IS THE NATIONALIZATION OF THE BANKING SECTOR A SOLUTION TO THE PRESENT FINANCIAL CRISIS?

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Abstract: We argue in this paper that the institutional premises of the contemporary banking system are erroneously defined. In consequence, contemporary commercial banks cannot operate under normal circumstances as any other sector of the economy. The three core elements of the contemporary financial system – namely fiat money, fractional reserve commercial banking and central banking – imply a system which is fundamentally socialized. The most logical coherent consequence of such an institutional setting is the full control and operation of the entire credit industry by the state. The present crisis is a consequence of such an institutional setting and the nationalization of commercial banking – a logical step according to the premises of the institutional setting – will but speed up the process of a long depression.

Keywords: central banking, commercial banking, fractional reserves, nationalization, financial crisis.

The contemporary economic depression that emerged in 2007 seems to not have been concluded. At the end of 2012, central banks around the world as well as international organizations admit that the world economy in general and the large economies (especially of the United States of America and member states of the European Union) are not fully recovered. The performance of the macro-economic indicators (economic growth, inflation, unemployment and so on) seems to be volatile and uncertainty persists in what regards the future development.

Such a dynamic of the largest economies at the international level seems to question the success of the measures undertaken by governments in order to address the difficulties of the first manifestations of the crisis. The problems seem to be qualitative (in the sense of the institutional settings) and not just quantitative (such as an unfortunate context). Under this assumption, measures that should not qualify as „*business as usual*" have to be undertaken by policy makers including a dramatic change of these institutional premises on which the financial system is built.

We argue in this paper that the institutional setting of the banking sector in modern economies is confronted with core inner contradictions. As opposed to other sectors of the contemporary predominantly market economies, the banking sector experiences a product that is not related to scarcity (the fiat money) as well as a central agency that plans the aggregate production (when the central bank decides how much credit to infuse in the economy) as well as the price of the product (when the central bank fixes the rate of interest). In this context, the private ownership of the commercial banking institutions is incompatible with the institutional setting as well as the objectives of a monetary system built around central banks. Based on a wrong definition of private property rights, the market for commercial banking will always fail. In consequence, the only logically coherent organization of the commercial banking under the system of central banking should be the total control of the entire financial intermediation by the state.

1. Political money

As opposed to the traditional perspective on the monetary phenomenon, the contemporary financial system is built on the institution of fiat money. Classical money was a commodity which performed the function of a medium of exchange [Mises, 1981]. Its core characteristic was that its supply was limited by the scarcity of the commodity itself. No political authority could increase or manipulate the money supply as the cost of production of such money – be it mining or military conquest – was always significant. For commodity money, there is always a floor on its purchasing power as there is a direct use value for any commodity which cannot be denied.

Modern economists have qualified however such a characteristic of the commodity money as an impediment to growth. It is not our intention to qualify here such a statement (which is grossly erroneous) but such economists have argued that such an inflexible money supply is a barrier to economic growth. In consequence, an historical process through which political authorities attempted to overpass the limits of natural scarcity of commodities lead to the adoption of the fiat money. In other words, money is considered a social convention which is entrusted to a political authority for management. They become political money whose supply is solely a political decision.

1.1 Fractional reserve banking

Besides the nature of the money, a financial system is fundamentally defined by the nature of credit. Financial intermediaries are those economic agents who intermediate the channeling of savings from households to private businesses and the state. An entire body of economic and legal literature has argued that the contemporary banking system is based on a faulty definition of property rights [de Soto, 2009].

In particular, the practice through banks awards loans from the capital they attract in their on-demand deposits is an aggression against the private property rights of such depositors. Economists have argued that demand deposits are fundamentally different from time deposits in the sense that they lack an explicit maturity. Commercial banks should keep such capital as readily available and meet any withdrawal from the part of their depositors with such resources. The financial intermediaries are entitled to demand a compensation for their warehousing services but, in the correct institutional setting, they should not be allowed to use such resources – even if they seem to be „*idle*" – for other uses such as financing of other clients of the bank. In consequence, in what regards demand deposits – which, by contract, can be liquidated by their depositors – the correct principle in a regime which recognizes and protects private property rights should be the rule of 100% reserves.

However, this is not the case in modern banking. The practice of private bankers to award loans from resources deposited on demand – which is an aggression against their private property rights – was sanctioned by positive law and, later, by public regulation. In consequence, private bankers benefit from a license to operate which is not met in other sectors. They are allowed to grant loans from resources they claim to be readily available for their rightful owner, the on-demand depositor.

