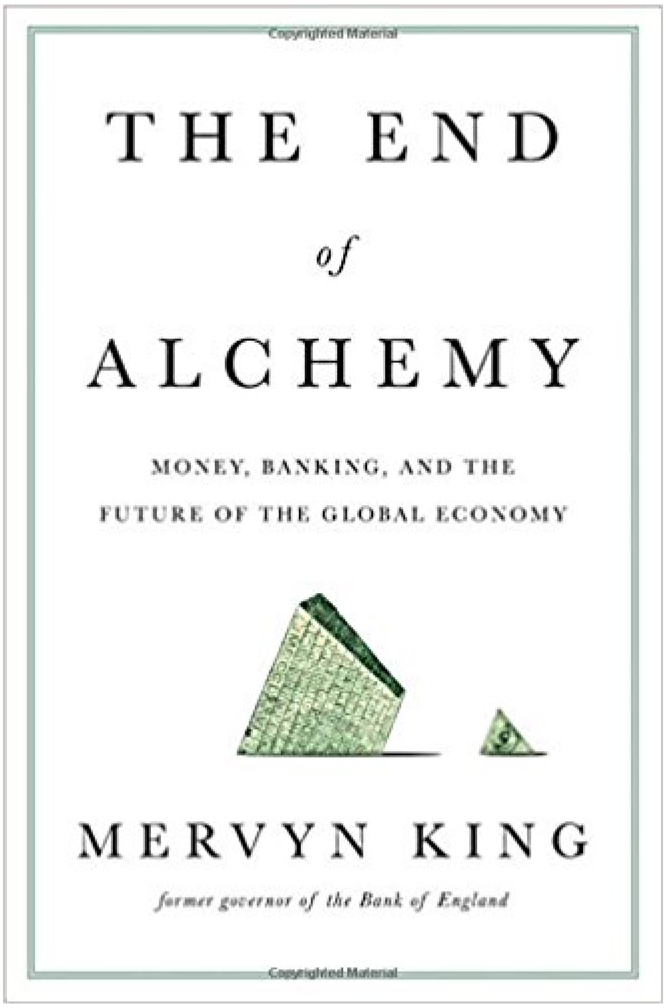
The End Of Alchemy: Money, Banking, And The Future Of The Global Economy



Synopsis

Ã¢â ¬Å“Mervyn King may well have written the most important book to come out of the financial crisis. Agree or disagree, KingÃ¢â ¬â„¢s visionary ideas deserve the attention of everyone from economics students to heads of state.Ã¢â ¬Â• Ã¢â ¬â ¢Lawrence H. SummersSomething is wrong with our banking system. We all sense that, but Mervyn King knows it firsthand; his ten years at the helm of the Bank of England, including at the height of the financial crisis, revealed profound truths about the mechanisms of our capitalist society. In The End of Alchemy he offers us an essential work about the history and future of money and banking, the keys to modern finance.The Industrial Revolution built the foundation of our modern capitalist age. Yet the flowering of technological innovations during that dynamic period relied on the widespread adoption of two much older ideas: the creation of paper money and the invention of banks that issued credit. We take these systems for granted today, yet at their core both ideas were revolutionary and almost magical. Common paper became as precious as gold, and risky long-term loans were transformed into safe short-term bank deposits. As King argues, this is financial alchemyÃ¢â ¬â ¢the creation of extraordinary financial powers that defy reality and common sense. Faith in these powers has led to huge benefits; the liquidity they create has fueled economic growth for two centuries now. However, they have also produced an unending string of economic disasters, from hyperinflations to banking collapses to the recent global recession and current stagnation.How do we reconcile the potent strengths of these ideas with their inherent weaknesses? King draws on his unique experience to present fresh interpretations of these economic forces and to point the way forward for the global economy. His bold solutions cut through current overstuffed and needlessly complex legislation to provide a clear path to durable prosperity and the end of overreliance on the alchemy of our financial ancestors.

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Customer Reviews

Ã¢â ¬Å“If [The End of Alchemy] gets the attention it deserves, it might just save the world.Ã¢â ¬Â• - Michael Lewis, Bloomberg ViewÃ¢â ¬Å“An outstandingly lucid account of postwar economic policymaking and the dilemmas we now face. . . . It is rare to encounter a book on economics quite as intellectually exhilarating as The End of AlchemyÃ¢â ¬â ¢a dazzling performance indeed.Ã¢â ¬Â• - John Plender, Financial TimesÃ¢â ¬Å“Offers both a deeply examined critique of economics as usual, and practical, controversial ideas on policy. It's a rare achievement.Ã¢â ¬Â• - Clive Crook, Bloomberg ViewÃ¢â ¬Å“I have read umpteen books about the financial crisis of 2007Ã¢â ¬â œ2008 and its lessons. This is the cleverest one, brimming over with new ideas. While other Ã¢â ¬Ëœlords of financeÃ¢â ¬â„¢ publish memoirs, King has produced a brilliant analysis not only of what went wrong in the global financial system but also of what went wrong in economics itself.Ã¢â ¬Â• - Niall FergusonÃ¢â ¬Å“A sophisticated and highly approachable study of how modern finance has lost its way. Few individuals are more qualified than Lord Mervyn King to imagine the banking of the future. His book should be required reading.Ã¢â ¬Â• - Henry KissingerÃ¢â ¬Å“Mervyn King asks, Ã¢â ¬ËœWhy has almost every industrialized country found it difficult to overcome the stagnation that followed the financial crisis in 2007Ã¢â ¬â œ2008, and why did money and banking, the alchemists of a market economy, turn into its Achilles heel?Ã¢â ¬â„¢ He addresses these questions, and much more. For those endeavoring to understand the greatest financial crisis of our time and the future of finance, this highly provocative book is a must-read.Ã¢â ¬Â• - Alan GreenspanÃ¢â ¬Å“Drawing on years of scholarly study of banking history and his real world experience in fighting financial panic, Mervyn King has set out a new framework for monetary and financial reform. Seemingly simple in concept, it challenges prevailing banking and market practice. The End of Alchemy demands debate and a well-reasoned response.Ã¢â ¬Â• - Paul A. VolckerÃ¢â ¬Å“Mervyn King may well have written the most important book to come out of the crisis. Agree or disagree, King's visionary ideas deserve the attention of everyone from economics students to heads of state.Ã¢â ¬Â• - Lawrence H. Summers

Mervyn King served as the governor of the Bank of England from 2003 to 2013. He was appointed

Baron King of Lothbury in 2013, a Knight of the Garter in 2014, and is currently a professor at both New York University and the London School of Economics.

