

LESSONS FROM THE FINANCIAL CRISIS: A LIBERTARIAN PERSPECTIVE

Professor Kevin Dowd



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Professor Kevin Dowd

1: INTRODUCTION

Good evening everyone. I would like to start by thanking my friends at the Libertarian Alliance for inviting me to give this lecture. It's good to see so many other friends here as well. I would like to thank you all for coming.

For those of us who were fortunate to know him, Chris Tame was an inspiring mentor and a loyal friend; he showed remarkable dignity and courage in the face of the illness that ultimately cost him his life, and his death was a massive loss. I owe him an immense personal debt myself, so it's a very special honour to speak at his memorial lecture.

Chris was a central figure in the rebirth of Classical Liberalism in this country and it is very appropriate that we meet here in the National Liberal Club. But the Liberalism that Chris espoused was not the watered down 'liberalism' of the 20th Liberal Party—the liberalism of Lloyd George or Jeremy Thorpe—but the Classical Liberalism of an earlier age—the Liberalism of Gladstone, and earlier still, the Classical Liberalism of the great moral philosophers of the 18th century Enlightenment.

My topic this evening is the current financial crisis. My theme is that the Classical Liberal perspective can help us both to understand the crisis and to find a way out of it.

I always like to begin with a nice quote, and we are spoilt for choice when it comes to quotes about the financial crisis. Amongst those I can quote in mixed company, my favourite one is a comment by a Wall Street passer-by when asked his thoughts about the bank bailouts: "Its like not being invited to a party and then being given the bill for it", he said.

This comment goes right to the heart of the matter—the widespread perception amongst the public that there is something wrong with the current financial system, i.e., that it lacks legitimacy. I agree with this view entirely: the current system does lack legitimacy and I am sure every right-thinking person would agree with me that it is manifestly indefensible.

Though correct, however, this perception is also dangerous, as it provides fodder for interventionists who argue that the current crisis is due to unconstrained market forces. Free markets have failed, they argue, so let's have more state control instead.

Such arguments are mistaken in every respect. The current system involves limited competition within the constraints of a large variety of state-mandated parameters – a managed (or rather, mismanaged) economy, but not nothing like *laissez-faire*. And it is this 'managed' economy that has failed us all so badly.

The roots of this managed economy back a very long way:

- We had the establishment of the Bank of England in 1694 and the subsequent development of central banking.
- We had the establishment of the limited liability statutes in the 1850s, passed against bitter opposition by those who claimed—rightly—that they were a recipe for irresponsible risk-taking at other people's expense.² This might sound familiar.
- We had the stage-by-stage destruction of the commodity monetary standard. The pound, which was originally—and literally—'as good as gold', was replaced with the current inconvertible pound, which is intrinsically worthless. One consequence of this was the horrendous inflation of the 1970s and 1980s, not to mention the danger that inflation will return again if current monetary policies persist.
- We had the development and widespread adoption of Keynesian macroeconomics from the 1930s on. Keynesianism was discredited and then abandoned in this country in 1976, but the Keynesian legacy—in essence, the belief in a managed economy—still survives and poses a grave threat to our future.
- In the late 20th century, we had the establishment of state-mandated deposit insurance.
- And, over this same period, we had the growth of vast systems of financial regulation: these included the establishment of the Financial Services Authority and the growth of international bank capital adequacy regulation. Contrary to what one often hears, banking is not the epitome of *laissez-faire*, but a heavily regulated industry.

My point here is each of these pillars of the current system—central banking, limited liability, inconvertible currency, the managed economy, deposit insurance and financial regulation—represents a major and profound state intervention into the economy, i.e., the opposite of a free market.

What I would like to do this evening is give my own view of the crisis as a Classical Liberal economist. Naturally, I can't pretend to have all the answers, but I think there is a way out: we can put together a workable reform package. We then need to be confident in it and advocate it with all the powers of persuasion that we can muster. Above all, as Chris always maintained, we need to win the battle of ideas against those who would argue that we need even more of the interventionist medicine (or rather, poison) that has already caused so much damage—and threatens to do so much more.

The stakes haven't this high since at least the 1930s.

2: WHAT WE SHOULDN'T DO

Let me begin by suggesting the policy responses that we don't want:

- We don't want more panic reactions by the authorities, again and again.³ The crisis needs a considered response.
- We don't want repeated massive bailouts at taxpayers' expense.
- We don't want government guarantees or deposit insurance.
- We don't want more fiscal stimulus.
- We don't want more financial regulations or more financial regulators: we have had more than enough of those already, thank you very much.⁴
- And, finally, we *definitely* don't want loose monetary policy.

This list might sound depressingly familiar: indeed, it includes pretty much everything that the Government has been doing. It is clear that these policies are not working and are actually making matters worse. These policies are also very costly and potentially highly dangerous.

Vast spending sprees are not only costly, but also threaten the integrity of the public finances: a joke going the rounds in the US is that the Obama team would have spent a trillion dollars before they had figured out where the restrooms are in the White House. Such spending is very irresponsible against a backdrop where leading experts are openly worrying about the long-term solvency of the United States itself, with the growth of unfunded future entitlements and the ageing population.⁵

The prognosis for this country isn't quite so dire, but it is still dire enough. The last thing we need is an orgy of wild Government spending.

As for loose monetary policy to stimulate credit, this fails to address the underlying problem – that credit is tight because confidence is lacking, not because interest rates are too high. Much more important, irresponsible monetary policy—in particular, printing money—threatens the

integrity of the currency. Printing money has been condemned by generations of monetary historians, and for good reason. And it doesn't become any more respectable if you do it but tell people you are doing 'quantitative easing' instead.⁶ Indeed, whatever you call it, there is no surer way to lay the foundations for a hyperinflation: remember the Weimar Republic after the First World War or modern Zimbabwe.

