The invisible hand on banking

The irony is that banking systems without a central bank – free banking systems – lay down a theoretical blueprint for central bank activities, justifying Reserve Bank of Australia operations since deregulation, writes *Trevor Coombes*.

Friedman (1986): "I took it for granted that the real resource cost of irredeemable paper was negligible. Experience under a universal irredeemable paper money standard makes it crystal clear that such an assumption is false for society as a whole and is likely to remain so unless and until a monetary structure emerges under an irredeemable paper standard that provides a high degree of long-run price-level predictability".

In other words, there is a natural tendency for central banks to erode the purchasing power of money. Central banks that are responsible for the viability of banks err on the side of caution and provide unnecessary liquidity to banks, fuelling money-financed inflationary episodes.

Free banking systems, which by their nature are coveted by the invisible hand, insulate markets, and so the broader economy, from monetary disturbances. A free bank that issues its banknotes – the money we use in our every day lives is central bank money – beyond the amount wanted by the non-bank public, typically end up in rival bank accounts, imposing adverse balances (interbank net debt) at the clearinghouse on the bank. Free banks that over issue must discard interest-earning assets to honour interbank debt and this negatively affects bank profit.

The pursuit of bank profit – which in this context is not a dirty word – means that surplus money does not transform itself into episodes of inflation. This is especially so when private money is convertible into an outside asset that has a stable price, which provides long-run price-level predictability. The invisible hand ensures convertibility because banknotes that are not convertible (irredeemable paper) are less desirable than convertible banknotes (Dowd, 1989). An irredeemable paper standard is imposed on society by law and inflation targets act (somewhat successfully) as a surrogate for outside assets in that inflation targets pin down the price level to a growth rate of 2 to 3 per cent per annum.

The invisible hand also ensures the emergence of robust bank balance sheets, thereby increasing the safety of deposits because free banks are less prone to runs and collapse. Any free bank with a poor reputation will suffer banknote reflux and accumulate adverse balances. Banks prevent this by investing in the confidence of the non-bank public by maintaining robust bank balance sheets. A run on a fragile, poorly-managed bank will result in it being purged from the market. This is unlikely to be contagious because there would be quality banks to which the non-bank public could run. When an insolvent bank

fails, it reflects the invisible hand allocating financial resources efficiently without the deleterious effects of systemic instability.

The incentive to maintain sound balance sheets is substantially eroded if poorly-managed banks are able to procure centralised loans in times of stress. If the central bank is responsible for the viability of the banking system, loans might be made available to banks without penalty, so that such support effectively operates as a bail-out mechanism. Deposits become less safe, because the bail-out mechanism fosters moral hazard – excessive risk-taking by banks. Other banks, seeing poorly-managed banks bailed out, have less urgency to manage their banks with integrity.

WHAT CENTRAL BANKS MAY DO LEGITIMATELY

Mitigating moral hazard

Central bank charters make central banks responsible for managing the liquidity of the banking system. So in effect, central banks face the conflict that their loans, while providing liquidity, foster moral hazard. The conflict is alleviated if the central bank brokers liquidity, much like a pawnbroker.

Any bank in need of liquidity must give up (temporarily or permanently) in exchange for liquidity an interest-earning asset. Banks simply alter the structure of their assets, not the size of their balance sheets. Centralised loans expand the size of bank balance sheets. Since banks give up interest-earning assets there is always a penalty.

This brokering approach to dispensing liquidity is at the heart of the Reserve Bank of Australia's (RBA's) use of purchase and repurchase (of financial bank assets) agreements and liquidity safety valves. The RBA does not compromise the robustness of the banking system when it stands at the ready to provide liquidity to banks on a daily basis. Ultimately this sends a strong signal against moral hazard.

Preserving the regulatory role of adverse balances

The principle of adverse balances has a regulatory role in contemporary banking.

It regulates bank profit and thus the size of banks, in that the accumulation of interbank debt at the clearinghouse causes banks to give up interest-earning assets. Banks cannot create more money than the amount the non-bank public wants to hold. Any bank that attempts to expand by relaxing credit standards or by undercutting the interest rates that rival banks charge on their loans – the prevailing market rate – will see the cheques written on it in the accounts of rival banks that manifest as adverse balances as rival banks present the cheques for redemption at clearing. The aggressive bank must reorganise its assets (purge itself of interest-earning assets). New loans under these conditions do not make profits for banks.

To preserve the principle of adverse clearings, central banks should follow RBA operations and broker liquidity. Loan support allows banks to avoid the consequences of adverse balances, but brokering liquidity does not.

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A BLUEPRINT

Overall one can see that free banking provides a blueprint for central bank tasks. Central banks that broker liquidity preserve the effectiveness of adverse clearings and ameliorate moral hazard, thus fostering robust banking systems.

RBA operations are well grounded in theory. The irony, however, is that the theory is based on the invisible hand, that is the principles of free banking. Banking is not inherently fragile, so that central banking is not what makes our deregulated banking robust. The monetary structure that has emerged under Australia's irredeemable paper standard provides for long-run price-level predictability.

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