Stop what youÃƒÂ¢Ã â ¬Ã â„¢re doing, drop everything, buy and read this book. Twice. IÃƒÂ¢Ã â ¬Ã â„¢ll start my second reading as soon as IÃƒÂ¢Ã â ¬Ã â„¢m done writing down my thoughts.IÃƒÂ¢Ã â ¬Ã â„¢d gladly swap all ten books IÃƒÂ¢Ã â ¬Ã â„¢ve read about the crisis (ÃƒÂ¢Ã â ¬Ã Å“mineÃƒÂ¢Ã â ¬Ã Â• at ten) for this modest and mischievous masterpiece.Mervyn King does not go looking for villains or victims here. You will not find the words ÃƒÂ¢Ã â ¬Ã Å“greedÃƒÂ¢Ã â ¬Ã Â• or ÃƒÂ¢Ã â ¬Ã Å“fearÃƒÂ¢Ã â ¬Ã Â• in this text, nor do you get any history recounted, unless it is to illustrate a point. What you get is an informal, comprehensive, passionate and witty treatise on the origins, purpose and future of money, banking and monetary policy.And yes, you do also find out what he thinks about the crisis. As a former central banker and protagonist in the crisis, he not only accepts blame for wrongheaded policy at the BOE, he also proposes changes to the banking system that address the problems he identifies with the status quo and will hopefully enhance the systemÃƒÂ¢Ã â ¬Ã â„¢s stability in the future.That is, indeed, the bit of the book that gives it its name: the ÃƒÂ¢Ã â ¬Ã Å“End of AlchemyÃƒÂ¢Ã â ¬Ã Â• is a proposal to move from a ÃƒÂ¢Ã â ¬Ã Å“lender of last resortÃƒÂ¢Ã â ¬Ã Â• model to a ÃƒÂ¢Ã â ¬Ã Å“pawnbrokerÃƒÂ¢Ã â ¬Ã Â• model of central banking; endorsements of the book by Summers, Volcker and Greenspan testify to its validity. The main idea is all bank assets at all times should be pre-assessed for central bank ÃƒÂ¢Ã â ¬Ã Å“haircutÃƒÂ¢Ã â ¬Ã Â• while nerves are calm and heads are cool; second, banks should only ever have current liabilities equal to the ÃƒÂ¢Ã â ¬Ã Å“pawned,ÃƒÂ¢Ã â ¬Ã Â• post-haircut amounts that could be pre-positioned to raise cash in a crisis. Neat, if insufficient at current levels of liabilities.Single events (dunno, the failure to bail out Lehman for example) do not merit mention in this narrative. This sets apart ÃƒÂ¢Ã â ¬Ã Å“The End of AlchemyÃƒÂ¢Ã â ¬Ã Â• from pretty much every other account of the events. My favorite book about the crisis is BlinderÃƒÂ¢Ã â ¬Ã â„¢s, and by a mile. But throughout my reading of that account a question kept coming back to my head that Christopher Hitchens once put in the mouth of Montesquieu: ÃƒÂ¢Ã â ¬Ã Å“If a great city or a great state should fall as the result of an apparent accident, then there would be a general reason why it required only an accident to make it fall.ÃƒÂ¢Ã â ¬Ã Â• Mervyn King goes looking for that general reason. My view is he does not come back empty-handed.If youÃƒÂ¢Ã â ¬Ã â„¢re looking for a villain, on the other hand, youÃƒÂ¢Ã â ¬Ã â„¢ve come to the wrong place. In Mervyn KingÃƒÂ¢Ã â ¬Ã â„¢s tour de force, even the word ÃƒÂ¢Ã â ¬Ã Å“marketsÃƒÂ¢Ã â ¬Ã Â• does not get a look-in. Much as there are improvements that he thinks ought to be made to the banking system, much as he does not find it was a tremendous idea to respond to all economic problems by cutting rates (and decries that they remain at emergency levels seven years later), much as he was no big fan of allowing the banks to become ÃƒÂ¢Ã â ¬Ã Å“too big to fail, sail or jail,ÃƒÂ¢Ã â ¬Ã Â• much as he finds great fault with the sundry ÃƒÂ¢Ã â ¬Ã Å“FXÃƒÂ¢Ã â ¬Ã Â• and ÃƒÂ¢Ã â ¬Ã Å“LIBORÃƒÂ¢Ã â ¬Ã Â• scandals, he argues very persuasively that the financial crisis was nothing but a symptom of political crisis. If we do not change our politics, he claims, if we do not address the microeconomics (as opposed to the macro), we will find ourselves in crisis very soon again in the future.His ÃƒÂ¢Ã â ¬Ã Å“pawnbrokerÃƒÂ¢Ã â ¬Ã Â• model of central banking would by itself be a valuable contribution, but it would be inconsistent for him to say our problem is political and leave things there. The problem, he believes, lies in our societiesÃƒÂ¢Ã â ¬Ã â„¢ and our governments' collective willingness to accept uneven growth if the alternative is no growth at all. China has been happy to allow consumption to languish at a minuscule level and has emphasized growth through investment and exports. It was about to countenance a rebalancing, but when that threatened growth itself, the engines were quickly reversed and stimulus was redoubled on the old investment and export axis. The US knows that interest rates at zero only allow those to benefit who are set up to borrow at that rate (he does not name the private equity owners and the CEOs of the S&P 500, but you know he means them) but if inequality is the price of growth, itÃƒÂ¢Ã â ¬Ã â„¢s happy to take it. And he puts up his hand and admits that under Eddie George the BOE where he was the Chief Economist was prepared to endorse a ÃƒÂ¢Ã â ¬Ã Å“two speed economyÃƒÂ¢Ã â ¬Ã Â• over a ÃƒÂ¢Ã â ¬Ã Å“no speed economy.