3: WHAT WE SHOULD DO

Turning now to the question of what we *should* do, I suggest that we think in terms of a journey:

- We want a clear idea of what we want the financial system to become: we want to be clear about our destination.
- Once we have this, we want to be clear how to get there: we need a route, a series of measures that takes us to our destination.

Free banking

The destination we want is a safe, stable and efficient financial system, and my main point here is that this *can* be attained through a system of financial *laissez-faire* or free banking.⁷ Before anyone objects that this is some abstract theory or unattainable pipe dream, I would point out that such systems are attainable and are firmly rooted in historical experience. (For those of you who are non-economists, by the way, let me offer you a tip: Never believe economists bearing theories, including me. Always insist on evidence.) Long before central banks spread across the world in the 20th century, we had many experiences of unregulated or lightly regulated banking systems—in Australia, Canada and many other countries—most famously, in Scotland before 1845. There were, I believe, some 60 cases, and some of these lasted a very long time. These systems were highly successful – they were innovative and also highly stable.⁸ The key to their success is that market forces forced the banks to be strong. There was no deposit insurance or state support, so bankers operated under the fear of a run, and could only maintain the confidence of their depositors if they acted conservatively. A bank that failed to maintain its depositors' confidence would literally be run out of business. On the other hand, if a bank was well run, pardon the pun, then there was no reason for depositors to run on it. In short, market forces forced the banks to limit their risk-taking and maintain financially strong balance sheets: the system worked.

The debates on banking reform in this period were very interesting, especially those in the early 19th century. In particular, there was a lively debate on the relative merits of the English central banking system and the Scottish free banking one. In essence, this controversy boiled down to the English economics establishment armed with lots of theories as to why free banking couldn't

work, on the one hand, ranged against Scottish advocates of free banking who argued that it patently did. So who would you believe, the economic theorists who said it couldn't work, because their theories said so, or their opponents, who said that if they just opened their eyes they would see for themselves?⁹

A prominent example on the English side was John Stuart Mill, who was a prominent economist as well as philosopher. He managed to persuade himself that free banking was unworkable in theory but got fed up arguing with people contradicting him by pointing to the Scottish experience. In the end, the best he could come up with was that free banking was very good north of the Tweed and very bad south of it—not the most convincing argument from one of the great minds of the 19th century.

A sound monetary standard

Underlying a stable financial system, we also want a sound monetary standard and again the 19th century provides a role model. This was the Golden Age of the gold standard. The gold pound was the admiration of the world and was in time eventually copied by virtually all other major countries. The famous legend on the pound note—"I promise to pay the bearer on demand the sum of one pound"—actually meant something. It meant, "I promise to pay a fixed amount of gold, a gold pound, in return for this paper note". Now that same legend means something very different. It means, in effect, "If you have nothing better to do than ask for your pound, we will humour you by exchanging it for another pound note just like it."

I am not suggesting by any means that the gold standard was perfect,¹⁰ but if we judge it by its record, it achieved much better price stability than the disastrous inconvertible paper money standard that replaced it.

Unfortunately, in the twentieth century the gold standard came to be seen as a pointless constraint against the issue—or, rather, over-issue—of currency. Economists argued that the Bank of England should be free to issue whatever amount of currency it (or its political masters) wanted. The old idea that the gold standard imposed a useful discipline against the over-issue of currency was discarded as out of date. Keynes famously told us that the gold standard was a relic of a barbarous age, and reassured us that modern governments were much too sophisticated to debase the currency. Modern governments were not like impecunious Roman emperors or medieval kings.

The results were catastrophic, but Keynes was right about one thing. Modern governments were *not* like Roman emperors or medieval kings: they were much *worse*, and produced much *greater* inflation rates than their predecessors ever managed to achieve. There is a

limit to how much inflation you can create by clipping the edges of your coins and putting them back into circulation, but the sky's the limit when you can just speed up the printing press or add additional zeroes to your notes.

So coming back to my main theme, our ultimate objective—in a nutshell—is a system of free banking on a sound commodity-based monetary standard.

How do we achieve this? And, more urgently, what we do about the crisis?

'Doing nothing'

One option that should have been considered all along is simply doing nothing - literally applying *laissez-faire* right in the middle of the crisis: no bailouts, no deposit guarantees and no fiscal stimulus. Just hang firm and let market forces do their work to correct the economy.

Such a policy has been successfully tried before. The then-US Treasury Secretary, Andrew Mellon, applied it successfully in the face of the sharp downturn of 1920-21, to give just one example. To quote Martin Hutchinson in a recent column:

In December 1929, as what we now know to have been the Great Depression loomed, Mellon outlined his formula for fighting recession "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. ... It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people." Mellon then foolishly remained at Treasury until 1932, a powerless spectator of the opposite approach taken by President Hoover, tarnishing his reputation for the rest of his lifetime and beyond.

There are a couple of points in Mellon's prognosis that have resonance today. "Purging the rottenness out of the system" is precisely what's required to sort out the banking mess, while "leading a more moral life" is fairly clearly also required after the over-consumption and excess of the bubble period. "High costs of living and high living will come down" is, however, directly contrary to the Keynesian majority view, which holds that deflation is the most serious possibility to fear, and that restoring consumption through government spending is a prime objective. (Hutchinson, 2009)¹¹

Mr Hutchinson is spot on. 'Doing nothing' would probably have been a lot better than what the Govern-

ment actually did: the economy would have experienced a very sharp but short shock. But it would have lanced the boil and the economy would have been on the road to recovery by now—and a lot less of our money would have been wasted in the process.

A market-based bank recovery programme

Nonetheless, I believe we can do better than this. A better option, I believe, is a bank recovery programme, but one based on market principles—a recovery programme with no state guarantees, no subsidised bailouts or any of that.

Such a programme needs to address the fundamental structural problems of the banking system—which government policies so far have signally failed to do.

The key to such a programme is to be found in the way that the market system deals with financially distressed firms.

