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Elliot Hentov
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Zhejiang University Academy of Internet Finance
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Following the "general theory of macro-finance", IMI aims to become a world-class think tank, focusing on the studies of international finance, in particular the international monetary system and RMB internationalization. Despite its relatively short history so far, IMI has established itself as a leading research institution and important forum, where industry leaders, policy makers and academic experts from home and abroad share their insights and expertise.

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CONTENTS

China

Sino-US Trade and Investment Relationship Needs Fairness and Reciprocity .... *Liu Jun*/01
Time for Economies to Build Bulwarks .... *Ding Jianping and Yang Jie*/03
Challenges Await China's Economy .... *Hong Hao*/05

RMB Internationalization

Creeping Gold Standard .... *Herbert Poenisch*/07
Measures for Global Renminbi Growth .... *Elliot Hentov*/10
Renminbi's Global Push is Forging Ahead .... *Xia Le*/12

Financial Regulation

Bank Regulations: An Existential Threat? .... *Steve H. Hanke*/14
Financial Risk Can't Be Ignored Amid Restructuring .... *Xiong Yuan*/17
Code of Conduct Needed to Reduce Moral Hazard .... *Li Honghan*/19

International

The First Brexit .... *David Marsh*/21
Financing Future Energy .... *Herbert Poenisch*/23
Emerging Markets Surpass Expectations .... *Gary Kleiman*/25
Sterling Lessons for Asia .... *Zeti Aziz*/27

Fintech

Barbarians at the Monetary Gate .... *Andrew Sheng and Xiao Geng*/29
Digital Future for Sterling .... *Victoria Cleland*/31
Fintech Fills Funding Shortfall .... *Greg Medcraft*/33

Sustainable Development

Are the Sustainable Development Goals Achievable? .... *Andrew Sheng and Xiao Geng*/35
Public Infrastructure Investment: A BRICS Perspective for Inclusive Sustainable Development
.... *Jaya Josie*/37

Research Report

East or West, Home is Best?——Are banks becoming more global or local?
.... *Zhejiang University Academy of Internet Finance*/47

Working Paper

Shadow Banking in China: Then and Now .... *Xi Chao and Xia Le*/54
Institutional Investors and the QE Portfolio Balance Channel
.... *Michael Joyce, Liu Zhuoshi and Ian Tonks*/66
The Impact of Internet Sales Tax in a Search Model of Money: Some Analytical Results
.... *Dai Tiantian, Jiang Shenyi, Liu Xiangbo and Wang Wen*/84

IMI News

Financial Regulation

Bank Regulation: An Existential Threat*

By STEVE H. HANKE[*]

Why was international financial officialdom so eager in late 2008 and indeed through 2009, 2010 and later, to raise banks' capital-asset ratios? To answer this question, there is more to the story than meets the eye. The starting point for the global bank capital obsession is to be found in Britain and its infamous 2007 Northern Rock affair. It was this British fiasco, rather than the September 2008 Lehman Brothers bankruptcy, that was the true beginning of the Great Financial Crisis and the Great Recession which followed.

On 9 August 2007, the European wholesale money markets froze up, after BNP Paribas announced that it was suspending withdrawals on three of its money market funds. These funds were heavily invested in U.S. subprime credit instruments, which had suddenly become difficult to trade and value. In the preceding two decades, many banks and financial intermediaries, in a number of countries, had financed their assets by borrowing from wholesale sources rather than from retail branch networks. In the U.K., Northern Rock, which had once been a cautiously-managed building society in mutual ownership, was one of these organizations.

With the wholesale money markets closed to new business, Northern Rock could not issue new securities or even roll over maturing debt. As significant liabilities were coming up for redemption, it faced a serious challenge in funding its business. In the years leading up to August 2007, Northern Rock had been consistently profitable, with sufficient capital and liquidity to meet regulatory norms. Readily available funds from the wholesale market had facilitated Northern Rock's rapid expansion from its demutualization in 1997; however, by mid-2007, it was highly leveraged (with assets that were over 60 times equity capital), and threatened by its inability to secure new wholesale finance.

Unable to secure the necessary short-term funding, Northern Rock informed its regulator (the Financial Services Authority) of its problems. Top FSA staff sought for potential buyers for Northern Rock, and they soon found one in the shape of Lloyd's Bank. But there was an inherent issue: Given that the money market was paralyzed by a lack of confidence and the fact that Lloyd's Bank had a similar reliance on the interbank market for financing, Lloyd's board was not 100% certain that it could obtain sufficient retail deposits or an interbank line to fund both its existing business and the purchase of Northern Rock. For the deal to go ahead, Lloyd's needed a standby loan facility perhaps as large as £45 billion. With the money market closed, only the Bank of England (BoE) could provide this facility.

By the end of the first week in September 2007, all of the FSA's senior staff and Paul Tucker, the Bank's senior executive for markets, wanted the Bank to provide Lloyd's with a standby facility. But, there was an obstacle: The governor of the BoE, Mervyn King would provide no help. To quote from Ivan Fallon's book *Black Horse Ride*, "'No,' [King] said decisively and abruptly, 'I could not in any way support that. It is not our job to support commercial takeovers.

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* This article appeared on Forbes.com on July 31, 2017.