ÃƒÂ¢Ã â ¬Ã Â•The result is the winners in this game of uneven growth end up saving their winnings. In doing so, they accumulate ÃƒÂ¢Ã â ¬Ã Å“assetsÃƒÂ¢Ã â ¬Ã Â• backed by the future sweat of those who fail to grow as fast, the losers. And if you donÃƒÂ¢Ã â ¬Ã â„¢t stop, the ÃƒÂ¢Ã â ¬Ã Å“assetsÃƒÂ¢Ã â ¬Ã Â• become ÃƒÂ¢Ã â ¬Ã Å“permanent transfers,ÃƒÂ¢Ã â ¬Ã Â• unless by some miracle the losers in this game of growth find a way to grow as well. Like Micawber, the strategy it to wait for something to come up and the slow growers to discover a growth model. It has not worked out. Neither the Greek government nor your average subprime borrower will pay in full, but our model is to carry on as if they will. Upheaval ensues.Our desperate efforts to subsequently stimulate growth at all costs get poor returns, he adds. QE, for example amounts to exchanging cash for assets. But at the point where 10yr rates are zero, you are merely exchanging cash for cash. You are no longer adding liquidity. Not only that, but you are suspending the market economy in the price of money. You are suspending capitalism itself if the government gets to set the price of one of the most important inputs, money.The sundry solutions we read about in the newspaper he also thinks are past their sell-by date and he goes debunking them one by one. He starts by rejecting the 4% inflation target. Quite simply, the moment you hit it, youÃƒÂ¢Ã â ¬Ã â„¢ll go straight back down to 2%. The policy has zero credibility.He gives short shrift to the ÃƒÂ¢Ã â ¬Ã Å“negative natural interest ratesÃƒÂ¢Ã â ¬Ã Â• that are part and parcel of the Larry Summers / Paul Krugman ÃƒÂ¢Ã â ¬Ã Å“secular stagnationÃƒÂ¢Ã â ¬Ã Â• mantra by in essence saying ÃƒÂ¢Ã â ¬Ã Å“yes, you can go tweak by a few basis points and set a negative administered rate to match this ÃƒÂ¢Ã â ¬Ã Å“naturalÃƒÂ¢Ã â ¬Ã Â• rate, but what if you cause a radical uncertainty shock from people observing the government is raiding their bank accounts?ÃƒÂ¢Ã â ¬Ã Â• Yes, some might do the rational thing and move the spending from the future to the present. But some might just panic and batten down the hatches, Greek style, in anticipation of the next way the government will raid the piggy bank. Why take the risk?In summary, he believes we have hit a new limit:The ÃƒÂ¢Ã â ¬Ã Å“paradox of policyÃƒÂ¢Ã â ¬Ã Â• is that you cannot overuse any type of macroeconomic policy. Same way if we all save we end up hurting the economy via the ÃƒÂ¢Ã â ¬Ã Å“paradox of thrift,ÃƒÂ¢Ã â ¬Ã Â• same way the rational expectations critique says that you cannot tax and spend your way to prosperity if you cannot point to direct benefits of your spending because people understand what you’re doing (and here he does concede that in the US for example it would not be a disaster to fix the odd airport), you also need to understand that all policies need to have a beginning and an end. Zero rates forever is especially silly for the non-US countries in particular, as it amounts to a permanent currency war. It is but another ÃƒÂ¢Ã â ¬Ã Å“prisonersÃƒÂ¢Ã â ¬Ã â„¢ dilemmaÃƒÂ¢Ã â ¬Ã Â• problem whereby we could all agree to stop debasing our own currency to steal growth from abroad, but probably never will. And in messing with our rates and currencies we get in the way of markets.A glancing look at the most recently fashionable ÃƒÂ¢Ã â ¬Ã Å“helicopter dropÃƒÂ¢Ã â ¬Ã Â• proposals also comes back with the same result.In Mervyn KingÃƒÂ¢Ã â ¬Ã â„¢s view, the way forward is to work on the only bit of growth that matters, which is productivity growth. HeÃƒÂ¢Ã â ¬Ã â„¢s read all the books about how weÃƒÂ¢Ã â ¬Ã â„¢ve picked the low-hanging fruit, but heÃƒÂ¢Ã â ¬Ã â„¢s agnostic about it. What if some of the miracle developments pan out in biotech or nanotech or whatever. You never know. More importantly, youÃƒÂ¢Ã â ¬Ã â„¢ve got no choice. The adult response to crisis is to re-focus all our economies toward growth by going through the detail work of eliminating each economyÃƒÂ¢Ã â ¬Ã â„¢s idiosyncratic inefficiencies and artificial rigidities.He thus proposes three important changes to the politics: First, he argues that structural changes to ossified economies are not issues to be tackled in the future, after we have fixed the macroeconomy. The time to tackle historically entrenched monopolies and historically built-in rentseeking, to tackle distortions in the tax code that affect the balance between spending and saving, or favor the public sector over the private sector, for example, is now. (A mention of Mancur Olson would not have been out of place here, btw.)Second, (and in the best British tradition of the Economist, for example) he quite unfashionably comes out batting for free trade.Third, he strongly advocates the abolition of fixed exchange-rate regimes between distinct sovereign states (for example, the EUR), because they are a very clear example of a mechanism that leads to imbalances in growth and foster the creation of bad debts.The reviews I read in the press made this third point their main focus, of course. That is a crying shame, because it sells the book short. As far as IÃƒÂ¢Ã â ¬Ã â„¢m concerned, ÃƒÂ¢Ã â ¬Ã Å“The End of AlchemyÃƒÂ¢Ã â ¬Ã Â• enters the charts at #1.Broad, irreverent, groundbreaking and wise, this is the treatise that should finally replace Bagehot under every central bankerÃƒÂ¢Ã â ¬Ã â„¢s pillow.