Suppose that washing machine manufacturers are in financial difficulty. They ask for a bailout but the Government (for once!) wisely refuses. So the firms call in the receivers. The receivers take control and seek to restructure the firms' balance sheets so that they can hopefully be returned to normal operation in a new, financially healthy, state. In essence, what would happen is that the firm's assets get written down. The value of the firms' assets is no longer enough to pay the firms' creditors, so the firms' shareholders pretty much lose everything, and the firms' creditors—the people who hold the firms' debt—also take a hit. If the firm is still potentially viable, it is then recapitalised with new shareholder capital and returned to normal operating mode in a financially healthy state.

The first key point here is the need for losses on the firm's assets to be realised and for the assets to be written down. The second key point is the need for the claims on those assets to be restructured so that the firm is adequately recapitalised.

We need to go from this situation to one where the firm's assets have been written down in value, the firm's liabilities (that is to say, sum of the firm's share capital and its debts) have been reduced in line with the fall in asset value, and where those liabilities have been restructured so that the debts are much lower and the share capital substantially higher. The combination of the three—asset writedowns, debt reduction and greater share capital—ensures that the firm is then financially healthy again.

I would suggest that this same approach be implemented regardless of whether we are dealing with distressed banks or washed out washing machine manufacturers.

Of course, I can hear the objections already: “You can't do that because banks are different?”

My response is that, of course banks are ‘different’. Every type of firm is different from any other. Bakers are different from washing machine manufacturers, and both of these are different from garbage removers, and so on. And they are all different from banks.

So all firms are ‘different’, in one way or another, but the legal system has never acknowledged that these differences are materially relevant when it comes to the laws of receivership or bankruptcy. There is no law of bankruptcy specific to banks, and a different law of bankruptcy that applies to all other firms. And, indeed, before the present crisis, the authorities themselves were telling us the same thing.¹²

My point here is that neither the law of bankruptcy nor the pre-crisis policy framework calls for distressed banks to be treated any differently from distressed washing machine manufacturers. There should be—and is—one (bankruptcy) code for all.

However, any receivership solution to a distressed firm should also take into account the *nature* of the firm's business. If the firm concerned was an electricity producer, the receivers wouldn't want to switch off the electricity generation process whilst they figured out what to do. Nor would you want to do the same to a financially distressed hospital. The way receivership is implemented needs to take account of the type of business concerned.

And, as far as banks are concerned, a successful bank receivership needs to take account of two very important aspects of banking that are critical to the successful functioning of the broader economy:

- The first of these is the credit system—banks play a central role in the provision of credit to the broader economy.
- The second consideration is that they are central to the operation of the payments system, on which the economy also depends.

Banks are central to the plumbing, as it were, of the economy itself. We certainly don't want to destroy the plumbing while we sort the banks out! But fortunately, we don't have to.

However, the Government itself has placed an obstacle that prevents bank receivership operating as it should. This obstacle is the Government's own guarantee to bank depositors. Ironic as it may sound—most people think a Government deposit guarantee must be a good thing because it reassures depositors—it is this very guarantee that prevents receivership from operating properly. Remember that the receivership model requires the creditors—in this case, the depositors—to take a hit, and it is

exactly this that the guarantee rules out. The guarantee therefore has to go.

The way forward, I would suggest, is for the Government to rescind this guarantee but as part and parcel of a bank recovery programme based on the receivership model.

The gist of this would work as follows. On close of business on a Friday in the not-far-off-future, let's say, the Government would quietly inform the banks that all government guarantees on bank deposits are to be immediately rescinded and the banks would have to fend for themselves. Any bank that felt confident about its prospects would then be able to weather the public reaction—the danger of a run. Many others would not, and would have no alternative but to go straight into receivership. Teams of receivers would quickly move in overnight to implement a pre-prepared plan of action.

They would then work fast over the weekend: it is important to do the job quickly to minimise economic disruption. Their first task would be to limit withdraws from bank assets and cash withdrawals would be limited for the duration of the operation. As much as reasonably possible, they need to keep the banks' assets in the banks for the duration of the operation.

The next task would be to write down the banks' assets. The only way to do this in a short time would be to apply pre-prepared writedown formulas: assets would be sorted into different classes, and assets in class x would get written down by $y\%$. Fortunately, it is not necessary for the writedowns to be 'realistic' or accurate. In fact, it is best if the writedowns are harsh and valuations biased on the conservative side. So, for example, if those who prepare these formulas are not sure what the valuations for a particular asset class should be, it is best that they go with worst case valuations to be on the safe side.

The third stage of the operation would be recapitalisation. The original shareholders would lose pretty much everything, and the new capital would come from depositors: the value of their deposit claims would be reduced, and some of their deposits would be converted into shares—a 'debt for equity' swap.

So, for instance, if a bank's assets are reckoned to be £80 and there is £100 in deposits, then the depositors will need to take a loss of £20. At the same time, some of their remaining £80 in deposits would be converted into shares. The exact amount converted into shares would depend on the receivers' judgements about how much share capital was needed to ensure that the bank could reopen safely.

In practice, we might also wish to ringfence the smaller depositors to protect them – and this would make the package easier to sell politically.

When the banks reopen on the Monday morning, they would be financially strong again, and their financial strength would give the public renewed confidence in them.

And, with a bit of luck, when the banks reopen, the markets would realise that the banks' assets were actually worth more than the £80 at which they were valued. The banks' share prices would rise, the new shareholders would make a capital gain and the banks' financial health would improve further. This would help kick start a virtuous circle in which the banks become stronger, public confidence returns and the credit squeeze comes to an end.

This solution would not be costless—depositors would need to take a loss, but who else should bear the losses if there is not enough shareholder capital?

This package has some *major* attractions:

- Confidence would return quickly and the economy could start to adjust and recover.
- There would be no further losses inflicted on the long-suffering taxpayer.
- There would be no need to lumber us with more useless, costly, financial regulation.
- There would be no need for the waste associated with fiscal stimulus.