2. Bank runs and the drive towards central banking

Such a commercial banking system based on fractional reserves is fundamentally unstable as the private banker that has awarded loans from the resources he claims to be readily available has engaged in a double accounting of money [Hulsmann, 2000]. He has promised the same economic good to two different clients – the debtor and the depositor. Such a double accounting is not revealed unless a significant number of depositors of the private banker demand their savings back. In this context, as the private banker cannot „*liquidate*" his assets – the loans awarded to their clients – in order to meet the payments demanded by their other clients – the on demand depositors – he will face cash flow insolvability. In other words, under such an institutional setting, commercial bankers are fundamentally illiquid.

This practice leads to a powerful drive towards the emergence of a provider of liquidity of last support, which is the central bank [Rothbard, 2009]. Obviously, under a monetary system of commodity money, such a provider of liquidity of last resort has to operate like an insurance company as he needs to maintain his own liquidity in the case that it wants to avoid the same fate of the individual commercial bankers. However, such a scenario is less probable due to the existence of a common pool of liquidity and to the fact that money are never „*consumed*" but they will always remain in the banking system. The task of liquidity supplier of last resort – commonly called „*lender of last resort*" – is however greatly facilitated under the contemporary system of fiat money where such a central bank has also the ability to artificially increase the money supply through different mechanisms.

2.1 Central banking: objectives and challenges

While central banks can be perceived as a result of the special-interests pressures of private bankers on political authority, the modernity allowed other developments that have changed the relationship between private bankers and central bankers. The modern state has specific objectives in what regards the macro-economic performance of the national economy. It wants credit expansion in order to fuel economic growth and reduce unemployment.

The logical challenge to the attempt to solve the problem of prosperity in a society through increases in money supply is obviously insurmountable. An infinite money supply won't translate in an infinite affluence of the citizens. In fact, economists who support monetary expansion – such as Lord Milton Keynes [Keynes, 1953] and his followers – loose from their sight the scarcity that is characteristic to any economic good. At some point in the future, credit expansion through increases in money supply would lead to inflation and the impossibility of market participants to employ economic calculation. In an environment where the prices of economic goods modify several times per day because of a massive unrestricted money supply, the skill to anticipate future prices and their relative structure is futile.

Under the contemporary banking system, the relationship between private bankers and central bankers is manifestly asymmetric in favor of the latter. Any commercial banker is – or should be – fully aware that absent the central bank his business is insolvent unless it uses equity as a significant ratio of his resources it awards as loans. Any time such a private banker experiences withdrawals from the part of the depositors, he has to transform at least some of his assets into liquidity through the mechanisms provided by the central bank.

Central banks have the ability to infuse any quantity of money in the money markets and also fix the benchmark rate of interest for the entire economy. The fundamental mechanism is simple indeed: when central banks want macro-economic performance, they reduce the rate of interest at which commercial banks can take loans and supply enough liquidity to meet any demand from the part of the banking sector (and, indirectly, to the economy). But it is obvious that the demand for money or credit from the "*real economy*" is not an exogenous data. Such a demand is dependent on the decision of the central bank to make credit available.

2.2 The financial intermediation from the perspective of the central banker: agency costs

While the origin of central banking derives from particular practices of private commercial bankers, the later developments in the banking field raise a logical challenge to the nature of the contemporary commercial banking sector: why the state stopped short of taking over the entire financial intermediation? As long as the production of money and credit is fundamentally controlled by the state, why should such a state need private commercial banks in order to "*transmit*" money and credit expansion to the entire economy?

Such a dilemma becomes even more obvious when economists talk of the agency costs theory. That is agents – in our case, commercial banks – may follow their own interests – that are called "subgoals" – as compared to the interests or objectives of their principal – in our case, the central bank. While central banks follow objectives such as the rapid and efficient transmission of the money and credit expansion into the economy, commercial banks may impede such goals through:

- their value added (and especially their rate of profit) can impede the original goals of central banks to transmit the increase in the money supply to the last debtors from the real (in the sense of non-financial) economy. Independent producers at different stages of the production cycle add their profit and increase the costs to the final consumer;
- the fractional reserves force the private commercial banks into a "*race-to-the-bottom*" in their exploration of possible minimum ratio of deposits-to-loans. Moreover, if the state or its central bank imposes a floor on this competition, it will manifest itself in the risk such competitor banks assume in their crediting practices. Competition among private commercial banks under a system of fractional-reserve leads to a serious endangering of the financial system;
- the moral hazard of private commercial bankers derives from their quality of agents to the objectives of the central bankers. As long as the central bank cannot impose all the conceivable types of conduct that such private agents could follow – due to bounded rationality and the core incompleteness of contracts even for central bankers – they will always find gaps in the regulatory environment that they could exploit at the expense of their principal. Take, for example, the outrageous salaries and rewards that some banks awarded to their employees from resources received from the state through bail-outs.

