

Perspective

by Steve Hanke



New York residents walk by a ticker announcing stock market plunging in New York

Banking Crises: Plus Ça Change ...

BANKING CRISES ARE ALL TOO COMMON. THEY ARE ALSO costly. The potential cost of the most recent bail-out package in the United States is a staggering \$2.25 trillion. That's 16% of GDP. Compared to the actual bail-out costs following Indonesia's banking crisis of 1997-98, the US figure is small change. Indeed, Indonesia's bail out costs amounted to 40% of GDP.

The most shocking thing about banking crises is that few lessons are learned. In Indonesia, for example, legislation passed in 2004 established a Deposit Guarantee Institution (Lembaga Penjamin Simpanan) that commenced operations in 2005.

The new law inexplicably codifies virtually all the disastrous measures that were taken during the 1997-98 crisis.

Today, facing the threat of a new banking crisis, the Indonesian political class has done what the chattering classes have done

worldwide: they have panicked. In consequence, bank deposits of up to about \$210,000 are now guaranteed by the government, up from just \$10,000 under the deposit guarantee law.

The Indonesian pattern is typical (See the accompanying table). After the 1997-98 crisis, deposit guarantee legislation was passed in order to prevent future crises. But, today, Indonesia faces a new potential crisis, and the authorities have responded by increasing the deposit guarantee.

It is now twenty-one times the level provided by the original law and a potential crisis still lurks.

Is there a better way to organize banking, so that it would be safer, sounder and more stable? That is, so that it wouldn't require backbreaking taxpayer bail outs?

Today, banks that accept deposits are not required to hold 100% liquid reserves against those deposits. Accordingly, banks



Asia-Pacific governments most recent deposit guarantee policy changes

Government	Most recent deposit guarantee policy
Australia	Guarantee all deposits with financial institutions for the next three years (Oct 12)
New Zealand	Guarantee retail deposits in New Zealand-registered banks, building societies, credit unions and deposit-taking finance companies (Oct 12)
Indonesia	Raised bank deposit guarantees to 2 billion rupiah from 100 million rupiah per account (Oct 13)
Hong Kong	Guarantee all customer bank deposits until end of 2010 (Oct 14)
Malaysia	Guarantee all ringgit and foreign currency deposits with commercial, Islamic and investment banks, and deposit-taking development financial institutions regulated by the central bank until December, 2010 (Oct 16)
Singapore	Guarantee all Singapore dollar and foreign currency deposits of individual and non-bank customers in banks, finance companies and merchant banks licensed by the Monetary Authority of Singapore (Oct 16)
South Korea	May expand deposit guarantee (Oct 17)

Source: Bloomberg News

operate under a fractional-reserve system that allows them to create liabilities: bank money.

To eliminate this element of discretion in the money circuit, fractional-reserve banking could be replaced by 100%-reserve banking. In short, banks would be required to cover all deposits they accept with 100% liquid reserves, which would restrict investments of depositors' money into "safe" and liquid securities such as government bonds or bonds guaranteed by the government.

Under 100%-reserve banking, banks that accepted deposits would essentially be transformed into money-market mutual funds – "narrow banks" – which could not create credit.

Accordingly, 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 any withdrawals.

Banking panics, system-wide banking crises, and taxpayer bail outs would all be relegated to history.

Another important advantage of 100%-reserve banking is that banks would need very little equity capital to cover the small risks associated with the matching of their assets and deposit liabilities. This makes the 100%-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 that do not accept deposits would assume that function. They would intermediate savings and generate credit (not money) by issuing shares and subordinated debt instruments (unsecured bonds that have low-ranking claims on a company's earnings and assets).

Safety, soundness, stability

THIS APPROACH FACILITATES CREDIT FLOWS WHILE SEPARATING money from credit. By doing so, it injects safety, soundness and stability into the credit circuit.

Indeed, shareholders would provide an important source of market discipline to the merchant banks because the banks' owners 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 subordinated debt 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 subordinated debt at significantly higher interest rates. Investors would purchase these instruments, just as they purchase high-yield junk bonds.

If banks that accept deposits were prohibited from creating bank money and were transformed into money-market mutual funds, bank runs would come to a halt. And more importantly, taxpayers would be off the hook, too. GA

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