Longer-term reform

Once the immediate crisis had been dealt with, some thought could be given to ensuring the long-term stability of the economy. This would boil down to rolling back the core pillars of hundreds of years of state intervention which I outlined earlier. I would suggest a reform package along the following principles:

- The abolition of deposit insurance and financial regulation.¹³
- Reform of corporate governance based on the repeal of the limited liability statutes.¹⁴
- The abolition of the central bank and the restoration of some form of commodity-based monetary standard. For instance, we might return to some form of gold standard, although I believe that we can do better than that.¹⁵

I am not disguising the fact that a lot of work would need to be done to work out how best to design and implement such reforms, but the important thing is to have a clear objective: No more FSA, no more financial regulation, no more Bank of England, no more inconvertible fiat money. Instead, a true system of financial and monetary *laissez-faire*: a stable financial system on a sound commodity-based monetary standard.

4: CONCLUDING COMMENTS

Let me now make a few closing comments. I appreciate that the idea of financial and monetary *laissez-faire* might come across to many as strange at first sight. The idea shocked me too when I first came across it—in fact, it was mind-shattering and it took some getting used to. However, it was also liberating and I eventually came to see it as entirely natural.¹⁶ After all, if free trade is a good thing in principle, which I believe it is, then what is wrong with free markets in financial services and money? So the fact that the idea might seem strange at first sight merely reflects the fact that we have been conditioned to be prejudiced against it. There was a time, after all, when everyone thought the world was flat. We should also remember that the historical record is very much on the side of those who support free banking and sound money. The 19th century was much less prone to financial crisis and the price level in the UK in 1914 was pretty much the same as it had been a century before at the Battle of Waterloo, or a century or two before that. That is a pretty good record and better than anything achieved since.

To paraphrase Keynes, the difficulty lies not so much in seeing new ideas, but in escaping from the hold of the old ideas that permeate into every corner of our minds.

But we also need to escape from the hold of Keynes himself. A hundred and fifty years ago, the great Classical Liberals such as Gladstone advocated that the government should manage its finances prudently, like any responsible household. Indeed, they did so in this very building. Then along came Keynes, who explicitly put himself in the dubious tradition of the monetary cranks of old who had been dismissed before then. He sneered at the Gladstonian notion that the government should manage its finances like a household and instead offered a macroeconomics founded on paradox—in particular, the paradox of thrift the gist of which is that we can somehow spend ourselves rich. The paradox of thrift is an interesting curiosity, but to build a whole school of macroeconomics on it is to lose perspective and throw common sense out of the window. It also leads to blinkered thinking and an excessive focus on aggregate demand and the alleged ‘need’ for stimulus. Instead, I prefer a more commonsense view of the macroeconomy that addresses the root problems—most especially, the need for structural adjustment—not the counterproductive sticking plaster of more government spending or yet another bailout. Gladstone would have agreed. So would Chris.

What a contrast with politicians today! I am reminded here of President Obama in a recent interview. When asked whether the latest spending package would involve money wisely spent, he responded by saying, in effect, that that didn’t particularly matter because it was a stimulus package, i.e., anything to boost spending for the sake of boosting spending. At the same time, Mr Obama

exhorts Americans to show financial responsibility whilst his own Administration throws all financial responsibility to the winds. This cannot be right. And it is Keynes, most of all, who has given this way of thinking a spurious respectability that it does not warrant. Keynes’s ultimate legacy is the macroeconomics of the madhouse.¹⁷

We have reached the point where current economic policies have become so ludicrous that cold analysis is no longer enough to do them proper justice. The best we can then do is resort to satire. And on this cheery note I would like to end with a disarmingly apt piece on the US bailouts. This deals with the infamous Tarp—the Troubled Assets Relief Program, and also makes some reference to the Federal National Mortgage Association (FNMA), more commonly known as Fannie Mae, a corrupt state-sponsored enterprise which played a notorious role in creating the subprime mess. So here is Bill Zucker’s Tarp song, available on the web at <http://www.youtube.com/watch?v=yGfQk9XXm24>.

Thank you all.

APPENDIX 1: LIMITED VS. UNLIMITED LIABILITY

The passage of the limited liability statutes in the 1850s gave rise to bitter controversy. Those who opposed limited liability argued that it would encourage excessive risk-taking at other people’s expense. To quote the author of one successful company law textbook:

The Law of Partnership hitherto has been ... that he who acts through an agent should be responsible for his agent’s acts, and that he who shares the profits of an enterprise ought also to be subject to its losses; that there is a moral obligation, which it is the duty of the laws of a civilised nation to enforce, to pay debts, perform contracts and make reparation for wrongs. Limited Liability is founded on the opposite principle ... (Cox, 1857, p. 42, n. 38)¹⁸

It is a modern myth, therefore, to maintain that limited liability is a creature of the market. To quote a recent study which I cannot recommend too highly:

limited liability under the Companies Acts was and is not the product of private negotiation in a market but of a public intervention. That the state created limited liability is, of course, allowed by all, but that by doing so it ousted the market is by no means realised by all; indeed in our leading company law textbooks the introduction of limited liability is often described as the result of laissez faire, which is precisely what it was not. ... In sum:

limited liability is not a creature of the market but rather a public intervention in the market. (Campbell and Griffin 2006, pp. 61-62)¹⁹

This has major implications for corporate governance, and suggests that recent attempts to reform corporate governance have been seriously misguided. The typical legislative response, especially in the US, is to impose ever more demanding and costly sets of rules and ever more severe criminal penalties. It should be obvious by now that this isn't working and the reason it isn't working is because it does not address the underlying causes. Writing in the wake of the Enron scandal and referring to the Sarbanes-Oxley Act (SOA) that followed it, Campbell and Griffin go on to observe that

... SOA has a familiar quality. It is huge and the penalties it provides, should they ever be applied, are draconian. But this is merely an exaggeration of the familiar stuff of corporate governance, and it is to the feeling of déjà vu that overcomes one as one reads SOA to which we want to draw attention. Rather like the blockbuster movie that, in the absence of real novelty in its script or direction, tries to create sensation by being merely louder and cruder than its predecessors, SOA is merely exaggerating the tired and familiar. But so ... we should have expected, for Enron itself is merely an exaggerated version of the commonplace. (Campbell and Griffin 2006, p. 53)

Limited liability is thus the key to successful corporate governance reform. And, I would add, what is the realistic alternative? Do we carry on increasing the rulebook and making penalties even harsher? But at what point do we accept that this formula is not working and will never work? The root problem is simply that limited liability creates incentives for socially excessive risk-taking—and until that incentive is corrected the problem of excessive risk-taking will continue to haunt us.

