthcoming. The use of the option clause, or even the possibility of its use, reduces the liquidity of bank liabilities and thus their moneyness. If redemption is as crucial for bank stability as Dowd argues, then option clauses would threaten that stability.

In order to satisfy the need for a safe asset, deposits would be attracted to the liabilities of those banks inspiring most confidence. While technical economies of scale in banking are not sufficient to induce concentration, there are significant economies of scale in generating confidence. The conventional judgement on confidence-inspiring portfolios would tend to favour large, well-established banks. This judgement would be reinforced continually by its consequence of high redeposit ratios for these banks. The liabilities of these banks would then dominate as media of exchange, and would tend to be held as reserves by the smaller banks. The stability of the smaller banks would then depend on the stability of the large banks, and the capacity of the large banks to assess the credit-worthiness of the small banks and to discipline imprudence. The stability of the system in other words would depend on the capacity and willingness of the large banks to act like a central bank.

The Benston–Kaufman proposal for a modified free banking scheme, whereby there would still be a central bank whose purpose would be to supply

the banking sector with adequate liquidity, would address the issue of system-wide instability up to a point. But there would be no direct lending of last resort to individual banks, and no supervision; supervision is seen as being superseded by risk-assessment by (competing) federal insurance agencies. It would be up to the interbank market, then, to decide on the terms on which reserves might be borrowed. But it has not been demonstrated that the allocation of reserves by the market would be based on better knowledge than that available to a central bank with a supervisory apparatus.

Already the banking system has moved in the direction of free banking by having capital adequacy ratios as the centrepiece of regulation. If banks want to expand credit, then they must convince the market that it is warranted. But the market has shown itself to make judgements which, in aggregate, are at odds even with available, concrete information. The market was remarkably sluggish in absorbing even the most obvious implications of the debt crisis. Free banking enthusiasts might argue that this myopia with respect to fundamentals is induced by the sense of security provided by the state, i.e. by moral hazard. But the onus is on them to prove that, without that sense of security, the market would have anticipated correctly the consequences of the increase in sovereign debt in the 1970s, for example.

Moral hazard is in any case far from pervasive in a regulated system. Banks faced increased uncertainty in the 1970s and 1980s, first with increased exchange instability, then with crumbling asset values, and finally with increased competition due to deregulation. Even with deposit insurance and lender-of-last-resort facilities, banks expressed increased liquidity preference by shortening the term of assets, securitisation and so on (see Strange, 1986; Gardener, 1988). If such tactics were applied successfully (and that is a big 'if'), they could protect banks from failure in a free banking system, but this is a far cry from Dowd's image of the prudent banking system meeting the economy's needs.

Finally, free bankers argue that the risk of contagion does not justify regulation. It is argued that deposits would simply be transferred from the banks with unsound portfolios to banks with sounder portfolios, thereby encouraging sound portfolio management. But this argument ignores the potential for systemic instability. As Minsky's (1982) theory elucidates, fragility increases for the financial system in general as the economy proceeds through an expansionary phase. Thus unrealistic expectations of asset values on the part of one bank are highly likely to be mirrored by unrealistic expectations on the part of other banks. Any resulting contagion would not be unreasonable; it would be the result of a change in conventional judgement about banks' asset values. This is where the Benston-Kaufman proposal is superior to the other free banking proposals: in the situation of a reversal in expectations about asset values, an increased supply of liquidity into the system (by the central bank) is the best policy for limiting the potential for instability.

III. THE HISTORICAL EVIDENCE

The historical evidence both of regulated and unregulated banking systems lends support to these arguments, contrary to the claims of the free bankers. However, historical evidence should only be addressed with great care to thought experiments designed for modern application. Chick (1992; 1993) argues convincingly that banking systems proceed through an evolutionary process, during which the nature of causal forces changes. The need to generate confidence in banking systems has encouraged the state to evolve a regulatory presence, but the outcome has been an ever-increasing capacity in the private sector to determine the volume and allocation of credit. This capacity is compounded by the massive financial superstructure built on the foundation of bank deposits as ultimate liquidity. The scope for systemic instability in the absence of countervailing action by the state is accordingly increased. Further, the notion of commodities, or commodity-linked assets, as bank reserves has been replaced by a combination of government liabilities and confidence in the state's capacity to encourage prudent bank behaviour. The free banking supporters are thus proposing to jump back from Chick's seventh stage of banking development to stage three.

