EuroPOLIS

The Audacity of Pessimism, or a Central Banker's Plea and Encouragement to Become Realistic

A Critical Review of *Mervyn King*'s *The End of Alchemy: Money, Banking and the Future of the Global Economy*

by Markus C. Kerber[1]

It is always interesting when, after retirement, the head of a Central Bank begins profiting from his academic freedom by writing down the analysis of his achievements in office. This is true for *Mervyn King* as well. However, in contrast to other central bankers, whose views are frequently biased, *King* tries to analyse, on an abstract level, what is going wrong in the banking industry and how it should be reformed. *Mervyn King*, who was the head of the Bank of England from 2003 to 2013, and who was in the meantime appointed by the Queen a Knight of the Garter in 2014, has apparently used his academic freedom as a professor at New York University and London School of Economics, to write both a masterpiece of understandable political economy and a highly valuable recommendation for reform. In a remarkably graphic language, Lord *King* depicts and analyses the pitfalls of the last years of financial capitalism. He qualifies the period from 1992-2007 as unprecedented stability in terms of both output and inflation.[2] He acknowledges the rise in debt levels due to the fact of ever-decreasing interest rates, the rise of the value of assets, and the enormous increase in the sums to be borrowed. This is true for household debt as well as for the debt of governments. Further feature of the years until 2008 was the highly increased leverage, the ratio of total assets or liabilities to the equity capital of the bank. Thereby the fall of prices by 2 % of the average value of the bankǿs assets could wipe out the whole of those held as equity, and leave it unable to serve as collaterals.

[1] Professor of Public Finance and Political Economy at Technology University Berlin, guest professor at University Paris II, Attorney of Law representing several complaints against ECB in the German Constitutional Court as well as in the European Court of Justice.
[2] See Mervyn Kingǿs *The End of Alchemy: Money, Banking and the Future of the Global Economy,* Page 22.

These three characteristic features are baptised by Lord *King* as ñthe goodò, ñthe badò and ñthe uglyò. His statements are not only objective and thought-provoking analyses, but inevitably lead to the question of whether and how to overcome the pitfalls of financial capitalism. To remain in the categories of Lord *King*: how can the money in the banking system be reformed to regain innocence and to wash away the ugly side of our financial capitalism which has been, according to him, caused by the great financial crisis in 2008.

It is not astounding that *King*, in the light of his professional past and despite a crystal-clear analysis which is partly an accusation of banking practices, does not come to radical findings, but submits pragmatic proposals.

As financial markets by their very nature are places of radical uncertainty, there is no way to foresee the risk of banks. Additionally, Lord *King* rejects the academic plan of authorities to forbid the creation of money by banks. He suggests a far-reaching solution which he calls the ñpawnbroker for all seasonsò.[3] Being of the opinion that Bagehotôs concept of the lender of last resort, which lends sufficient liquidity to illiquid banking institutions at penalty rates, is outdated, *King* thinks that what is needed is an entity which lends, in time of crisis, to almost everyone who pledges collaterals sufficient to guarantee the value of the loan. That is a clear distinction from the practice of central banks which, in great financial crises, lent to banks irrespective of their viability and irrespective of the quality of their collaterals.[4] Apparently the ñpawnbroker for all seasonsò is supposed to achieve three aims: First to ensure that all the credit losses are backed by actual cash, or guaranteed contingent claim on reserves at the central bank. Secondly, to ensure that the profusion of the liquidity insurance is mandatory and paid upfront. And thirdly, to reassign a system which, in effect, imposes limits to the degree of ñalchemyò in the financial system. In other words, private financial intermediaries should bear the social costs of alchemy.

[3] Page XXXX69.

[4] The qualification of Greek debt as eligible for repo operations and in 2010 by ECB is a good example of that collateral /lending practice by ECB or by central banks.