APPENDIX 2: THE LOOMING INSOLVENCY OF THE UNITED STATES

For years—and well before the currency crisis erupted—*informed observers had been warning of a looming fiscal disaster in the United States. They had been warning of the longer-term fiscal gap—the extra tax burden that would have to be imposed on current and future taxpayers, relative to current policy, for the federal government to meet existing longer spending commitments. The controversy over this issue had focused on the impact of an ageing population, longer life expectancies, rising medical costs and so forth, on the future cost of the federal government's Social Security and (more recently) Medicare commitments. Recent official estimates put the cost at a terrifying \$99.2 trillion, equivalent to a per-*

person liability of \$330,000 or \$1.3 million for a family of four (!), over 25 times the average household's income (Fisher, 2008).²⁰ To finance such a gap using income taxation would require income tax revenues—not rates—rising by 68%. Given that a very large rise in tax rates would lead encourage some workers to work less, such an increase in tax revenues—assuming for the sake of argument that it is even possible in the first place—would require an even greater increase in tax rates. Thus, attempting to raise anything like this amount of revenue would create horrendous disincentive effects, and may not be feasible anyway. Alternatively:

Suppose we decided to tackle the issue solely on the spending side. It turns out that total discretionary spending in the federal budget, if maintained at its current share of GDP in perpetuity, is 3 percent larger than the entitlement shortfall. So all we would have to do to fully fund our nation's entitlement programs would be to cut discretionary spending by 97 percent. But hold on. That discretionary spending includes defense and national security, education, the environment and many other areas, not just those controversial earmarks that make the evening news. All of them would have to be cut—almost eliminated, really—to tackle this problem through discretionary spending. (Fisher, 2008)

To put it bluntly: virtually the whole US federal government would have to be closed down (although this might not be a bad thing in itself!). And these are not the words of some fringe crackpot—Mr Fisher is the President of the Federal Reserve Bank of Dallas.

The size and continuing growth of these commitments thus threaten the long-term financial viability of the United States government itself, and serious commentators are now openly taking about the prospect of it becoming bankrupt. These include a leading authority on this subject, Boston University economist Laurence J. Kotlikoff, who recently asked, "Is the United States bankrupt?" and envisaged a possible future in which future generations of educated Americans emigrate abroad in massive numbers to flee the burdens currently being built up for them (Kotlikoff, 2006).²¹ To quote Mr Fisher again:

I see a frightful storm brewing in the form of untethered government debt. ... Unless we take steps to deal with it, the long-term fiscal situation of the federal government will be unimaginably more devastating to our economic prosperity than the subprime debacle and the recent debauching of credit markets that we are now working so hard to correct.

Throughout history, many nations, when confronted by sizable debts they were unable or unwilling to pay, have seized upon an appar-

ently painless solution to this dilemma: monetization. Just have the monetary authority run cash off the printing presses until the debt is repaid, the story goes; then promise to be responsible from that point on and hope your sins will be forgiven by God and Milton Friedman and everyone else.

We know from centuries of evidence in countless economies, from ancient Rome to today's Zimbabwe, that running the printing press to pay off today's bills leads to much worse problems later on. The inflation that results ... turns out to be much worse than the fiscal pain those countries hoped to avoid. (Fisher, 2008).

And remember that all this was in the pipeline *before* the current crisis hit.²² Mr Obama's admission that the Federal Government is likely to run trillion dollar-plus deficits for years to come only makes a very bad situation all that much worse.

APPENDIX 3: PRINTING MONEY

Current monetary policies both in the United States and here in the UK aim to 'stimulate' the economy by any means possible, not flinching even from the desperate policy of printing money (or its electronic equivalent). The parties responsible prefer to eschew the loaded term 'printing money' because of its unpleasant connotations. However, this policy has unpleasant connotations for good reason: printing money is the most condemned monetary policy of all time—as the quote at the end of the last Appendix nicely demonstrates—and threatens to create a catastrophe.

In an inconvertible fiat monetary system, the monetary base—the liabilities of the central bank, which consist of the notes it issues to the public and the deposits it issues to the commercial banks—has a pivotal role, and stands at the apex of an inverted monetary pyramid. There is so much monetary base at the bottom, and this is determined by central bank monetary policy. Based on this base, we then have the broader monetary aggregates: M1 (currency plus demand deposits), M2, M3 (in essence, M1 plus more and more deposits) and so on. These nominal values, in turn, will determine prices throughout the economy.

Milton Friedman once imagined a thought-experiment in which the Federal Reserve sends out a helicopter that drops freshly printed dollar notes on the public below. This would constitute an exogenous increase in the monetary base. In time, the extra monetary base would feed through the system—the other monetary aggregates would increase in turn, and eventually prices too. Other things being equal, a doubling of the monetary base should lead the other aggregates and prices to double as

well.

This argument hinges on the monetary velocities remaining fairly stable, but the evidence suggests that they are reasonably stable other than over very short periods: velocity might fall for short periods (and, indeed, it has fallen since the onset of the crisis as people hoard money, in part because of lack of confidence), but over the longer term (and as confidence returns), then velocities will tend to return to more normal levels.

