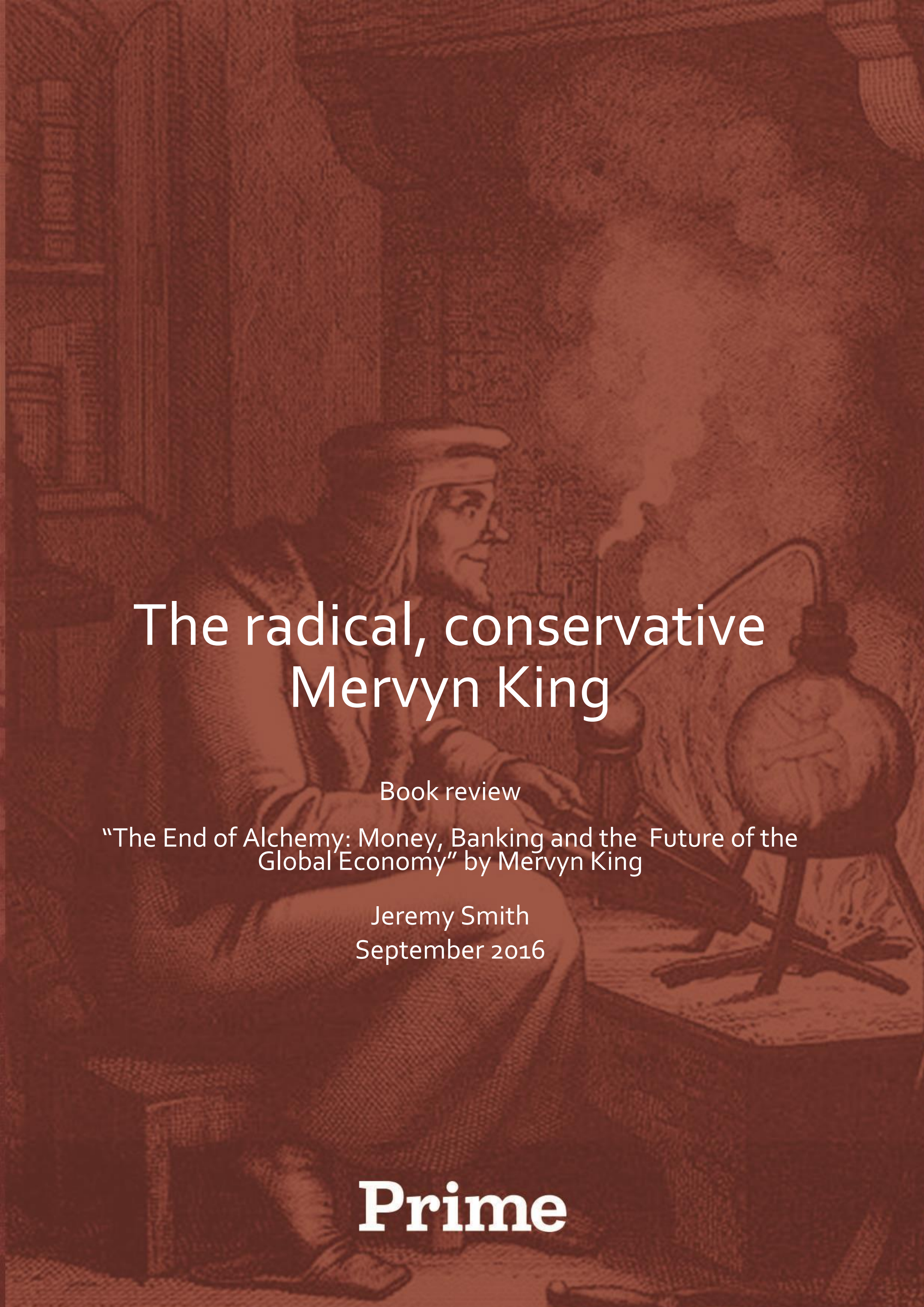

The radical, conservative Mervyn King

Book review

“The End of Alchemy: Money, Banking and the Future of the Global Economy” by Mervyn King

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Prime

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A review of "The End of Alchemy: Money, Banking and the Future of the Global Economy" by Mervyn King, published by Little, Brown 2016

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation."
J.M.Keynes, The General Theory p.159

Introduction

Mervyn King's recent tome, "The End of Alchemy", is an engaging but mysterious endeavour. It is a mix of real insights and at times hinting at fairly radical thinking, especially for a central banker, but intermingled with some ambivalence and contradiction. Big questions are raised, some important proposals put forward, but his conclusion on future policy in particular is a huge disappointment, as we shall see. And at the heart is a confusion as to what really is the "alchemy" in our system of money and banking that we need to contend with, and as to whether indeed "alchemy" is really the major problem to be addressed.

Along the way, he touches on many key issues – his chapter on the problems of the Eurozone is sharply critical and depressing, and quite bold in its critique for someone so recently involved as a EU central banker, since he suggests there are only four ways out of the current problems[1], none of which are politically acceptable to the main players; this leaves only the current "strategy" of muddling through and hoping for something to turn up. He sees no prospect for moves to political union. (His section on the euro merits a separate, more detailed analysis than I can offer here).

The great financial crisis

King offers in Chapter 1 a brief survey of the post-1930s (mainly post-1970s) world, culminating in the Great Financial Crisis of 2007-9. The chapter is entitled "The Good, the Bad and the Ugly". The Good "was a period between about 1990 and 2007 of unprecedented stability of both output and inflation – the Great Stability", in which "inflation targeting and central bank independence spread to more than thirty countries." The Bad was "the rise in debt levels", and the Ugly "the development of an extremely fragile banking system". By 2008 "the Ugly led the Bad to overwhelm the Good." The Good is presented in effect as being done by the central banks, leaving the Bad and Ugly down to others. In what follows, there is no hint of fault on the part of central bankers or policy makers. Macavity wasn't there.