The theoretical value of Lord *King*ôs proposal is remarkable. However, in practice it is difficult to encapsulate the penalty or the price of the insurance by the haircuts, or within the haircuts required by the central bank. The neglected academic attention to ñqualitative easingò practices by the ECB shows how difficult it is to evaluate the adequateness of haircuts for a great number of collaterals.[5] But *King*ôs postulate for the pawnbroker to lend to almost anyone in exchange for extremely valuable collaterals ignores the fundamental problem of banking insolvency. The Bagehot rule applies only to illiquid banks, not to insolvent banks. The conceptual difference between these two notions is extremely difficult and mainly depends on a realistic, fair assessment. If the pawnbroker lends to almost everyone, then the banking sector remains a neutral reserve, escaping from the rules of the market economy. Of course, *King* admits that from time to time banks fail because failure is part of a prosperous market economy.[6] He does not exclude bank resolution, but insists that with his pawnbroker system reorganization and bankruptcy would be more easily implemented. This point is insufficiently argued. Neither does *King* prove that the ñpawnbroker for all seasonsò would help to develop the expectation that banks will no longer be bailed out.

Although Lord *King* poses the right questions (such as ñAre banks too important to fail?ò), he does not tackle the major problem of fully integrating banks into the logic of market economy: as the significant part of national QE by the Central Banks of France, Italy and Spain has been revealed, and the amounts of state bonds held by Italian and French banks prove that banks are part of a quasi-stateôs infrastructure, entertaining a collusive relationship with the national government and its management of public finance. The interest of the government to keep every bank, and particularly big banks, alive serves the purpose of managers of important banks who continue their jobs and earn money at astronomic levels without any personal risk. The German economist Helmut Arndt, though not a theoretical genius, had developed in the 70s a pragmatic approach to

[5] See Kerber, ñECB as a source of instabilityò.
[6] See Page 278.

10178 Berlin Hackescher Markt 4
Tel. 030-843 14 136
Fax 030-843 14 137
E-Mail:message@europolis-online.org
Internet: www.europolis-online.org
75016 Paris 25 bis rue Jasmin
Tel. 1- 76 90 68 77

measure the power of finance.[7] During the preparation of German antitrust laws, he examined the triangle of power between government, corporations and the market. His ideas deserve rediscovery and his findings need an update in the unavoidable debate on financial capitalism.

As a matter of fact, we should mention the chapter that Lord *King* dedicates to central banks.[8] Under the polemical title, *The End of Alchemy: Money, Banking and the Future of the Global Economy*, he comes, however, to apologetic conclusions, which are probably owed to his executive responsibility as the governor of Bank of England as well as to his links with his former central banking colleagues.

*King*ʻs critique is more striking when he describes the feature of the Eurozone and the necessity of debt redemption for Greece in particular. By hinting at the irrefutable necessity of trade surpluses and growth to pay back the enormous burden of debt, Lord *King* repeats a commonplace. Reminding Germany of her own history,[9] he dares to compare the situation after World War 1 and World War 2 with the homemade Greek default in 2015.

Lord *King*, quoting the Nazi central banker of Hjalmar Schacht to support his thesis, compares very different pairs of shoes. If Germany did not fully pay back the reparation plan imposed upon her by the Versailles treaty, she refused something and bargained for that because the Versailles treaty in that regard was not only illegitimate but fully repudiated by the German People.[10] The German debt redemption after the 2nd World War was not a present by the allied forces, but mere economic logic to bring the people in the heart of Europe back on the road of democracy and market economy. This has proved a success in the past, and will prove in the future as well. Its unique achievements, the organization of industry, and its determination to become, irreversibly, a member of the western world retroactively justify reduction policy. The German reader becomes sad at

[7] Helmut Arndt, *Wirtschaftliche Macht: Tatsachen und Theorien* . München, 1974.
[8] Page 156.
[9] Page 340.
[10] Keynes, The Economic Consequences of the Peace, 1919.

10178 Berlin Hackescher Markt 4 E-Mail:message@europolis-online.org 75016 Paris 25 bis rue Jasmin
Tel. 030-843 14 136 Internet: www.europolis-online.org Tel. 1- 76 90 68 77
Fax 030-843 14 137

the end of Lord *King*ôs book, when he, a distinct expert and a man of world, compares post-war Germany to a parasite Mediterranean country which, perhaps, would have been better administrated under Turkish rule.