In this context, it is interesting to consider the US monetary base over the few months or so. The monetary base was fairly stable for years and had a value of about \$870 billion in August 2008. Since then it has grown rapidly, and the latest available figure puts it at about \$1,579 billion—a growth rate of around 80%—and it is projected to rise to around \$3,000 billion.²³

The stage is therefore being set for the return of inflation—with a vengeance.

APPENDIX 4: DIFFERENT TYPES OF FREE BANKING

The term 'free banking' is usually used to refer to a system of banking (or more generally, a financial system) in which banks are unregulated or lightly regulated and there is no central bank. Most historical free banking systems—and there were many of them—operated on a gold standard. The banks would issue notes or deposits and were compelled, on demand, to exchange these for gold coin. Failure to do so was breach of contract.

There were many different types of 'free banking' proposed in the past, and there are quite a number of different systems proposed over the past generation or so. Some of these are cranky, however, and it is very important that modern free bankers distance themselves from cranks and advocate reforms that are grounded as solidly as possible in the historical record. We don't want to be dismissed as cranks ourselves, and those who oppose free banking rarely miss half a chance to do so: after all, it saves them the inconvenience of having to deal with our arguments on their merits.

Amongst the other types of free banking or related systems are:

- *Free banking on a frozen monetary base:* we freeze the monetary base, abolish the central bank, and deregulate the banks. This however is still a form of fiat standard and we can do better by anchoring the monetary standard itself (e.g., as under a gold standard).
- *Competing currencies and privatisation of money* (Hayek 1976a,b): these proposals did a great deal to bring attention to the free banking issue, but don't say much about the monetary standard as such.²⁴

The type of free banking I would prefer is free banking anchored on a commodity-based monetary standard, i.e., no inconvertible fiat money. This combines the benefits of deregulation in financial services with the benefits of sound money.

I believe that we should take our ‘sense’ of sound money from the historical record, and the gold standard is a natural starting point. This does *not* mean that a modern system of free banking should involve necessarily a gold standard. Instead, we might take the gold standard as our default and ask if it is possible to improve on the gold standard, and I believe we can: see Appendix 6 below.

APPENDIX 5: FREE BANKING VS. CENTRAL BANKING IN 18TH AND EARLY 19TH CENTURY BRITAIN

During this period, both free banking and central banking systems existed side-by-side in Britain: an early form of central banking in England and Wales, and free banking in Scotland.²⁵

England and Wales

The origins of English central banking go back to an infamous incident in 1672, when the Government of Charles II defaulted on its debts and ruined many of the early London goldsmith-bankers. The English Government’s credit rating was also ruined and the later Government of William III had great difficulty raising finance to fight in the wars against the French King Louis XIV. A Scottish financier, William Paterson, then proposed a deal in which the English Parliament charter a bank with various privileges, and this new bank would give the Government a subsidised loan. This new bank was to be the Bank of England, and it had a fixed-period charter to operate. The Bank’s privileges were strengthened further in 1709 when an Act was passed limiting other English banks to be partnerships of no more than six partners. Over the years, the charter of the Bank was periodically renewed, and the Government received repeated subsidised loans with which to finance its wars and the expanding British Empire.

Unfortunately, the six-partner rule made English banks small and unstable: banks were also unable to achieve the size to become financially strong or exploit the economies of scale implicit in the business of banking; the partnership corporate form was itself also unstable, not least because the partnership dissolved each time a partner left or died. The English banking system was therefore highly unstable and subject to periodic crises in which large numbers of banks would fail.

The worst of these was the great crisis of December 1825. This crisis was the worst financial crisis in English history—at least up until the last two years—and brought

the Bank of England itself to the brink of failure. It was said later that the country had come within twenty-four hours of reverting to barter. Literally hundreds of English banks and those involved with them had been ruined, and the effects on the economy were disastrous. Feeling against the Bank of England was naturally running very high, and in the aftermath of the crisis it looked as though the Bank’s opponents would actually succeed in blocking the renewal of its charter. Indeed, at one point, in 1826, the Prime Minister, Lord Liverpool, even wrote to the Bank to tell it that Parliament was against renewal and there was nothing the Government could do about it. (These were the days when the Government felt obliged to listen to Parliament!) Unfortunately, the Government had changed by the time the charter came up for renewal; the new Government then rigged the Parliamentary inquiry into the Bank charter question, and a certain amount of behind-the-scenes manoeuvring got the Bank Charter Bill through. The Bank therefore lived to fight another day. The attack on the Bank then gradually fizzled out and, by the end of the nineteenth century, all of this was ancient history.

Yet the fact remains that the free marketers of their day—the great reformers who swept away many of the old monopolies and other restrictions against free trade—themselves came within an ace of destroying the Bank of England and establishing free banking throughout Britain.

Scotland

The history of Scottish banking was very different. The first Scottish bank, the Bank of Scotland, was founded in 1695, and had the various privileges associated with the joint stock company in those times. Within a couple of decades, however, there was no longer a Scottish Parliament, and the Bank of Scotland fell out of favour with the Westminster Government because of its suspected Jacobite sympathies. Accordingly, the Government was happy to lend it support to a rival, the new and loyal, Royal Bank of Scotland, in 1716. The two banks were bitter rivals and attempted for a long time to drive each other out of business. But unable to destroy each other, the two banks eventually began to co-operate, and new banks were also established in the years afterwards. This co-operation led to major advances in banking practice, many of which subsequently spread to the rest of the world. Most notable amongst these was the practice of note acceptance and exchange, whereby the banks would accept each others’ notes over the counter and then exchange them later after the end of business. When chequeable deposits later emerged, this practice was subsequently extended to the acceptance and exchange of cheques, which still forms the centrepiece of the bank payments system today.

Thus, by the mid-18th century, Scotland had evolved a world-leading free banking system operating on a gold

standard. (Strictly speaking, the monetary standard of the time was a gold-and-silver bimetalism, but the legal ratio of gold and silver meant was such that people chose to meet their obligations with gold rather than silver. The system therefore operated as a *de facto* a gold standard.)

