

Money Reform

New international crises are just over the horizon without some dramatic money and banking reforms.

BY STEVE H. HANKE

Currency and banking crises gave hell to emerging market economies in the 1990s. They have also placed heavy burdens on taxpayers around the world who have been forced to finance ever-larger bailouts of crisis-ridden banking systems. But to listen to conventional wisdom these days, one might think the crises of the type recently encountered in Mexico, Southeast Asia, and Russia are a thing of the past.

Indeed, most cognoscente aren't losing sleep over the possibility of new eruptions. These fair weather folks believe the world has somehow changed since 1997-98. For a dose of reality, however, they should crack the Bank for International Settlements (BIS) recently released *Annual Report*.

The BIS folks in Basle aren't sleeping soundly. As they see it, the prospects for a hard landing in the United States are now real, and the liquidity in many of the emerging markets has dried up, causing market volatility (risks) to soar. If that isn't bad enough, the money and banking crisis-proofing needed in these emerging economies has not occurred since 1998, leaving the countries exposed to bad weather.

As long as emerging market countries retain their own national currencies and fractional reserve banking practices, and as long as the prospect of bailouts exists, trouble is certain. In fact, policymakers' attempts to safely maneuver their economies will be about as successful "as a one-armed blind man in a dark room trying to shove a pound of melted butter into a wild cat's left ear with a red-hot needle," as a P.G. Wodehouse's character Ukridge put it.

The failure of the bailout therapy — a fact carefully documented by Michael Bordo and Anna J. Schwartz — has brought forth a flood of proposals to reform the international financial architecture. The International Financial Institutions Advisory Commission, for example, has proposed that the International Monetary Fund (IMF) restrict its lending to rescues, rather than bailouts. This would transform the IMF into a pseudo-international lender of last resort along classical lines.

The classical lender-of-last-resort idea was first pro-

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posed in the nineteenth century by Henry Thornton and Walter Bagehot. The classical theory held that banking panics could be averted if central banks stood ready to supply liquidity (base or high-powered money) at rates above those prevailing in the market to solvent, but illiquid banks that put up good collateral.

In practice, central banks don't adhere to the classical prescription. In fact, central banks in emerging market countries egregiously flaunt classical lender-of-last-resort rules. The Bank of Indonesia (BI), for example, was declared insolvent earlier this year because it had broken every classical rule in the book. In late 1997 and early 1998, the BI allowed commercial banks to overdraft the payments system to the tune of \$37 billion. Insolvent banks automatically received high-powered liquidity from the BI at below market rates and without putting up any collateral. Among other things, I had to bring these irregularities to the attention of former President Suharto while operating as his adviser.

What does this mean for the prospect of the IMF acting as an international lender of last resort? The IMF cannot create high-powered money. Consequently, it could only act as a pseudo-lender of last resort, one that had to rely on its own resources, its ability to borrow, or its capacity to create more Special Drawing Rights. This liquidity would be funneled through the IMF's Supplementary Reserve Facility and be made available at penalty rates to borrowers that put up good collateral.

International capital markets are ready, willing, and able to provide liquidity on these terms. Indeed, in December 1996 Argentina adopted a formal "liquidity policy." Its linchpin has been a contingent repurchase facility in which the Argentine

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central bank has the option to sell certain domestic assets valued at about \$7 billion in exchange for U.S. dollars to a group of international banks subject to a repurchase clause. The cost of this liquidity protection is modest. The option premium is 32 basis points and the cost of funds implicit in the repo agree-

ment is roughly LIBOR plus 205 basis points. Mexico has also tapped international capital markets for liquidity protection by establishing a \$2.1 billion credit line with international banks. Both of these liquidity arrangements are features of ordinary banking business and do not imply lender-of-last-resort services.

Who needs the IMF as an international lender of last resort? No one. At best, it would be a half-baked, redundant affair.