King's account of the crisis is a good summary of many of the problems and attitudes that triggered the crisis. While the central banks come off quite lightly, the bank regulators of the world (the UK's regulator, the FSA, was not part of the Bank of England at the time) are singled out for giving "an emphatic no" (September 2007) to the central bankers' question whether the US sub-prime market was big enough to bring down major banks. King does affirm that "the economic path on which the world economy was proceeding was clearly unsustainable", and he asks two good if obvious questions – why the inertia before the crisis (surely a question for and about central bankers as much as any others), and why has so little been done to change the underlying causal factors? He rightly comments:

[1] Continue with high unemployment in periphery states until prices and wages fall enough to restore competitiveness; create high inflation in surplus countries, and fall in value of euro; abandon attempt to restore competitiveness and accept indefinite need for 'north to south' transfers; accept partial or total break-up of euro area.

> "The strange thing is that after arguably the biggest financial crisis in history, nothing much has really changed in terms either of the fundamental structure of banking or the reliance on central banks to restore macroeconomic prosperity."

King also points out what is evident - that since the crisis, weak demand has become a deep-seated problem, "one that appears immune to further monetary stimulus." His answer to all these points takes him to his principal theme – we live in a monetary economy rather than "the text-book description of a market economy, in which households and businesses produce and trade with each other". The differences between these two concepts are "profound" .

The no-blame game

But first, was anyone to blame for the crisis. In Mervyn King's judgment? Well, not really. We may want – he says - to blame the likes of Fred Goodwin (RBS) or Dick Fuld (CEO, Lehman's) as villains of the piece, but this is "a story about deeper forces shaping the constraints that governed the actions of individuals."[2]

In his Introduction, King already seeks to diffuse (or defuse) any allocation of "blame":

> "Since the crisis, many have been tempted to play the game of deciding who was to blame for such a disastrous outcome. But blaming individuals is counterproductive – it leads you to think that if just a few, or indeed many, of those people were punished then we would never experience a crisis again. If only it were that simple.
>
> A generation of the brightest and best were lured into banking, and especially into trading, by the promise of immense financial rewards and by the intellectual challenge of the work that created such rich returns. They were badly misled. The crisis was a failure of a system, and the ideas that underpinned it, not of individual policy-makers or bankers… There was a general misunderstanding of how the world economy worked…" (page 3).

Note the use of the passive voice and the "there was" formulation, classic grammatical devices for distancing the author from the statement, or the deed; and admire the wonderful conclusion (as if pronounced from outer space) of the last sentence – "there was a general misunderstanding of how the world economy worked." Hmm. This comes remarkably close to the words of Sir Nicholas Macpherson, the recently-retired Permanent Secretary at the UK Treasury, who told George Parker of the FT:[3]

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[2] I am sorry he does not even mention my own number one villain, Matt Ridley, whose abject failure of leadership (as Chairman) of Northern Rock left – in his own words – a "catastrophic black mark" on his CV; Ridley is a hard-line neoliberal and sceptic on climate change, who now sits and votes in the House of Lords as a hereditary Conservative peer. An exemplary manifestation of all that is rotten with and within the British establishment.

[3] Quote from the Financial Times, "Veteran of Treasury battles tots up a decade's wins and losses", 14 April 2016. See also my article on PRIME's website, "So. Farewell Sir Nicholas. Yes, you were monumentally wrong."

> "I see myself as one of a number of people in finance ministries, central bank regulators, in the UK and the US who failed to see the crisis coming, who failed to spot the build-up of risk… This was a monumental collective intellectual error."

So here, between Macpherson and King, we can put together the official explanation for the crisis:

Due to a monumental collective intellectual error, there was a general misunderstanding of how the world economy worked. (Though for "intellectual", I feel we should substitute "ideological".)

It is at least good to know how our two leading civil servants during the crisis seek to explain it – it tells us a lot about the capacity of our economic and financial establishment. But that's it, folks. Big error, general misunderstanding. No individual responsible for anything much. Once again, Macavity wasn't there.

Neither King nor Macpherson before him seeks to explain why there were quite a few economists (mainly but not only non-mainstream) who were not party to the "general misunderstanding", who in fact forewarned that the crisis was imminent.

Should we blame the 'economists'?

The nearest King gets to allocating any blame is indeed in relation to 'economists' – without differentiating Good economists from the Bad (let alone the Ugly) - yet it is unclear at the end whether he wishes to press the indictment:

> "If we don't blame the actors, then why not the playwright? Economists have been cast by many as the villain. An abstract and increasingly mathematical discipline, economics is seen as having failed to predict the crisis. This is rather like blaming science for the occasional occurrence of a natural disaster. Yet we would blame scientists if incorrect theories made disasters more likely…" (page 3).

One of the arguments of his book, King says, is that "economics" (note the abstraction) "has encouraged ways of thinking that made crises more probable". But he charges economists not with the economic equivalent of causing death by dangerous driving, but with a lesser misdemeanour:

> "Economists have brought the problem upon themselves by pretending that they can forecast."