The Scottish system prospered under a regime of malign neglect by the Westminster Government. It was highly stable, and Scotland was free of the banking instability that plagued the English (central) banking system south of the border. Most impressively, Scotland was barely touched by the great crisis of 1825, which almost destroyed the English banking system.

The Scottish banking system was the envy of the world and, not unreasonably, the Scottish people were very proud of it. They were also very protective of it. In 1825, it had been proposed to abolish the Scottish pound note, which had become the centrepiece of the Scottish system. The proposal aroused outrage in Scotland, and there was even talk of open rebellion. There then emerged the controversy between the theorists of the English economics establishment, on the one side, who failed to understand the Scottish system, and the practical people on the Scottish side, who emphasised the proven track record of the Scottish system, and the manifest problems of the English one. The most prominent among was the latter was Sir Walter Scott, whose celebrated “Letters of Malachi Malagrowther” of 1826 provided a scathing and, sadly, still all-too-relevant statement of the main issues in this controversy:

Here stands theory, a scroll in her hand, full of deep and mysterious combinations of figures, the least failure in any one of which may alter the result entirely, and which you must take on trust There lies before you a practical System, successful for upwards of a century. The one allures you with promises ... of untold gold,—the other appeals to the miracles already wrought [on] your behalf. The one shows you provinces, the wealth of which has been tripled under her management,—the other a problem which has never been practically solved. Here you have a pamphlet [on economics]—there a fishing town—here the long-continued prosperity of a whole nation—and there the opinion of a professor of Economics [and an English professor of economics, no doubt: KD], that in such circumstances she ought not by true principles to have prospered at all.

The Scots won the argument and their precious pound note was preserved. Unfortunately, twenty years later, the English establishment got their revenge: Robert Peel pushed through an Act that imposed 100% reserve requirements on the Scottish banks and effectively ended

Scottish free banking.

APPENDIX 6: A BETTER COMMODITY-BASED MONETARY STANDARD THAN GOLD?

There is a long history of attempts to improve on the gold standard—that is to say, to produce a commodity-based monetary standard that will produce greater price stability than the gold standard managed to achieve. Prominent amongst the leading thinkers in this area are the great American economists Irving Fisher and Milton Friedman.

In the early years of the 20th century, Fisher proposed a ‘compensated dollar’ the idea behind which was to stabilise the purchasing power of the dollar by changing the number of gold grains in the dollar in accordance with some specified rules (see, e.g., Fisher, 1911).²⁶ Unfortunately, the devil is in the detail in these matters and there are a number of weaknesses in the way in which his scheme would have operated. These weaknesses leave me to believe that Fisher’s scheme would not have delivered price stability or been invulnerable to speculative attacks that could destroy it.²⁷

In the 1950s, Friedman proposed a ‘commodity-reserve currency’ in which issuer of currency would commit to buy and sell unlimited quantities of a specified bundle of commodities for a given nominal amount.²⁸ One way to think about this scheme is that it attempted to generalise the gold standard by tying down the price of a basket of goods that included more than just gold. This would, hopefully, ensure that the value of the dollar was less vulnerable to changes in the demand and supply of gold. More ambitiously, the idea was to have a basket whose value was closely correlated with the value of the price index one wished to target (e.g., the Consumer Price Index or CPI). Unfortunately, only a small fraction of the goods and services whose values are represented in the CPI can be physically delivered over the counter: it is only thing to hand over a gold coin, but quite another to hand over perishable goods and even harder to hand over services (e.g., half a haircut?). And if we restrict ourselves to a basket of goods (and services?) that is deliverable over the counter, then the price of this basket will only be loosely correlated with the CPI we wish to target, and so the scheme will not achieve its objective of ensuring price stability.

This problem remained intractable for a long time. The emergence of commodity derivatives contracts then created the possibility of new commodity-based schemes in which the deliverable would not be physical commodities as such, but financial derivatives contracts specified with the prices of commodities (or commodities and services) as their underlying variable. A number of proposals have been made over the last 20 years or more in which the issuer of currency would buy and sell such contracts at a fixed price, and the contracts would be de-

signed in such a way that when demand for them equalled the supply, the price level would be expected to remain as it is. Examples are the schemes of Sumner (1989) and Dowd (1994) in which the issuers of currency would peg the price of macroeconomic derivatives of one sort or another.²⁹ Further work is still required to fully flesh these proposals out and resolve remaining implementation issues, but I think we are in sight of being able to solve this problem and come up with a fully workable scheme—a commodity-based monetary standard that will achieve price-level stability and, moreover, do so automatically, without relying on having to be managed by the central bank or anyone else.