Few would deny that there have been periods of significant financial instability when banks have been regulated (see Minsky, 1982; Kindleberger, 1978; Davis, 1992). The case is easiest to make with respect to the United States, where the regulatory system has been conditioned by a dual state-federal structure and strongly conflicting interests. Yet it does not follow at all that the only reasonable alternative is no regulation. Many episodes of financial instability can be traced to misguided attempts to use regulatory power to control the money supply; since such a project is unworkable (see Goodhart, 1994), it is not surprising that it should produce instability. Yet, free bankers share the monetarist view (applicable if at all only to early stages of banking development) that inflation is determined by the money supply which in turn is determined by bank reserves. Money supply regulation is accordingly the focus of their attention (see Benston, 1991, and Kaufman, 1991). The import of the argument presented here is that more attention needs to be paid instead to prudential regulation.

Benston and Kaufman (1995, 1996) conclude from the US evidence that financial fragility is not the result of bank behaviour since it has tended to follow rather than precede failures in the real economy. But their evidence of financial instability accentuating instability in the real sector, far from contradicting Minsky's theory, actually supports it. It is in the nature of systemic fragility that the real and financial cycles are closely interrelated. Credit expansion to finance productive activity is diverted to unproductive activity when the real cycle turns around; financial euphoria takes on a life of its own which is eventually curtailed because high leverage makes borrowers particularly vulnerable to any normal shock. This pattern has been reinforced by the increasing participation of industrial companies in financial markets as lenders as well as borrowers. Thus, while the bursting of a euphoric financial

bubble can be identified with the failure of individual financial institutions, it is systemic fragility which accounts for the systemic consequences of such micro failures.

The evidence of historical episodes of free banking is perhaps most pertinent to the debate. There has been some dispute in the literature as to what actually constitutes an episode of free banking. For example, the experience of Scotland in 1695–1845 cannot be isolated from the presence of the Bank of England. The Canadian free banking experience of 1820–1935 was coloured by the fact the Bank of Upper Canada and the Bank of Montreal were owned to a significant extent by politicians in Upper Canada and Lower Canada respectively.

At issue here is not just the question of how to interpret evidence, but the deeper question of whether the purist version of free banking as free competition is actually meaningful. Conventions and regulation exist along a continuum, with the only ultimate distinction being that it is the state which enacts regulation; but then the state and centres of power in the private sector also exist along a continuum. It is not legitimate to focus, as Dowd (1996) does, on a dual of regulation/*laissez-faire*. Given the central historical role of the state and of long-established conventions in the financial sector, the onus is on free bankers to demonstrate the merits of overturning history, not the reverse.

Indeed the successful episodes of free banking were those which evolved conventions which closely mirrored state regulation. There has been a wide range of free banking episodes, but the two to receive most attention until recently are the United States case and the Scottish case. There is dispute as to whether the United States experience constituted a success (see for example Gorton, 1985; Dowd, 1989, chapter 5), but the Scottish experience has been widely used to support influential arguments for free banking (see for example White, 1984; Dowd, 1989; Hayek, 1990).

While the Scottish case can indeed be interpreted as successful, it can also be seen to illustrate the arguments made above about the unworkability of the type of free banking scenario put forward by Dowd (1996). (See Dow and Smithin, 1992.) First, the banking system evolved its own form of central banking. The two ‘old banks’, the Bank of Scotland and the Royal Bank of Scotland, set up a note exchange and an exchange equalisation system, accepted the notes of other banks to curtail runs (most notably in the case of the Ayr Bank), disciplined banks whose credit creation was judged excessive (by refusing access to clearing) and made representations to Westminster on behalf of the banking system as a whole. The other banks in turn held their reserves with the old banks, which adopted an authoritative role, based on market power, which does not square with Dowd’s (1996) ‘club’ interpretation.

