

Central Banking in a Free Society

SUMMARY

- Central banks are an essential component of a free and efficient banking system. They evolve naturally in a market economy and enable banks to economise on cash.
- Over time banks have reduced both liquidity and capital to what, at the time of the difficulties at Northern Rock, were historically low levels. This has allowed businesses and households to enjoy considerably reduced costs of borrowing from banks.
- The lender-of-last-resort role is a crucial function of central banks. The facility should be provided liberally to a bank in need of liquidity, just as was described by Bagehot in the nineteenth century.
- Very occasionally the central bank may wish to provide facilities to organisations outside the clearing bank system (such as AIG in the recent episode of financial instability), but this should always be done with a view to protecting the banking payments system.
- It is sometimes difficult to distinguish between banks that are insolvent and banks that are simply illiquid. Only the latter are entitled to lender-of-last-resort facilities as of right.
- Those responsible for making decisions about providing lender-of-last-resort facilities need to have experience of the banking system, and to have been involved with

the regulation and supervision of banks. Officialdom's performance in the Northern Rock affair suffered from lack of clarity about the respective roles of the Bank of England and the Financial Services Authority.

- This confusion about their roles was largely the result of Gordon Brown's dismemberment of the Bank of England in 1997. During the Northern Rock affair the Bank of England did not act promptly and efficiently as a banker to the banking system, as it had done in previous financial crises.
- Banks have to pay a penalty rate for, and to provide good-quality collateral against, lender-of-last-resort facilities. The claim by the present Governor of the Bank of England, Mervyn King, that last-resort assistance leads to moral hazard is overstated. By contrast, deposit insurance systems do create moral hazard. Such systems should be limited in scope and do not need to be pre-funded.
- The Bank of England needs to be active in providing lender-of-last-resort funds when necessary and should make this clear in contracts with clearing banks; it should be privatised and have its capital provided by clearing banks; and it should have returned to it the powers to regulate the banking system.
- This proposal would provide a stable set of incentives to keep regulation to the minimum necessary to maintain the stability of the banking system. Banks themselves, because they provide capital to the Bank of England, would suffer if one of their number were reckless and regulation too light. They would also suffer if there were over-regulation. The central bank, because it would be owned by the clearing banks, would have the right incentive structure to provide the appropriate degree of regulation.