3. Why commercial banks are still not taken over by the state?

The fact that a monetary and banking system built around the institution or central bank – which is fundamentally a socialized system – still allows the operation of private commercial banks point to possible benefits that such a structure could bring to central bankers. It is, in fact, the discussion centered on the problem of outsourcing of government services to private producers.

- despite the costs of "*competition*" in commercial banking, private enterprise in this field still allows some sort of economic calculation. In other words, the decision to nationalize the entire banking system could lead to a huge state mega-bank that is "*too big to survive*";
- the private banks still allow a better screening and monitoring mechanisms as regards the quality of the real / non-financial debtors as long as there are incentives specific to the private sector. Private commercial banks still compete in this distorted environment to attract talented individuals who are motivated by correct incentives to excel in their duties. A system based on a central bank who cannot politically decide how to compensate performance is a challenge;
- a banking system controlled by the state could allow a massive confiscation and appropriation by politicians of the rents generated by such a monopoly. Such a system could put enormous pressure on banks to allocate credit according to political or rent extracting individuals;
- the political rhetoric: such fundamentally unstable system should be thrown out on the shoulders of the market. From a political perspective, "a market failure" is better than "a government failure".

3.1 Contemporary arguments for the nationalization of banking

Such a short list described above is obviously somehow different from the argumentation met in public debates around this dilemma. Mainstream economists usually do not reach the debate around the legitimacy of property rights in the financial sector and the agency problems of private commercial bankers. Instead, economists like Paul Krugman have called for such a nationalization in the context of the contemporary financial crisis on, apparently, political grounds: "*If taxpayers are footing the bill for rescuing the banks, why shouldn't they get ownership, at least until private buyers can be found*" [Krugman, 2009].

According to the same opinion, there are three core arguments for nationalization:
1. "*commercial bankers are too big to regulate*" so the government takeover is the only way to make them conduct money and credit policy according to the standards proposed by the state;
2. banks cannot be allowed to fail because of the danger posed to the entire economy;
3. bailouts towards private commercial banks are not legitimate as they favor certain economic agents at the expense of the others.

In fact, even proponents like Paul Krugman seems not to be very clear when they spoke of "*nationalization*" as their language more probably refer to the nationalization of certain individual banking institutions. In fact, this economist support the idea of Alan Greenspan, former governor of the Federal Reserve in U.S.A. who concluded that "*it may be necessary to temporarily nationalize some banks in order to facilitate a swift and orderly restructuring*" [Huba and Luce, 2009]. Such an opinion seemed to be shared also by other well-known economists such as Nassim Taleb and Nouriel Roubini.

3.2 Contemporary arguments against the nationalization of banking

The arguments against the nationalization of the banking sector are weak and unarticulated. Nobody really opposed the massive packages of financial assistance offered by Western governments to their ailing financial sectors and especially to their banking industries. As these government measures won't produce the intended effects – which theory says that they should not – the opposition to government ownership of the entire banking sector won't find a serious opposition.

Paradoxically, the only such opposition could emerge from those economists who are sympathetic to private enterprise in general and do not perceive the massive distortions in the operation of the contemporary banking sectors. Obviously, this is the same logical error as for the supporters of the market mechanisms who are not aware of the needed institutional setting: private property rights and freedom of exchange.

Conclusions

Capitalism, that is, a social system based on private property and freedom of exchange, is the most natural and efficient mechanism for allocation of resources and provision of correct incentives to act for private agents. However, if the mechanism of competition is based on faulty premises (that is, an erroneous system of private property), the concepts of private enterprise and market economy are devoid of any meaning. The nationalization of the banking sector under the contemporary circumstances of the financial crisis is the most coherent logical consequence of the premises on which such a sector is built. Deeper the crisis in which the economy will remain, more frequent such calls for nationalization.

Obviously, such a total take-over by the state authority of the allocation of credit in the economy won't solve the crisis and would most probably lead to further redistributive measures. The loss in welfare will be massive and socialism will be in sight.

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