While this system succeeded because central banking evolved naturally in the private sector, it cannot be presumed that such would necessarily always be the case. Scotland was a small, cohesive community, with strong and strongly-perceived interdependencies. Indeed it would be unduly cynical, and a misunderstanding of history, to argue that the activities of the two old banks were motivated purely by narrow self-interest. Any self-interest was tempered

by a profound sense of community and the potential for strong social sanctions. But it would be hard to argue that this would be a good general description of the context of free banking were it to be introduced now. Without an element of public-spiritedness among leading banks, it would be quite possible for moral hazard to dominate, so that central banking and thus scope for financial stability would not naturally emerge.

The Scottish experience also illustrates two further points. First, Dowd (1989) lays much stress on the use of option clauses to preempt bank runs. The clauses were used widely in Scotland in the early 1760s by private banks which were expanding credit rapidly. The 1765 legislation forbidding use of option clauses was enacted because representations were made to the old banks, following public meetings, to lobby Westminster; the uncertainty attached to the notes' value made them unacceptable to the general public. Indeed even after 1765 public meetings resulted in boycotts of notes other than those of the Bank of Scotland and the Royal Bank of Scotland because of continuing uncertainty as to their value. Option clauses and uncertain value had removed the moneyness of the private banks' notes.

Secondly, the consequence of the old banks' notes being the standard of value encouraged concentration of the banking system. Certainly there were periods of competition, but each wave of entry was followed by a process of concentration. Such concentration is the natural consequence of the need to satisfy the demand for a stable money asset. It is evident in a wide range of banking histories, and is currently evident in the United States and in Europe following the first flush of competition encouraged by deregulation. There is no reason to doubt that a free banking experiment would also end up in concentration in the banking system.

Finally, in more recent times, the debt crisis illustrates further the need for central banking functions which naturally arises in a deregulated environment. Sovereign debt expanded in the 1970s on a flimsy knowledge base. When banks' asset values collapsed, they were faced with the dilemma of whether to write debts off or to reschedule, and concerns were voiced about the stability of the international financial system. The solution was found by making recourse to the IMF, whose knowledge base is much more extensive than that of individual banks, which can take a system-wide view, and which has a well-established supervisory apparatus. Faced with a systemic problem, the market demonstrated its need for a world central bank which even goes beyond the remit of national central banks.

Thus, at best, a totally deregulated market would throw up its own version of a central bank, with its provision of a standard of value and its supervisory-regulatory presence. But the long struggle in the United States to establish the Federal Reserve System provides just one example of impediments in the way of the emergence of central banking.

IV. THE FUTURE OF BANK REGULATION

What has been presented here is an argument against complete deregulation of banking, or a restriction of regulation to deposit insurance and the generalised

provision of lender-of-last-resort facilities to the system as a whole. It is an argument for regulation on the grounds that the moneyness which is necessary to the working of the monetary system is a public good. However it is not an argument for complacency about bank regulation; regulation by its nature is problematic and certainly involves costs (see Gowland, 1990). But economists should feel comfortable with addressing trade-offs between costs and benefits, and suspicious of any proposal which is presented as a cost-less solution.

The regulatory issues facing us now arise from market structural diffusion (see Gardener, 1988), itself the product partly of deregulation. This diffusion has altered the place of banks in the financial system and changed the knowledge requirements of the market and of bank regulators. Experience with attempts to promote European integration in banking demonstrates amply the significance of different national market conventions, which in turn are complicated by different regulatory traditions. What generates confidence in one tradition is not necessarily what generates confidence in another tradition. There is the additional question regarding the institutional separation of bank supervision and attendant regulation from efforts to control monetary aggregates.

Urgent regulatory issues are therefore posed by the potential for financial instability which has arisen with a partial dismantling of regulation and from the changing role and behaviour of banks themselves. To suggest a complete removal of regulation as the solution to these issues is both to admit defeat and to court disaster.

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