It is of course true in a certain sense that accurate forecasting is not possible, and this might be considered a helpful defence also for central bankers and decision-makers to any charge of dangerous driving of the economy! Already at page 11, King affirms that

> "Crises do not come out of thin air but are the result of the **unavoidable** mistakes made by people struggling to cope with an unknowable future." [my emphasis]

Yet while I concede that precise forecasts are rarely right, surely some mistakes are less "unavoidable" than others; the ability to forecast the general direction of the economy and assess major risks is surely part of the justification for the existence of the discipline and profession. Yet the orthodox profession as a whole flunked it. The Office for Budget Responsibility springs to mind as a body charged by law with forecasting, but it is not mentioned by King.

King is foreshadowing here one of his main themes – the working of the principle of "radical uncertainty". While there are many risks to which probabilities may be assigned (as in insurance), there are also events where it is not possible (in his language) to define or imagine all possible outcomes, and so one cannot assign probabilities to them. Radical uncertainty, for this reason, "drives a gaping hole through the idea of complete and competitive markets", since these depend on reasoned calculation.[4] *(Question for readers of this review – is Brexit a good example of radical uncertainty for which serious forecasting is impossible? In which case the Remain campaign's reliance on Treasury modelling was even more dubious!)*

Based on his principle of "radical uncertainty", King offers economists something in between a defence and a plea in mitigation:

> "No one can easily predict an unknowable future, and economists are no exception. Despite the criticism, modern economics provides a distinctive and useful way of thinking about the world. But no subject can stand still, and economics must change, perhaps quite radically, as a result of the searing experience of the crisis." (Page 3)

As to the first part of this curious paragraph, King confuses two distinctly different meanings or ranges of "prediction". One meaning relates to the broad analysis of a situation – were the developed economies' circumstances, from say 2005 onwards, such that a severe crisis was either certain or very likely, and likely to strike imminently? Surely the answer here is that such a prediction should have been capable of being made by economists.

The second meaning of "prediction" involves more precise and detailed estimates of how the crisis would unfold – e.g. would it start in 2007, then intensify and finally break in the summer of 2008, what the precise level of recession would be, how high unemployment would go. We can't blame the profession for not getting all this right. But nor should we let the economists (or indeed central bankers) off the hook for getting the broad "understanding" wrong.

Back to King's passage on the need to change economics.

It is certainly positive to see such a senior establishment figure call for radical changes in the discipline. Here he is certainly in advance of the position of his fellow central banker, Ben Bernanke, who in 2010 (when chair of the Fed) had argued:

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[4] Keynes's chapter 12 of the General Theory, on the State of Long-Term Expectation, had raised the problems of forecasting in relation to capital investment, and the degrees of certainty or confidence that we can attach to expectations; "it would be foolish…to attach great weight to matters which are very uncertain".

> "Although economists have much to learn from this crisis, as I will discuss, I think that calls for a radical reworking of the field go too far."[5]

But alas, the only direct advice given on the 'radical' shift required is that economists should stand on the shoulders of giants of the past, not kneel in front of them. This advances things little. But clearly, for King, central to change is a better understanding of the working and role of money and banking - and their impact on the economy. Which leads us to his central theme and metaphor of "alchemy."

What is meant by "alchemy"?

I have come away with a sense that the title of this book, "The Alchemy of Money", was dreamt up (or created out of thin air) before any serious consideration was given on how to actually work the metaphor to transmute the base metal of readers' ignorance of money and banking into the gold of understanding. Dictionary definitions of alchemy include the following:

> "a medieval chemical science and speculative philosophy aiming to achieve the transmutation of the base metals into gold, the discovery of a universal cure for disease, and the discovery of a means of indefinitely prolonging life"
> "a power or process of transforming something common into something special".

Now the evolution of money can perhaps be seen - from one perspective - rather as the *reverse* to this process; as a process first of transmuting "intrinsically valuable" gold into intrinsically less valuable coins of baser metal, and then into paper, and then from tangible paper into pure digital abstraction. The catalyst for these alchemical reactions is the exercise of the sovereign's power, the fiat.

In Goethe's Faust, and reminding us of John Law a century earlier, the alchemical transmutation is not from actual gold to paper, but involves the creation of economic and monetary value - in effect from thin air - into paper issued with the Emperor's state authority, and notionally backed, in an indeterminate way, from an assumed but non-specific stock of unmined or hidden gold which lies beneath the Emperor's territory. The acceptance and wide use of this "base" (fiat) paper itself creates economic value.[6]

For me, the creation of social and economic value out of the mysteries of our banking and monetary systems – with the attendant risks and therefore requiring commensurate controls – could have been a fruitful way for King of treating "alchemy", but that is not really how the metaphor is explored. (He could also have argued that the "gold" created via private money

[5] Remarks to the conference "On the Implications of the Financial Crisis for Economics" , 24 September 2010
[6] The alchemy ultimately fails in this case as the Emperor and his team are shown to take things to excess. Goethe used his poem to warn of the dangers of monetary excess; his conservative monetary approach is reflected to this day in official German monetary policy, as personified in Bundesbank Chairman Jens Weidmann. See for example Jens Weidmann's speech on "*Money creation and responsibility*", 18 September 2012, where he says "Goethe already analysed the core problem of today's monetary policy based on paper money around 180 years ago…"

creation out of thin air is the "gold" in the pockets of the denizens of Wall Street and the City of London, but this is also not his argument).