---SPOILER ALERT, next comes my summary of his main points, it’s NOT my reviewHe starts by posing the question outright: WhatÃƒÂ¢Ã â ¬Ã â„¢s money good for? Mervyn KingÃƒÂ¢Ã â ¬Ã â„¢s answer:First of all, you need money to get ÃƒÂ¢Ã â ¬Ã Å“stuffÃƒÂ¢Ã â ¬Ã Â• now. ThatÃƒÂ¢Ã â ¬Ã â„¢s what we all want money for.This gives rise to the need for money to be acceptable by all as a means of exchange, or else you wonÃƒÂ¢Ã â ¬Ã â„¢t get your ÃƒÂ¢Ã â ¬Ã Å“stuff.ÃƒÂ¢Ã â ¬Ã Â• In turn, this means that the concept of ÃƒÂ¢Ã â ¬Ã Å“private moneyÃƒÂ¢Ã â ¬Ã Â• issued by private banks has historically always faded away. Once upon a time every bank in the US could issue its own money. While the economics of this practice was sound (the free market did indeed provide an appropriate discount for every bankÃƒÂ¢Ã â ¬Ã â„¢s ÃƒÂ¢Ã â ¬Ã Å“dollarsÃƒÂ¢Ã â ¬Ã Â• versus the best banksÃƒÂ¢Ã â ¬Ã â„¢ ÃƒÂ¢Ã â ¬Ã Å“dollarsÃƒÂ¢Ã â ¬Ã Â•) the practice was rather uneconomic, as every American needed access to a cheatsheet telling him what his private dollars were worth and where. The need for money to be an easy way to facilitate exchange eventually led to one type of dollar / pound / kroner dominating, the one issued by the most important bank in the realm. In many countries, this bank eventually became the ÃƒÂ¢Ã â ¬Ã Å“centralÃƒÂ¢Ã â ¬Ã Â• bank, though in other countries the central bank was created, but always modelled on the precedent from the countries where the model originated, namely as a bank.Second, you need money to avoid having to make up your mind now about what ÃƒÂ¢Ã â ¬Ã Å“stuffÃƒÂ¢Ã â ¬Ã Â• you want to get later, with two factors making this necessary: 1. (Incomplete markets) there might not be a ÃƒÂ¢Ã â ¬Ã Å“marketÃƒÂ¢Ã â ¬Ã Â• for you to secure flexible tickets to your kidÃƒÂ¢Ã â ¬Ã â„¢s college graduation in three yearsÃƒÂ¢Ã â ¬Ã â„¢ time; 2. (Uncertainty) what if you hit the jackpot and in three yearsÃƒÂ¢Ã â ¬Ã â„¢ time you might want to take the whole clan by chauffeured limousine? Money can act as a store of value for you and allow you to make that decision later, when you know your circumstances (resolving the uncertainty) and somebody can sell you a ticket (the market for the relevant tickets finally exists).This second use of money gives rise to the additional need for the money to be acceptable under all circumstances, good and bad. To actually provide cover in uncertainty, it needs to be ÃƒÂ¢Ã â ¬Ã Å“money goodÃƒÂ¢Ã â ¬Ã Â• in all future imaginable scenaria.Third, you need money to put a price on things. Only in prisonersÃƒÂ¢Ã â ¬Ã â„¢ camps would you care to use packets of Marlboro as a unit of account. To fulfill this third purpose, money needs to have a stable price, of course, and this comfortably segues into Mervyn KingÃƒÂ¢Ã â ¬Ã â„¢s discussion of inflation and why we need to keep it in check and how we lost control in the seventies due to ÃƒÂ¢Ã â ¬Ã Å“paradox of policy,ÃƒÂ¢Ã â ¬Ã Â• his symmetrical rebuttal of the ÃƒÂ¢Ã â ¬Ã Å“paradox of thrift,ÃƒÂ¢Ã â ¬Ã Â• and a much cooler way to say (among other uses of this pithy aphorism) that there is no such thing as a long-run Philips curve.This looks a lot like the traditional answer to the question, but a seed is already planted: in the world of ÃƒÂ¢Ã â ¬Ã Å“radical uncertaintyÃƒÂ¢Ã â ¬Ã Â• we actually inhabit, where many outcomes are possible (you could win the lottery and buy yourself a jet to fly your family to the graduation or you could go bust and pull your kid out of school and be grateful for any savings you had scrounged) money is more valuable than in a world of more measurable uncertainty where you can put a probability on all outcomes: in some states of the world, money is the ultimate necessity.The economic models we use (and, more significantly, the economic models central banks use) have no use for money, because they do not account for radical uncertainty. They work under the assumption that you can plan for that graduation now. In reality, Mervyn King explains, when crisis strikes, a need for money arises that normally is not there and is thus nowhere to be found in our models.Next, he asks, what is it that makes something ÃƒÂ¢Ã â ¬Ã Å“money?ÃƒÂ¢Ã â ¬Ã Â•The loser-type answer to the question is that something is money if all economic agents believe it to be money. Others say money needs to be scarce. Others that it must be based on something real and tangible, like for example gold.Mervyn King shoots down the first answer as a tautology (ÃƒÂ¢Ã â ¬Ã Å“OK, cool,ÃƒÂ¢Ã â ¬Ã Â• heÃƒÂ¢Ã â ¬Ã â„¢d say in my dialect of English, ÃƒÂ¢Ã â ¬Ã Å“but what is it that makes the economic agents believe?