ENDNOTES

1. Kevin Dowd is professor of financial risk management at Nottingham University Business School. He thanks Dave Campbell, Tim Evans, Sean Gabb, Alex Singleton and especially Brian Micklethwait for their feedbacks and inputs to the lecture.
2. Appendix 1 elaborates on this issue.
3. Government reactions to the crisis are reminiscent of Corporal Jones in *Dad's Army*, running around in a panic telling us not to panic.
4. I would also make a couple of points here about the Financial Services Authority, who brought us the Northern Rock fiasco: their handling of the Rock was aptly described by journalist Alex Brummer as something from an episode of the Keystone Kops. (See A. Brummer, *The Crunch: The Scandal of Northern Rock and the Escalating Credit Crisis*, London: Random House, p. 107.) But now they promise us that they won't let this happen again (yeah, as my younger daughter would say) and are going to get tough in the future. Well, the SEC in the US had a reputation for being ferociously tough, but they still didn't notice a \$60 billion-plus Ponzi scheme operating for decades right under their noses. I am referring, of course, to the infamous case of Bernie Madoff-with-my-money, and that only came to light because Mr Madoff's own sons turned him in. So who do the FSA think they are kidding?
5. See Appendix 2 for more on this problem.
6. Appendix 3 has more on printing money.
7. There are various different types of free banking and related systems, and these are discussed at more length in Appendix 4.
8. For more on these, see, e.g., the case studies in K. Dowd, *The Experience of Free Banking* (Routledge, 1992).
9. Appendix 5 has more on the histories of Scottish free banking and of English central banking, and the controversies surrounding them. See also, e.g., or V. C. Smith *The Rationale of Central Banking*, London: P. S. King, 1936 or L. H. White *Free Banking in Britain: Theory, Experience, and Debate: 1800-1845*, Cambridge: Cambridge University Press, 1984.
10. The main weakness of the gold standard was that it made the price level dependent on factors that affected the supply of or demand for gold. For example, prices rose significantly after the gold discoveries of the late 1840s and mid-1890s, and prices under the gold standard fell considerably in the quarter century before 1896. The gold standard was also highly controversial at times, most especially in the United States in the late 19th century, as evidenced by William Jennings Bryan's famous 'cross of gold' speech in 1896. In this country and in the British dominions overseas, by contrast, the gold standard was fairly uncontroversial and widely admired.
11. M. Hutchinson, "The Liquidationist Alternative," *The Bear's Lair*, February 16, 2009. Available on the web at http://www.prudentbear.com/index.php/commentary/bearslair?art_id=10192.
12. If I may digress again for a moment to remind our authorities of their own stated policies before the crisis, there were to be no more bailouts of badly run financial institutions: we were no longer operating in zero-failure regime when it came to financial institutions. If a bank got itself into difficulties, it could expect no public bailout and it could go to the wall as far as the authorities were concerned. This was from the very same people who masterminded the bailouts of the last 18 months. All hot air as it has turned out. The word 'backtracking' doesn't begin to describe it.
13. The armies of financial regulators should be sent packing: the good ones will get jobs in the private sector and the bad ones can become academics. And, speaking as an academic myself, the *really* bad ones can always become university administrators.
14. Needless to say, this would be a major task and we urgently need research on what such reforms might entail and how they could be implemented.
15. This is a second task also requiring urgent research.
16. I am embarrassed to admit how long this took. I first came across the idea when I was a second-year undergraduate at the University of Sheffield in 1979. I read Hayek's *Privatization of Money*, but wasn't sure what to make of it. On the other hand, I found Friedman easy to follow and very convincing. I subsequently went to the University of Western Ontario to study monetarism further and then came across the early 19th century British free banking controversy in 1983 or early 1984. I was fascinated by the idea, and soon persuaded myself that monetarism was limited because it merely sought to control the monetary monopoly, whereas the more natural solution was surely to abolish the monopoly itself. When I put this to my then-supervisor, David Laidler (PhD Chicago), he was dismissive and told me to get on with my dissertation. My immediate reaction was that if a Chicago PhD isn't worried about a monopoly, then I must be onto something. His reaction confirmed my belief that free banking was the way forward. After that, I discovered that others—most particularly, Larry White—were also thinking along similar lines, and the modern debate on free banking then opened up in the later 1980s.
17. This reminds me of the classical economists' definition of waste: waste is where a bus full of Keynesian economists goes over a cliff and there are still some empty seats.
18. E. W. Cox, *New Law and Practice of Joint Stock Companies*, 4th edition. London: Law Times Office, 1857.
19. D. Campbell, and S. Griffin, "Enron and the end of corporate governance." Pp. 47-72 in S. MacLeod (ed.) *Global Governance and the Quest for Justice*, Oxford: Hart Publishing, 2006, pp. 61-62.
20. See R. W. Fisher, "Storms on the horizon", remarks before the Commonwealth Club of California, May 28, 2008. As is so commonly the case, this problem has grown to be as bad as it has mainly because politicians of neither party have been willing to take responsibility to rein it in. Even during the golden years before the financial crisis, the Bush administration and the Congress allowed it to become worse by raising discretionary spending and boosting future Medicare commitments whilst taking no action to raise receipts; for their part, Democrats in the Congress studiously refused to deal with the issue. The past refusal of politicians to deal with this issue does not instill any confidence that the politicians now taking office will do any better; the blunt fact is that they have little political incentive to deal with it—it is easiest to spend now and leave others in the future to clean up the mess.
21. L. J. Kotlikoff, "Is the United States Bankrupt?" *Federal Reserve Bank of St. Louis Review* Vol. 88, No. 4, July/August 2006, pp. 235-49.
22. In this context, Patrick Creadon's new film *I.O.U.S.A.* is much to be recommended: this follows the attempts of the former US Comptroller General David Walker as he criss-crosses the US trying to get his fellow-citizens to appreciate the scale of the calamity awaiting them and what they can do about it.
23. The other monetary aggregates have also been growing sharply, but by nothing like as much as the monetary base.
24. See F. A. Hayek *Choice in Currency: A Way to Stop Inflation*, IEA Occasional Paper 48, London: Institute of Economic Affairs, 1976a; *Denationalisation of Money*, Hobart Paper, London: Institute of Economic Affairs, 1976b.
25. For more on this history, see, e.g., Smith (1936), White (1984) or K. Dowd *The State and the Monetary System*, Oxford: Philip Allan, 1989.
26. I. Fisher, *The Purchasing Power of Money: Its Determination and Relation to Credit, Interest and Crises*, New York: Macmillan, 1911.
27. K. Dowd, "The 'compensated dollar' revisited." Pp. 104-113 in K. Dowd, *Money and the Market: Essays in Free Banking*. London: Routledge, 2000.
28. M. Friedman, "Commodity-reserve currency," *Journal of Political Economy*, Vol. 59, pp. 203-232, 1951.
29. See: S. Sumner, "Using futures instrument prices to target nominal income," *Bulletin of Economic Research*, Vol. 41, pp. 157-162, 1989; or K. Dowd, "A proposal to end inflation," *Economic Journal*, Vol. 104, 1994, pp. 828-840.