Definition 1

So what does King himself mean by alchemy? After reading the book, it is still not so clear to me, as he varies his definitions. But alchemy is always seen by King as something negative, something to bring to an end. (Whereas one can view alchemy in a more positive light; Paracelsus for example was an alchemist, who sought to use scientific experiment to advance medical progress). In his Introduction, King sets the scene:

> "For much of modern history, and for good reason, money and banking have been seen as the magical elements that liberated us from a stagnant feudal system and permitted the emergence of dynamic markets capable of making the long-term investments necessary to support a growing economy. **The idea that paper money could replace intrinsically valuable gold and precious metals, and that banks could take secure short-term deposits and transform them into long-term risky investments**, came into its own with the Industrial Revolution in the eighteenth century. It was both revolutionary and immensely seductive**. It was in fact financial alchemy – the creation of extraordinary financial powers that defy reality and common sense.** Pursuit of this monetary elixir has brought a series of economic disasters – from hyperinflations to banking collapses. Why have money and banking, the alchemists of a market economy, turned into its Achilles heel?" (Pages 4-5; my emphasis[7]).

So here, King merges two distinct points to create his common sense-defying alchemy – (a) the replacement of "intrinsically valuable gold and precious metals" by paper money, and (b) the transforming of secure short-term deposits into long-term risky investments.

This already poses problems. What does he mean in this context by "intrinsically valuable gold", for example? Are gold coins whose denomination differs from their "value" as gold deemed to be intrinsically valuable, or is such fiat coin-money already a step towards "alchemy" even before paper money? Nor, as a separate point, is it clear that the development of the banking system's "alchemy" played so much of a role in the British Industrial Revolution, which was largely financed from other sources, including the slave trade.

Definition 2

Now just a few pages on, King gives us a slightly different, or more precise, definition of alchemy:

[7] Passages in bold in citations from the book are my own author's emphasis throughout this review.

> "By alchemy I mean **the belief that all paper money can be turned into an intrinsically valuable commodity, such as gold, on demand,** and that **money kept in banks can be taken out whenever depositors ask for it**." (Page 8).

I find this new dual definition very odd, in the context of the book's main theme. In the first limb, he harks back to an era that has decidedly passed – the age of the gold standard. No one now believes that paper money can be turned into gold, and one may doubt whether people ever did truly believe it, at least in the last 200 years. So even if true in the past, it is irrelevant now.

As to the second limb, of course most current account depositors do believe that they *should* be able to take "their" money out at will to respect their absolute 'liquidity preference', and in effect, that is what compulsory deposit insurance is about (though it may take some time to sort out). But I am not so sure that people believe they necessarily *can* do so, at least immediately, which is why there was the start of a run on Northern Rock.

King continues:

> "The truth is that money, in all forms, depends on trust in its issuer. Confidence in paper money depends on the ability and willingness of governments not to abuse their power to print money. Bank deposits are backed by long-term risky loans that cannot quickly be converted into money. For centuries, alchemy has been the basis of our system of money and banking."

The point about trust is of course valid, but (non-liquid) long-term loans are not necessarily unduly risky if made for sound business purposes and backed by good collateral *within a stable financial system*. The main problem is casino banking - speculative or obviously unjustified or excessive borrowing and lending.

The promise of alchemy

By page 50, King has subtly reformulated his account of the development of "alchemy":

> "The central idea of this book is that money and banking are particular historical institutions that developed before modern capitalism, and owe a great deal to the technology of earlier times. They permitted the development of a market economy and promised financial alchemy. But in the end it was that financial alchemy that led to their downfall. Money and banking proved to be not a form of alchemy, but the Achilles heel of capitalism…"

So here, money and banking "promised financial alchemy" which presumably means banks could safely (via taking deposits and making loans) help to generate economic development and prosperity. The "promise" referred to must presumably be along the lines of "deposit your money with us, and we will help society (and you), by our lending, to create ever-growing economic development". On this reading, alchemy can fail (crises and recessions), but surely we have yet to see the actual "downfall" of money and banking, or capitalism, despite the great financial crisis, and however grave their shortcomings.

This public "promise" of financial alchemy sits oddly with King's previous definition, which is the (presumably insidious) inculcation of a (false) belief to be held by citizens, that they can access "their" money at will and turn it into gold on demand.

Definition 3

We have to wait till page 250 to find what I feel is a clearer exposition of what King really seems to mean by alchemy - "the apparent transformation of risk into safety":

> "For centuries, alchemy has been the basis of our system of money and banking. Governments pretended that paper money could be turned into gold even when there was more of the former than the latter. Banks pretended that short-term riskless deposits could be used to finance long-term risky investments. In both cases, **the alchemy is the apparent transformation of risk into safety."**

Despite the government's formal commitment to convertibility, I would guess that most users of paper money saw it as that, "money", and the commitment was – for the most part and most of the time - simply a sign that the government stood behind the currency and its "value". Whether people generally thought that everyone could *simultaneously* convert all paper money into gold, I rather doubt – at least over the last 200 years.

I am, moreover, not even clear what King is trying to say here in relation to the banks and deposits. They either did use short-term deposits to fund long-term loans – in which case there was no *pretence* - or they did not, in which case it seems bizarre that they would pretend that they were doing so!

I thought his point was the opposite, namely the banks pretended that deposits were always safe. I would have thought that King's truer formulation would be the precise obverse of that which he has given, namely that "the alchemy is the transformation of apparent safety [of deposits] into risk." But that would indeed be turning (from the depositor's perspective) the gold of safety into the base metal of risk, which is surely the very reverse of alchemy…

King continues as follows:

> "For a society to base its financial system on alchemy is a poor advertisement for its rationality. The key to ending the alchemy is to ensure that the risks involved in money and banking are correctly identified and borne by those who enjoy the benefits from our financial system."

Here we can agree on the solution, so far as this goes. Risk should indeed be identified, and borne by those who stand to gain from speculation. But elsewhere King refers to the banking system as a "public good", and this implies that it does (or at least should) perform socially necessary and useful tasks – of facilitating investment in the productive economy, as well as taking ordinary deposits (of salaries etc.). Yet if banks are to be able both to hold short-term customer deposits and lend to the real economy, some element of risk has to be involved. The question is how to manage it.