Money and Credit Circuits

	Current State of Affairs	Proposed Set-Up
Central Banking	Yes	No
National Base Money	Yes	No
Bank Money	Yes	No
Bank Credit	Yes	No
Separate Money and Credit Circuits	No	Yes

Like most of the proposals to reform the international financial architecture, the IMF as a pseudo-international lender of last resort is, at best, marginal. To promote money and banking that are more sound, a broader and more innovative approach is required. Let's first consider the source of currency crises. During the last century, there has been an explosion of central banks and new national monies. In 1900, there were only eighteen central banks in the world. By 1940, that number had risen to forty. After World War Two and with the growth of newly independent countries, the number of central banks grew rapidly, more than tripling to 136 in 1980. Today, there are 173 central banks. Not surprisingly, the IMF played a leading role in this dramatic growth of central banking. And why not? It resulted in jobs for the boys.

Central banking and national currencies in emerging market countries, particularly those with a weak rule of law, have been a disaster. Indeed, this one-two punch has been the source of currency crises. If central banks and national currencies were abolished in emerging market countries, currency crises in those countries would be put in the dustbin. After all, a country that adopted a sound foreign currency would no longer have an exchange rate vis-à-vis that foreign currency. So how could such a country have a currency crisis?

Would this be radical? Not really. Thirty-one political entities use foreign currencies as legal tender. In the last year alone, Kosovo, Montenegro, East Timor, and Ecuador have re-

placed their national currencies with either the D-mark or the greenback. And that's not all. The Senate Banking Committee is reviewing a "dollarization" bill sponsored by Senator Connie Mack. If that bill becomes law, the U.S. would share the seignorage generated by producing dollars with countries that replaced their national currencies with the dollar. This would dramatically reduce the cost of dollarization for countries that qualified. It would also benefit the U.S. because currency-crisis-free dollarized countries would realize higher and less volatile growth rates.

A monetary reform that makes base money sound, but leaves bank money unsound, is incomplete. Clearing banks are not required to hold 100 percent liquid reserves against checkable deposits. Accordingly, this fractional reserve system allows banks to create liabilities (bank money). To eliminate this element of discretion in the money circuit, fractional-reserve banking should be replaced by 100 percent-reserve banking. By requiring bank deposits to be covered by 100 percent liquid reserves, the money circuit would be closed and bank money

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would be as sound as base money.

Under 100 percent-reserve banking, banks that accepted deposits would be transformed into money-market mutual funds. Depositors would no longer have to live in fear of being unable to withdraw their deposits because banks would have the liquid reserves to cover withdrawals. Banking panics, system-wide banking crises, and tax-payer bailouts would be a thing of the past.

Another important advantage of 100 percent-reserve banking is the fact that banks would need very little equity capital to cover the small risks associated with the matching of their assets and deposits. This makes the 100 percent-reserve system particularly well suited for emerging economies, where banks are notoriously undercapitalized.

How would credit be supplied in such a money and banking system? Merchant (or investment) banks would assume that function. They could intermediate savings and generate credit (not money) by issuing shares and/or subordinated debt instruments.

This approach facilitates credit flows, while separating

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money from credit. By doing so, safety and soundness would be injected into the credit circuit. Indeed, shareholders would provide an important source of market discipline to the merchant banks because the owners of these banks would risk losing their investments in case of merchant bank failures. The other element in the merchant banks' capital structure would be provided by subordinated debt. This debt also provides an attractive source of market discipline because, as distinct from depositors, the holders of capital notes cannot withdraw their funds on demand when bad news surfaces. The holders of subordinated debt would, therefore, have an incentive to monitor the merchant bankers carefully.

Would speculative entrepreneurial ventures never get loans because merchant banks would be too conservative? Not at all. Banks that specialized in riskier loans would simply issue capital notes at significantly higher interest rates. Investors would purchase these instruments, just as they purchase junk bonds in the United States.

Much like a three-legged stool, the cure for currency and banking crises in emerging market countries rests on three closely linked reforms. First, national monies must be replaced by sound foreign money. Second, banks that accept deposits must be transformed into money market mutual funds. And last, credit must be provided by merchant banks. If implemented, these reforms would allay many of the BIS's current fears and allow the folks in Basle to sleep soundly. ♦

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