ÃƒÂ¢Ã â ¬Ã Â•) and has some fun debunking gold (metallic, tangible, but ultimately ÃƒÂ¢Ã â ¬Ã Å“barbarousÃƒÂ¢Ã â ¬Ã Â• and unsuitable as a basis for our economy, read the book if you want to get the whole story), and Bitcoin (whatÃƒÂ¢Ã â ¬Ã â„¢s to stop a million people from creating a million strands of otherwise very scarce cryptocurrency) and focuses on the main driver of what makes money, erm, money: Power.He offers proof by example: In Iraq there were two monies between the 1993 and the 2003 invasion: Saddam-sanctioned money used in the South and the older ÃƒÂ¢Ã â ¬Ã Å“SwissÃƒÂ¢Ã â ¬Ã Â• notes used in the northern no-fly zone Saddam was kept out of. The northern ÃƒÂ¢Ã â ¬Ã Å“SwissÃƒÂ¢Ã â ¬Ã Â• notes were pure paper. You could not use them to pay tax anywhere, there was no central bank supporting them anywhere, they were legal tender for nothing. Yet people used them for a full decade, in expectation of the fact that the West would at some point invade again and restore their status. It was the expected imposition of foreign political power that lent value to these notes, and it was even vindicated when Paul Bremer exchanged them for dollars after the 2003 invasion.Politics is very much what makes the EUR ÃƒÂ¢Ã â ¬Ã Å“moneyÃƒÂ¢Ã â ¬Ã Â• in Mervyn KingÃƒÂ¢Ã â ¬Ã â„¢s view. On p. 227 he notes that DraghiÃƒÂ¢Ã â ¬Ã â„¢s ÃƒÂ¢Ã â ¬Ã Å“whatever it takesÃƒÂ¢Ã â ¬Ã Â• impromptu speech from July 26, 2012 may well have ÃƒÂ¢Ã â ¬Ã Å“reverberated around the world, but just as important was the joint statement made the following day by Chancellor Merkel and President Hollande, indicating their full commitment to the Euro and support for DraghiÃƒÂ¢Ã â ¬Ã â„¢s intention. It was clear the ECB would buy, or was actively considering buying, Spanish and Italian government debt.ÃƒÂ¢Ã â ¬Ã Â•By that as means of introduction, we arrive at the main issue that lends its title to the book: Who makes money? What is the chemistry involved?Answer: Money may require political support to actually be ÃƒÂ¢Ã â ¬Ã Å“money good,ÃƒÂ¢Ã â ¬Ã Â• but it continues to be made privately, exactly as it would have been made in pre-Fed America. Most money that exists in the world (all of M1, M2, M3 etc. a fair bit more than 90% of all money in the world, basically) arises in the very private act whereby you walk in the bank, ask for a loan, the bank looks at your credentials and (poof!) an account is opened for you and the money you asked for is sitting in there as a deposit. Your deposit!Out of thin air, the bank has decided that it has a liability to you, namely the amount that is now sitting in your account. At the same time, it also holds an asset: the fact that you need to pay that money back (with interest) at some time in the future. That is how most money on earth is born, basically. Privately. The government imposes some rules on the bank, and will stand behind the currency you and the banker have just created, but it does not sit there in the room with you and your bank manager.And then you can go buy a taxi, for example. The bankÃƒÂ¢Ã â ¬Ã â„¢s liability moves from your bank account to that of the Mercedes Benz dealer, and the bankÃƒÂ¢Ã â ¬Ã â„¢s asset remains your promise to pay back the loan one day. If the car can be offered as collateral for the loan, chances are you get a much better rate. If itÃƒÂ¢Ã â ¬Ã â„¢s a piece of real estate you financed, even better. The dealer now has money that did not exist before you walked into the bank for that interview. And you owe the bank some money you did not owe before either. The cash thatÃƒÂ¢Ã â ¬Ã â„¢s sitting in the dealerÃƒÂ¢Ã â ¬Ã â„¢s account is freshly-made money.Next, suppose word gets out that your bank really does not know what itÃƒÂ¢Ã â ¬Ã â„¢s doing. All sorts of customers, like your friendly Merc dealer, get in line to pull their money out. What next?Regardless of whether this perception is true or not, the bank has a problem. It cannot call you and ask for your money back now. You can very legitimately point to the terms of your loan and say ÃƒÂ¢Ã â ¬Ã Å“call me in three yearsÃƒÂ¢Ã â ¬Ã â„¢ time.ÃƒÂ¢Ã â ¬Ã Â• It will be keeping some precautionary cash to one side, but if every single depositor turns up, the last few will be gravely disappointed.This is where central banks step in.What it will do is1. Go through the bankÃƒÂ¢Ã â ¬Ã â„¢s books to see if the rumor is correct that the bank made bad loans in excess of the value of the shareholdersÃƒÂ¢Ã â ¬Ã â„¢ equity2. If the rumor is false, it will lend the bank all the money it needs to pay off the worried depositors3. If the rumor is correct, on the other hand, the central bank will(i) explain to equity holders in the bank that they no longer own shares in the bank(ii) explain to all bond holders in the bank that they may suffer partial or total loss(iii) move all the good loans of your bankÃƒÂ¢Ã â ¬Ã â„¢s to a healthy bank, adding to its assets(iv) move deposits equal to the above amount to the same healthy bank, adding to its liabilities(v) if the excess of deposits over good loans is more than the bonds outstanding wipe out all bondholders and the necessary amount of deposits(vi) otherwise pay to bond holders the difference between the value of the bonds and the excess of deposits over good loansThese are two very different outcomes. In the first case the bank faces a liquidity issue and the central bank will step in and stand behind it. In the second case the bank has a solvency issue: it is insolvent / bankrupt / choose your favorite word.Which brings us to the nexus of the problem. The manual for central bankers says that when faced with a liquidity crisis, a central bank must actively go in, accept the assets of the solvent banks on its own balance sheet and lend against those assets the necessary money to the bank to pay all its depositors. Moreover, it must do so at a very expensive price (a high interest rate), to make sure banks think twice about having to rely on this backstop.So your car loan will spend some time on the central bankÃƒÂ¢Ã â ¬Ã â„¢s books until the crisis has gone away. Meanwhile, your bank will be given some (very expensive) liquidity. That is, in short, the ÃƒÂ¢Ã â ¬Ã Å“Lender of Last