The essence of alchemy (or definition 4)

A few pages on, King seems to define alchemy in yet another way:

> "**The pretence that the illiquid real assets of an economy** – the factories, capital equipment, houses and offices – **can suddenly be converted into money or liquidity** is the essence of the alchemy of the present system. Banks and other financial intermediaries will always try to finance illiquid assets by issuing liquid liabilities because they make profits by paying less on the latter than they earn on the former." (Page 253).

Now note that in this passage, King does not refer to wild speculative lending by banks as being "the essence of the alchemy". No, he is referring to the banks' ordinary useful lending to create illiquid real assets - the sorts of useful assets we need (unless, that is, the banks over-lend beyond the capacity of the economy).

What King has done is to conflate two separate issues, and call the product of his conflation "alchemy". Banks receive (create) short-term deposits from customers; they may also (a) make longer term loans to fund illiquid assets for sound purposes that benefit society, or (b) make longer loans to fund illiquid assets for speculative purposes that (assuming all goes well) benefit only the banks and end-speculators. Surely it is (b) that should be King's – and our - target, not (a).

He seems to imply this when he says:

> "Ordinary current accounts are not vehicles for speculative investments and it is important that they have a stable value in terms of money, in which payments are denominated. But **if a bank has assets that are highly risky**, as many of its loans may be, then **it is alchemy to pretend that deposits can be secure**." (Page 254).

Alas, this is yet another meaning ascribed to poor old alchemy.

The 'end of alchemy' – what does it mean?

From all the above, I deduce that there is no single clear target that can be identified as the "alchemy" of the banking system that should be abolished. Yet King set himself the question of "how we can end the alchemy of our present system of money and banking".

To sum up, we have seen that King's "alchemy" covers all of these:

- The idea that paper money can replace intrinsically valuable gold and precious metals,
- The idea that banks can take secure short-term deposits and transform them into long-term risky investments
- the belief that all paper money can be turned into an intrinsically valuable commodity, such as gold, on demand,
- the belief that that money kept in banks can be taken out whenever depositors ask for it
- the apparent transformation of risk into safety, e.g. by governments pretending that paper money could be turned into gold even when there was more of the former than the latter.
- the apparent transformation of risk into safety e.g. by banks pretending that short-term riskless deposits could be used to finance long-term risky investments.
- the pretence that deposits can be secure even if a bank has highly risky assets

But King even goes further at the end of his book, arguing that

> "For many centuries, **money and banking were financial alchemy**, seen as a source of strength when in fact they were the weak link of a capitalist economy." (Page 369).

So money and banking did not just *include* aspects we can call alchemy – they actually *were* alchemy! If so, to get rid of alchemy, we would have to do away with our current system of private banking and money creation altogether and replace them with a system based on a quite different logic. Cue radical monetary reform, if not revolution.

To achieve this would require an end, at minimum, to the ability of private banks to create "money" (though King does not explain in detail the creation of money from thin air by banks making loans and "entering the number in a computer" to create the money deposit, it is implicit in his discussion).

King looks at some length at the 1933 Chicago Plan, put forward by Irving Fisher and others, which would require banks to hold sufficient liquid assets as reserves to back 100% of their deposits. The concept has been supported in recent years by the economists Benes and Kumhof (from the IMF) and in various forms by the economists working with Positive Money such as Ben Dyson and Andrew Jackson, as well as by Martin Wolf of the FT.

The disadvantages of the Chicago Plan (and its recent successors)

King is not persuaded to adopt such proposals. While it is true that – if implemented - there would be no incentive for a depositors' run on the bank,

> "[W]ho would perform the many functions that banks carry out today, especially lending to businesses and households, so enabling them to build factories and purchase homes?... If deposits must be backed with safe government securities, then it follows logically that all other assets, essentially risky loans to the private sector, must be financed by issuing equity or long-term debt... As a result, this approach

> would, in effect, separate safe and liquid 'narrow' banks, carrying out payment services, from risky and illiquid 'wide' banks performing all other activities." (Page 262).

Apart from the fact that the banks would lobby furiously against such proposals, King thinks that

> "…eliminating alchemy in this particular way has some other disadvantages" (page 264).

(Here, then, we get close to an admission that we must be careful not to throw the baby out with the alchemical bathwater!)

First disadvantage, such a change to narrow and wide banks would be disruptive, forcing a costly reorganisation of the structure and balance sheets of the banking institutions;

Second, (and this seems strange to me after all his talk about alchemy) the complete separation into narrow and wide banks

> "denies the chance to exploit potential economic benefits from allowing financial intermediaries to explore and develop different ways of linking savers, with a preference for safety and liquidity, and borrowers, with a desire to borrow flexibly and over a long period…"

Third, and he sees this as the most important disadvantage of the updated Chicago Plan

> "…radical uncertainty means that it is impossible for the market to provide insurance against all possible contingencies, and one role of governments is to provide catastrophic insurance when something wholly unexpected happens. Ending alchemy does not in itself eliminate large fluctuations in spending and production. In a world of radical uncertainty, where it is possible that households and businesses will make significant 'mistakes' about the future profitability of investments, there is always a risk of unexpected sharp changes in total spending."

As King points out, while depositors' bank runs are assumed to be eliminated by the Chicago Plan, this simply moves the key area of risk to changes in the value of assets held by businesses and households, and thus to the solvency of the wide banks. He is dubious about the capacity of central banks to play a useful role in intervening in these asset markets:

> "I am not sure that their track record justifies an optimistic judgement of the ability of central banks to see the rocks ahead and steer the economy around them".