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I'm not prepared to provide any liquidity on that basis'". The truth is that King — who had come from a modest background in England's unremarkable West Midlands — loathed bankers and the City of London. The crisis gave King an opportunity to translate the loathing into action. Fallon quotes one banker as saying, "Mervyn saw his job as being to teach the banks and the markets a lesson."

Somehow or other, the tensions between the various players could not be kept quiet. The situation became so desperate that Northern Rock had to be provided with an emergency loan facility from the BoE. Without that, it would no longer be able to pay cash over the counter to retail depositors (or to transfer money to other banks via the online service at its website, which crashed). However, the British Broadcasting Corporation (BBC) bungled the announcement of the facility, provoking a massive run disproportional to Northern Rock's potential losses. The BoE was obliged to lend Northern Rock tens of billions of pounds to preserve the convertibility of bank deposits into notes. On 17 September 2007, the Chancellor of the Exchequer, Alistair Darling, decided to announce a state guarantee on Northern Rock's deposits, which brought the run to an end.

The underlying issue raised by the Northern Rock affair was the eligibility of commercial banking organizations, which are profit-making (or at any rate profit-seeking), for loans from the central bank. The traditional understanding in the U.K. before 2007 had been that solvent banks, and certainly solvent banks that had complied with regulations, could seek central bank help in funding their businesses if normal market sources (such as the interbank market) had become unreliable. Usually, they would have to offer good collateral and the central bank would be expected to charge a penalty rate. The standard vocabulary in these cases is that the central bank would be a "lender-of-last-resort." In no way did this imply that the central bank would be indifferent to the concerns of all stakeholders, including shareholders.

Although in practice the BoE was involved in two big lender-of-last-resort episodes during his governorship (Northern Rock in September 2007, and RBS and HBOS in October 2008), King did his damnedest to keep loans to commercial banks off the BoE's balance sheet altogether. The implications of King's position are dangerous for banks and arguably for the entire financial system in a capitalist economy.

King maintained that it was not the central bank's role to lend to commercial banks on a long-term basis. Rather, that was a job only for the private sector or taxpayers acting via the government. By the phrase "on a long-term basis," King understood a period of six months, taking his cue from a European Commission "decision" on 5 December 2007. If a bank could not find alternative finance for its assets once a last-resort loan has lasted six months, that bank would have to seek and find new money from the private sector or be taken into state ownership. By extension, the state would be entitled to seize the whole business with no compensation to shareholders. Exactly six months after Darling's announcement of the state guarantee, the state did just that. Northern Rock's assets were seized 17 March 2008.

In the weeks after the Lehman bankruptcy, much of the British banking system was in exactly the same position Northern Rock had been in autumn 2007. They had faced difficulties in rolling over liabilities in the wholesale markets and might not have been able to fund their businesses. Meanwhile, because of the line being taken by the BoE under Mervyn King, they knew that any borrowings from it were time-limited, and might prove suicidal for managements and shareholders.

The only remaining private sector option was to raise new equity or bond capital by the sale of securities. Here was the connection between King's attitude towards central bank loans to commercial banks and officialdom's insistence on extra bank capital as the solution to the crisis. Because in King's judgement central banks were not to lend to commercial banks except for a

few months, and even then on a frankly unfriendly basis, commercial banks would be obliged to raise more capital if they could not otherwise finance their loan portfolios. By this reasoning, bank recapitalization was a priority—indeed, an absolute priority—in the fraught circumstances of late 2008.

The Labour government in power during the crisis period, with Gordon Brown as Prime Minister and Alistair Darling as Chancellor, did have other sources of advice. Nevertheless, as governor of the BoE, King was in an immensely powerful and influential position. It seems that his point of view managed to sway Brown, although possibly not Darling to the same degree. At the G20 meetings in late 2008, Brown was fully committed to bank recapitalization as the right answer to the crisis. Brown, in the prologue to his book, *Beyond the Crash*, judged that "doing nothing was not an option" and that "only one possible course of action remained." He almost glorified the moment when he underlined twice "Recapitalize NOW".

Although Brown did not like King on a personal basis, he had plainly absorbed King's message. Both men deemed loans from the BoE to the U.K.'s commercial banks as a form of "taxpayers' money," and both were suspicious of banks and bankers. If extra capital was the correct response to banks' funding strains, and if the stock market was not prepared to buy newly-issued securities from the banks, any large-scale official intervention had to take the form of capital injections from the state. If current managements and shareholders opposed such injections on the grounds that the new money diluted their interests, the British government could—and in fact did—threaten nationalization without compensation.

In short, Gordon Brown decided to indulge in a sophisticated form of bank-bashing, and perhaps surprisingly, managed to attract many like-minded souls on the international financial scene. Hardly anyone among the politicians, regulators, and central bankers in the peak supranational organizations (the BIS, the IMF, and so on) offered a word of dissent as the British argument for bank recapitalization was introduced and developed at the G20 meetings in late 2008. And so, officialdom embraced a dangerous set of pro-cyclical regulatory policies.

As Marcus Agius, chairman of Barclays, told his shareholders, the banks now faced "an existential threat". And I would add, so did the economies that embraced the bank recapitalization mantra.