ResortÃƒÂ¢Ã â ¬Ã Â• model of central banking.Two things happened in finance, one in the run-up to the crisis and one during the crisis that made it impossible to implement this model:The first, Mervyn King sees as an example of ÃƒÂ¢Ã â ¬Ã Å“prisonersÃƒÂ¢Ã â ¬Ã â„¢ dilemma.ÃƒÂ¢Ã â ¬Ã Â• Banks knew that the assets they were accumulating were increasingly poor. But any bank that was not willing to carry on playing the game (ÃƒÂ¢Ã â ¬Ã Å“dancingÃƒÂ¢Ã â ¬Ã Â• in the words of Citigroup CEO Chuck Prince) was at risk of not only falling behind its competitors, it was at risk of getting bought by a competitor. The option to remain prudent was simply not available to any self-respecting banking CEO. ÃƒÂ¢Ã â ¬Ã Å“While the musicÃƒÂ¢Ã â ¬Ã â„¢s playing, youÃƒÂ¢Ã â ¬Ã â„¢ve got to get up and dance.ÃƒÂ¢Ã â ¬Ã Â•The second thing that happened was that when things turned, they did not just turn by a little. ÃƒÂ¢Ã â ¬Ã Å“Radical uncertaintyÃƒÂ¢Ã â ¬Ã Â• meant that asset prices for fancy, incomprehensible structures like CDOs went from 100 straight to near-zero. We went from the point of discussing how much houses would go up in the US to negative housing price appreciation. Entire structures that were predicated on housing prices carrying on upwards were upended. There was nobody willing to hold them who was not already up to his eyeballs in the stuff.Even more importantly, in this world of ÃƒÂ¢Ã â ¬Ã Å“radical uncertaintyÃƒÂ¢Ã â ¬Ã Â• if your institution was known to be holding tainted assets, your depositors did not waste any time pulling money out. The hedge funds that had been using Bear Sterns, Lehman and Morgan Stanley as their prime broker, to say nothing of individuals owning shares in money market funds yanked out their money first and asked questions second, as was the rational thing for them to do. The last guy to pull his money out of a dying bank gets nothing.In the crisis that ensued, the central banks (especially in Europe) that were called upon to provide the necessary liquidity had no time to inspect the banksÃƒÂ¢Ã â ¬Ã â„¢ assets, no opportunity to tell the wheat from the chaff; they found themselves with a gun to their collective head to lend at a discount rate (rather than a punitive rate) and with virtually no haircuts against collateral they had never seen before. The alternative was to let the entire banking system crumble. They did not get a chance to follow BagehotÃƒÂ¢Ã â ¬Ã â„¢s teachings. Even in the US, Hank PaulsonÃƒÂ¢Ã â ¬Ã â„¢s TARP could not be made to work, because there had never been a sober, non-crisis, assessment of what a legitimate value would be for all the ÃƒÂ¢Ã â ¬Ã Å“troubled assets.ÃƒÂ¢Ã â ¬Ã Â•Mervyn King believes we need to do better, and proposes the PAWNBROKER MODEL:The model is very simple once somebody has told you about it and it amounts to a permanent, marked-to-rational-market pre-packaged TARP for all bank assetsIn the future, Mervyn King recommends that every asset a bank holds should be assigned a shadow ÃƒÂ¢Ã â ¬Ã Å“haircutÃƒÂ¢Ã â ¬Ã Â• that is assessed seriously and is monitored actively. So if a loan has a haircut of 30% then the bank knows that at all times it can pledge it to the central bank for 70 cents on the dollar. If banksÃƒÂ¢Ã â ¬Ã â„¢ current liabilities (deposits, mainly) never exceed the total amount of cash the central bank will be able to exchange for thus pledged assets, then the banks will never find themselves in a situation where they are short of cash.This has many benefits: First, there can never be a successful run on a bank anymore. Second, all values are assessed when things are calm, not in the heat of a crisis. Third, things never run wild.Sadly, the horse has bolted the barn on this third front. Banks today have many many more assets than central banks could reasonably expected to lend against, even with haircuts. So Mervyn King proposes that we move to his new model slowly, over a 20 year period, say.Even with this fix in place, however, his assessment is that we are not even beginning to scratch the surface. Finance was the thermometer of the crisis. ItÃƒÂ¢Ã â ¬Ã â„¢s where the imbalances came in evidence, not where they were caused.The roots of the crisis, he believes, lie in the very engine of our society, our growth model.Collectively, the governments of pretty much all countries in the world are happy to turn a blind eye to uneven growth if the alternative is no growth at all, and that is where the problem lies. This I describe above.This framework also serves to explain why QE was necessary in this past crisis.When the crisis hit and every single bank found its clients banging on its door for cash, there was a slow but steady way for