King's alternative – "the pawnbroker for all seasons"

King understands, therefore that the risks of the banking sector are not limited to those faced by the ordinary depositor today, but – even if ordinary deposits are made safe – systemic risks can also be present in the case of future wide banks:

> "Although wide banks cannot create money in the form of deposits, they can still borrow short and lend long. In both cases they use collateral.... even wide banks create a degree of alchemy. When unexpectedly bad news arrives, collateral falls in value and is perceived as more volatile and less liquid than before. Lenders will want more collateral to continue or roll over existing loans."

And so on in the downward spiral, with interconnected impact. So King offers a compromise approach:

> "The new way forward is to recognize that the prohibition on the creation of money by private banks is not likely to be sufficient to eliminate alchemy in our financial system. Radical uncertainty means that the provision of catastrophic insurance [bail-outs] in some circumstances is desirable..." (Page 269).

The trouble with the traditional Lender of Last Resort (LOLR), "in the presence of alchemy", is that the central bank is obliged to lend against bad collateral at inadequate haircuts and low or zero penalty rates. The answer, says King, is to act during normal times, with the central bank acting as "pawnbroker for all seasons". The principle is to ensure that banks will always have sufficient access to cash to meet the demands of depositors and others supplying short-term unsecured debt.

Each bank would then pre-position collateral at the central bank in advance, at "haircuts" (discounts) determined in advance by the central bank for that type of asset. This would mean that the private bank knows how much it can borrow in a crisis from the central bank. This amount plus its existing central bank reserves makes up the "effective liquid assets" of the bank. (King argues that given practice under QE, the assessment of collateral and calculation of haircuts have become routine and can, therefore, fairly simply become a "normal function" of a central bank).

One then assesses the banks' liabilities, adding up its total demand deposits and short-term (up to one year?) debt. This total is the bank's "effective liquid liabilities". And the rule is that "their effective liquid assets should exceed their effective liquid liabilities."

The scheme would be phased in over say a 20 year period, and would in King's view "add a desirable degree of flexibility to the Chicago Plan". It would apply to all financial intermediaries, banks and shadow banks, which issue unsecured debt with a maturity of less than a year. He contends that it would finally get rid of alchemy from our private banking system.

Is 'alchemy' the main problem?

I have read several reviews of Mervyn King's book, and none that is fundamentally critical of his "pawnbroker of last resort" proposal. It indeed seems to add a touch of sense and flexibility to the modern variants of the Chicago Plan, which in effect start from the monetarist fallacy, that what we need to do above all is control the production and quantity of money. Paul Krugman, in his review for the New York Review of Books, calls King's

> "…an interesting proposal. But I have to admit that I'm not sure how it follows from his emphasis on radical uncertainty or how different it is, in a fundamental sense, from the system we now have."

Now Krugman, for all his strengths, has been criticized often for not understanding money creation and banking, but on this point, I share the doubts. Either the central bank takes a very pessimistic view, in which case the haircuts are very large and the scope for new lending commensurately smaller, or they are more moderate, in which case unknown unknowns (or known unknowns) could falsify the assumptions and end in crisis. In any event, bad stuff (crisis) can still happen on a massive scale outside the scope of the pawnbroker of last resort's jurisdiction which – though theoretically being at the risk-takers' risk – may have huge repercussions for all sectors due to the interconnectedness of the system and be seen to require intervention.

For the bigger issue in all this debate is whether – within a neoliberal system of global financialisation – any such proposal can work, when the bigger risks are not those of "alchemy" in the senses described, but in the vast risks and indebtedness that are created in the wider shadow banking system. Even if there is "cover" for short-term deposits and short-term unsecured debt, the system can still blow up. And the central bank may once more feel that there is no alternative but to step in and bail out.

In "This Time is Different", Messrs Rogoff and Reinhart point out that in the post 2nd World War period until the 1970s, there were no major banking crises. In a short blog I wrote in 2014, I pointed out:

> The book includes a chart (13.1) at p.205 which plots the proportion of countries with banking crises, from 1900 to 2008, weighted by their share of world income. It shows several peaks from 1900 to 1928, then the giant peak of the Great Depression, falling back to almost zero in 1940. Barring a small hill in the 1947-50 period, the chart is completely flat at zero until 1972, since when it rises and falls dramatically, most recently in 2008-9. They comment:
>
> "Figure 13.1 also reminds us of the relative calm from the late 1940s to the early 1970s. This calm may be partly explained by booming world growth but perhaps more so by the repression of the domestic financial markets (in varying degrees) and the heavy-handed use of capital controls that followed for many years after World War II…

Since the early 1970s, financial and international capital account liberalization – reduction and removal of barriers to investment inside and outside a country – have taken root worldwide. So, too, have banking crises…"

During the "golden era" from the 1940s to the 1970s, economies did have peaks and troughs, but did not suffer from banking crises and major banking collapses. Moreover, economic activity (measured in GDP) expanded on average at a faster annual rate during that period than in more recent times. The main problem, I would argue, is therefore not alchemy, but the extent of risk and regulation that the system permits.

Towards capital controls and tougher macroprudential regulation?

The recent revivals of the Chicago Plan, and notably the Benes and Kumhof proposals and those from Positive Money, have been criticized on several grounds which are relevant (if to a lesser degree) also to King's proposals.

In "A critique of full reserve banking" (University of Sheffield, 2015), Sheila Dow, Guðrún Johnsen and Alberto Montagnoli argue that the full reserve banking plans lead to a sharp split between 'heavily controlled money' and 'the provision of savings vehicles and credit' which is unlikely to work or benefit society. Instead, they place a greater emphasis on more traditional regulation of traditional banks, and close attention (with potential curbs) on the rest of the financial system

The heterodox economist Brett Fiebiger in his article "'The Chicago Plan revisited': a friendly critique"[8] also sees the bigger problem as "a deficient neoliberal regulatory regime" and the uncontrolled expansion of shadow banking etc., rather than that of depository banks creating money as debt.

Neither of the above articles is explicit in one important respect – in order to return to the greater degree of safety and lack of banking crisis that marked the "Golden Age", we need to consider some forms of capital controls[9], or functionally equivalent limitations on the unrestrained free flow of capital across borders, at times of excess credit growth. For long an idea that dared not speak its name in polite neoliberal circles, the concept of capital control is gradually being rehabilitated, notably in the context of protecting emerging economies from destabilizing effects of rapid in and out flows. See for example the IMF Working Paper "Capital Controls or Macroprudential Regulation?" (2015) by Anton Korinek and Damiano Sandri, and in particular the work of Hélène Rey, e.g. "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence" (2015).

Ms Rey reaches a qualified conclusion which casts major doubt on the assumed (by neoclassical economics) benefits of financial integration:

[8] European Journal of Economics and Economic Policies, 2014

[9] My co-director of PRIME, Ann Pettifor, in her review of Geoffrey Ingham's "Capitalism", *The Power to Create Money 'Out of Thin Air'*, does refer explicitly to the need for capital controls.

"So both on the empirical side and on the calibration side, it is so far hard to find robust support for large quantifiable benefits of international financial integration. I do not claim that there are no benefits to international financial integration, only that they have been remarkably elusive so far given the scale of financial globalization the world has undergone."

She poses four (possibly cumulative) options for action to protect economies from the severe risk of financial crisis fuelled by cross-border capital flows:

> One could: a) impose targeted capital controls; b) act on one of the sources of the financial cycle itself: the monetary policy of the Fed and other main central banks; c) act on the transmission channel cyclically by limiting credit growth and leverage during the upturn of the cycle using national policies (and possibly doing the reverse during downturns)—i.e., putting in place macroprudential policies; d) act on the transmission channel structurally by imposing stricter limits on leverage for all financial intermediaries."

The last words here – "for all financial intermediaries" – are particularly relevant because they show that it is not just the narrow banking sector that needs to be controlled. "It is really excessive credit growth that is the main issue of concerns", Ms Rey concludes – and credit growth may go far beyond the creation of money by private banks. It is fair to say that she in general recommends strong macroprudential regulation above capital controls, but she sees the power to impose controls as a tool that "should not be discarded".

Controlling the financial system

Returning to Mervyn King's recommendations in the light of these debates, we may conclude that he has surely put forward a proposal which provides more flexibility and provides a less tight constraint than the current varieties of the Chicago Plan that have been floated. However, I feel they focus on too narrow a set of problems which he has sought to encapsulate under the generic name of "alchemy" – focussing mainly on the risks faced by the ordinary short-term depositor, and the need to protect society from banks' abusing their power to create money 'out of thin air'.

However, it is evident that this is not the only problem, and was not the main problem in relation to the causes and consequences of the great financial crisis. Here, we are driven to far wider issues of the neoliberal international financial system and how, if not tightly managed, it multiplies risk and interconnectedness throughout the formal and shadow banking sectors.

King is in fact well aware – as one would expect - of this wider issue of international interconnection, non-regulation and risk magnification, which he deals with under his heading of "the Ugly":

> "The Ugly was the development of an extremely fragile banking system…Banks diversified and expanded rapidly after deregulation… The assets of large

international banks doubled in the five years before 2008… they became so closely interconnected that a problem in one would spread rapidly to others, magnifying rather than spreading risk. **Banks relied less and less on their own resources to finance lending and became more and more dependent on borrowing**." [My emphasis].

This last passage is surely vital and rather undermines the whole of his book's emphasis on alchemy. The transmission of risk through the system is not only (or mainly) that banks have short-term liabilities to depositors but lend long-term, but that they have become speculators on a historically unprecedented scale – and have borrowed the funds to enable them to do so.

The problem is therefore not (in my view) "alchemy" – but excessive speculation by banks and other parts of the finance sector that bears little or no relationship to the needs of the productive economy. And the answers therefore have to be system-wide, enabling society to control the finance sector as a whole, and not just the part of it that houses our current accounts and provides "payment services" - and puts us at financial (but also political and social) risk thereby.

Facing the future – "the audacity of pessimism"

At the outset of the review, I said that King's recommendations for the future are a great disappointment, and a surprising one given his approach. The last chapter's title, "the audacity of pessimism", announces to us that he is not, well, as optimistic in his audacity as Barack Obama claimed to be in 2004. Its sub-heading is "the prisoner's dilemma and the coming crisis" which gives a clue that he does not see things ending well:

> "Without reform of the financial system…, another crisis is certain, and the failure to tackle the disequilibrium in the world economy makes it likely that it will come sooner rather than later." (Pages 334-5).

But we have the opportunity to do something about it, he says, rather than simply give in to our pessimism.

Along the way, he offers an unexpectedly radical view on sovereign debt cancellation. He argues the case for debt relief for Greece, and probably for other Eurozone countries in due course, but goes into another extraordinary (given his position) criticism of the management of the Eurozone:

> "Put bluntly, monetary union has created a conflict between a centralised elite on the one hand, and the forces of democracy at the national level on the other. This is extraordinarily dangerous…" (Pages 343-4).