the banks to shore up their cash balances, and they all ruthlessly pursued it. It was to refuse to extend credit to clients (including very healthy clients) who were unlucky enough to see their loan reach its maturity. So suppose a bank has 20 billion worth of loans it has given to its clients, of which 2 billion mature within the next year. Further suppose that half the clients with a maturing loan still need the credit. That’s 1 billion of loans the bank will refuse to extend so it can shore up its cash balances.This is, in other words, money that is being destroyed, never to come back. The private market once created this money and the private market is now destroying it. The central bank can do absolutely nothing about it. It cannot TELL the bank in question "these are excellent, creditworthy clients who clearly just demonstrated they can pay you back, why are you abandoning them in the middle of the storm?"It is "inside" money that is being destroyed, the "private" kind of money that is more than 90% of the money supply, as discussed. The central banks had to step in. Through QE they bought good assets from the banking system. Against the proceeds from the sales, the banks were credited with balances in their account with the central bank, also known as "outside" money, or M0. In doing so, the central banks replenished, to the extent possible, the money that had gone missing from the system.(I can be counted on to confuse "inside" and "outside," but the mnemonic aid is the fact that the private banking system is, inevitably, the point of reference: money made privately, "inside" the private banking system, is "inside" money)Outside observers, who were used to time-honored relationships between "outside" money and inflation screamed bloody murder and started fantasizing about the wheel-barrows we’d all need to buy to carry around our inflation-plagued cash, but their fears were misplaced. The M0 that was issued on the back of QE was but a poor substitute for the "inside" money that had disappeared when the banking system unilaterally decided to stop extending credit in order to conserve cash.An added benefit of the "pawnbroker" model, of course, is that it would act on this problem from both sides: not only would it have the cash at the ready, it would presumably also act as a natural brake in terms of fewer low-quality loans being given, so creditworthy companies do not get cash starved if they need to roll a loan in the middle of a crisis caused by lending to less creditworthy borrowers.I do, needless to say, have some issues with the book I donÃƒÂ¢Ã â ¬Ã â„¢t agree absolutely everything. In no particular order:His 20 trillion allegedly BIS-sourced statistic on the size of the derivatives market is wrong. The market is comfortably larger than 500 trillion. The BIS number discusses the IN-THE-MONEY-AMOUNT of these derivatives and definitely underestimates them, conveniently so. This way we get to pretend we have enough good collateral.No mention is made of the horrible incentives inherent in ÃƒÂ¢Ã â ¬Ã Å“originate and distributeÃƒÂ¢Ã â ¬Ã Â• and the fact that only the government can resolve them. This is how come Fanny and Freddie are now left as the only show in townNo mention of ÃƒÂ¢Ã â ¬Ã Å“ValeantÃƒÂ¢Ã â ¬Ã Â• model of whatÃƒÂ¢Ã â ¬Ã â„¢s been keeping growth down. Krugman highlights this a fair bit. Post crisis, basically a whole host of goods and services are provided by monopolies. The competitor perished in the crisis and the government has refused to step in and punish the miscreants. Thank God for pantomime villains like Martin Shrkeli whose actions highlight this type of activity and bring it to the limelight.Make up your mind about 1921, sir: did economy turn around by itself or did Fed put rates super-low? He argues both in different parts of the book.Craps on Germany a bit too much for my taste: NOT the same as China. Germany is pursuing manufacturing hoping that meanwhile Europe will go back to normal. In the scenario where Europe is toast and Germany remains, but only in that scenario, then yes it needs to change model. And why is it bizarre that in the latest Greek memorandum there was a clause about Sunday trading? That is precisely the kind of microeconomic change it had been hoped Greece would adopt. Look at the enormous changes Italy effected on its pension system in the run-up to getting accepted into the EUR, for example. The pact is "you will reform and in doing so will be able to export to Germany via more efficient tourism, e.g. by being able to sell stuff to German tourists on a Sunday; we will support you in the meantime"Is disrespectful to Minsky: his ÃƒÂ¢Ã â ¬Ã Å“prisonerÃƒÂ¢Ã â ¬Ã â„¢s dilemmaÃƒÂ¢Ã â ¬Ã Â• issue and his discussion of

Chuck Prince is pure Minsky. It is the mechanism whereby stability breeds instability.Also, and given he argues in favor of free trade, including bilateral deals, I would have liked him to take his axe at the anti-globalization arguments that are out there (but I guess he would have been off-topic)Finally, there’s the McAfee and Brynjolfsson theory out there about how information technology is destroying white collar jobs of the repetitive nature, and I’d have liked him to have given his assessment of where he ranks the order of magnitude of this very real problem compared with the "uneven growth" he identifies as the major bane of today’s economic landscape.My point about Germany notwithstanding, p.231 is pure poetry. All of it

Mervyn King, the former governor of The Bank of England, has written a very readable book on the interaction of money and banking on the global economy. He offers his insights as a practical banker and a serious economist for the way forward from the financial crisis of 2007-09 that we are still reeling from.Although he discusses a host of topics relating to how people make decisions in practice compared to how economic theory suggests they behave, the problems of the fixed exchange rate regime within the European Union, and the difficulties of making policy within a framework of competing nations; I will focus on two issues that he raised.The first is his suggested reform for the banking system. His reform is a modified ÃƒÂ¢Ã â ¬Ã Å“Chicago PlanÃƒÂ¢Ã â ¬Ã Â• of the 1930s which called for 100% reserves. Under that regime bank deposits would be matched with cash and short term government securities. Hence no risk and no potential for bank runs. In contrast the current system is based on fractional reserves where banks hold a small portion of their deposits in reserves and lend out the balance. This process is KingÃƒÂ¢Ã â ¬Ã â„¢s alchemy where short maturity deposits are transformed into long term assets. In the jargon of economists this process is called ÃƒÂ¢Ã â ¬Ã Å“maturity transformation.ÃƒÂ¢Ã â ¬Ã Â•This system is inherently unstable because the cash is not there to pay off depositors if they want all of their money at once. To deal with this contradiction the central bank acts as a lender of last resort to meet the demands of anxious depositors. This gives rise to the issue of ÃƒÂ¢Ã â ¬Ã Å“too big to fail.ÃƒÂ¢Ã â ¬Ã Â• KingÃƒÂ¢Ã â ¬Ã â„¢s compromise is to turn the central bank into a ÃƒÂ¢Ã â ¬Ã Å“pawnbroker for all seasons.ÃƒÂ¢Ã â ¬Ã Â• Under his proposed system banks must hold sufficient reserves, liquid assets and discounted long term assets to meet all deposit and short term borrowing liabilities. The discounted assets would be valued at a ÃƒÂ¢Ã â ¬Ã Å“normal timesÃƒÂ¢Ã â ¬Ã Â• value with an appropriate ÃƒÂ¢Ã â ¬Ã Å“hair-cutÃƒÂ¢Ã â ¬Ã Â• to allow for risk and those asset could be pawned at the central bank should the need arise. Any lending above this threshold would have to be funded by additional equity and long term liabilities. Thus depositors would feel secure that their money be there when they needed it.All this is fine and good, except there would be very little incentive for banks to make risky loans. Why is that bad? It is bad because new businesses, new ideas and new construction have to be funded if the economy is going to achieve the growth that most of us desire. To undertake KingÃƒÂ¢Ã â ¬Ã â„¢s reforms we would need new institutions to undertake those risks. King is silent on this question.The other issue that King raises that I would like to discuss is that the universal answer to all financial crises is to throw central bank money at it. We have been doing this for nine years. The problem that King rightly raises is that if the problem is structural rather than liquidity, throwing money at the crisis will delay solving the structural imbalances. To KingÃƒÂ¢Ã â ¬Ã â„¢s mind central bankers in this environment may set interest rates too high to permit growth, but too low to allow for a structural adjustment.The issue in the West is that savings are too low, while in the East consumption is too low. For example in order for the U.S. to cure its chronic trade deficit the savings rate has to rise and consumption has to fall, while ChinaÃƒÂ¢Ã â ¬Ã â„¢s huge trade surplus has to be cured by higher consumption and lower savings. Politically asking people to reduce consumption is a hard sell so the easy way out is to keep interest rates low that works to keep consumption up.All told Mervyn King has written an important book that will play a significant role in the ongoing debates over banking reform and monetary policy. He also offers a well done primer on current thinking on monetary policy that is accessible to the lay reader.

This is an excellent explanation of money and banking that makes sense out of the complex issues surrounding the 2008 financial collapse and the subsequent worldwide stall in economic growth. Most important of all, it was not quite what you think. Mervyn King, as the former head of the Bank of England, knows of what he speaks. His writing style is clear and easy to understand. You will not find a better explanation of the current ineffectiveness of monetary policy and the challenges that we face. There are no easy answers here but what is clear is that we are caught in a trap of our own making - slow growth, excessive debt, ineffective monetary policy and no appetite for fiscal stimulus.

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