He foresees "not only an economic but a political crisis" in Europe. This is not a new argument, but very strong stuff from such an establishment source (one wonders how far he had earlier expressed such thoughts to his EU colleagues). Furthermore, and praying Keynes's argument from 1922 in aid:

> "If the members of the euro decide to hang together, the burden of servicing external debts may become too great to remain consistent with political stability." (Page 345).

More broadly, he adds his voice to those of us who have long argued for a "sovereign debt restructuring mechanism", as debated within the IMF in 2003 (and in which PRIME's director Ann Pettifor was heavily involved) and – as King notes – vetoed by the USA and Germany. It is good to see him give his backing, since it is both necessary yet unfashionable at present among policy-makers.

King is evidently not an *ultra*-globalisation supporter, as this passage shows:

> "Misguided attempts to suppress national sovereignty in the management of an integrated world economy will threaten democracy and the legitimacy of the world order… As time goes by, parallels between the inter-war period and the present become disturbingly more apparent. The decade before 2007, when the financial crisis began, seems in retrospect to have more in common with the 1920s than we realised…. After 2008, the parallels with the 1930s also began to grow." (Page 351).

He does not see much ground for optimism that the slow growth seen since the crisis is likely to pick up soon or easily. He argues that monetary and fiscal stimulus was right in 2008-9, but that in recent years,

> "…extraordinary monetary stimulus has brought forward consumption from the future, digging a hole in future demand. With a prospect of weak demand in the future, the expected return on investment becomes depressed." (Page 356).

This weak demand is because in countries like the UK and US, businesses and households have adopted a "rational narrative" that consumer spending was unsustainably high before the crisis; they need to move to a new equilibrium based on a "revised narrative". From this, King argues – to my mind unpersuasively:

> "Low growth in the global economy reflects less a lack of 'animal spirits' and more the inability of the market, constrained by governments, to move to a new set of real interest rates in order to find a new equilibrium." (Pages 356-7).

This presumably means higher interest rates across the board, of which even modest hints have so far caused market tantrums more than market support. But King opposes further monetary or fiscal expansion, including 'helicopter money'. Central banks, he repeats, have thus far by their policies encouraged households and businesses to bring forward spending from the future, but since no new equilibrium of demand has been found, "it is rational to be pessimistic about future demand." (I would argue that it would also be rational to be pessimistic if the new equilibrium had been found, since this could only be at a lower level, if one follows King's logic).

King’s orthodox prescriptions

Now we seem to be reaching a crescendo… how do we escape the trap of rational pessimism? What should policy-makers do? There should be two broad aims – to raise expected incomes by a bold programme to raise future productivity (um, yes…) and to encourage relative prices, especially exchange rates, to move in a direction to support a more sustainable pattern of demand and production. As King says, these are “easy to state and hard to carry out” (what does the second involve?), but in his view there is no alternative, barring a crash in asset prices and the resulting defaults to reset the economy…

Okay, so what should we actually do, since “we can do better”? King offers, in the final ten pages of his book, a reform programme comprising three elements.

First, the development and gradual implementation of measures to boost productivity. Again, we ask, what measures? Answer - for example, in the product market to reduce monopolies and increase competition; in the tax system to reduce distortions between saving and spending; in the public sector “to reduce the cost of providing public services”; to lower the regulatory burden imposed on the private sector; more generally, improve the public infrastructure to support the rest of the economy.

Oh dear. *Reducing the cost of public services* – surely someone has thought of that already – has King not heard of austerity policies?

Second element – the promotion of trade. Sign up quick to TPP and TTIP. King has the audacity of extreme optimism in claiming that

> “These two agreements are an important part of any attempt to raise real incomes.”

He does not appear to understand that they are also part of the ultra-globalisers’ agenda to reduce the power of national democracy – which elsewhere he sees as politically dangerous - by strengthening the rights of multinational corporations.

Third element – the restoration of floating exchange rates. (The pound sterling’s fall after the EU Referendum may be an interesting case study – we shall see whether in addition to a growth in exports, there is a shift to “domestic substitutes for imports”).

I was truly dismayed by this tired set of failed and insignificant proposals. In his review, Paul Krugman shares this sense of reader-deflation:

> “All that talk about the need to ditch conventional economics, to embrace the reality of radical uncertainty – and the punchline is the same as the recommendations of every IMF program for the past sixty years: structural reform and free trade. Really? That’s it?”

Supply-side sunshine, or wind in demand-side sails?

Just before the end of the book, King offers us a wonderfully bad rhetorical (and meteorological) flourish:

> "We can roll back the black cloud of uncertainty and allow the rays of supply-side sunshine to peer through in order to return to a more balanced and sustainable path of economic growth."

No, no, please spare us the supply-side dogma! What we surely need is a more fiscally fair infrastructure wind in our demand-side sails (powering a ship built at near zero interest rates) to help us cross the turbulent seas and reach port safely…

I can't help feeling that by this time Mervyn King was getting tired and facing a publisher's deadline which meant that he had too little time to think through the conclusions. Or maybe he is so pessimistic in reality that he was simply *pretending* there's a way through to success and safety, a recipe that avoids another deep crisis – his own personal form of economic alchemy.

Early on, King refers to his intellectual heritage – which he tells us comes from Keynes as well as the neoclassical tradition. Whilst from time to time, we can see a tiny bit of Keynes's influence on his thinking, in the end, and try as he does to provide quite radical thinking on many topics, King's roots are more firmly planted in the drought-damaged garden of orthodox neoclassical economics. But for underlining so strongly the critical role of money and banking in economics, we can and should still be grateful to Mervyn King.

*Cover Image: 19th Century engraving of Homunculus from Goethe's Faust Part II – Wikimedia

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