OPINION

A Bill to Fight Crony Capitalism

By Steve Baker

If you borrow a friend's painting and promise that you will give it back on demand, and you then lend that same painting to somebody else, you have committed a fraud. The same rules do not apply, however, to bankers. British parliamentarians have an opportunity to change that today, and I hope they do.

Today, banks enjoy the legal privilege of fractional reserve banking, meaning they may lend out what they already owe depositors. By lending and investing on-demand deposits, banks create money by extending credit. When the bank's investments turn sour—and investments often turn sour at some point—the bank cannot pay back the deposits and goes bust. Unless it manages to convince politicians that it is too large to fail, in which case it will be bailed out by taxpayers.

This skewed relationship between bank deposits and normal contract and property rights, combined with state interventions like the central planning of interest rates and various guarantees, is what causes boom and bust. Today I will be supporting my colleague Douglas Carswell, member of Parliament for Clacton, as he introduces a bill to phase out fractional reserve banking. Our friends in the U.S. and Europe are watching closely, for the same crony capitalism afflicts the world.

Leading up to the recent financial crisis, banks borrowed (and continue to borrow) at absurdly low rates from central banks. Their salesmen then flogged mortgages on commission to those with no hope of repaying the principal from their income. This junk was pooled and flogged again, this time anonymously, to hapless investors prepared to believe that housing prices could only rise, and that the risk of default did not correlate across their portfolios. This is just one of the errors of contemporary financial capitalism.

Our reform measure will give consumers a choice in how banks use your deposits.

Our Regulation of Deposits and Lending bill would allow you, Britons, to choose how your money is used. You would have the choice either to deposit your money for safe-keeping, or to save it for a term to be invested further by the bank. If safe-keeping is your choice, you can have your money back on demand. Your property rights would be intact—you would remain the owner of your deposit. You would probably not earn interest; in fact you may have to pay for the privilege of direct access through branches and cash machines. If, however, you want a yield, you may choose to deposit your money for a term instead. The bank can then invest it further, potentially earning you an income.

Credit would continue to exist, backed by real savings. The saver would be fully aware of the benefits and risks when choosing between depositing money and saving it for a term.

Two years ago the world economy crashed, yet no progress has been made in trying to prevent new crises. Ending fractional reserve banking has been proposed at various times by various economists of the three great traditions—Keynesian, Monetarist and Austrian. One could ask why the call to end the anti-capitalist legal privilege of fractional reserve banking has not come louder and sooner?

Is it outrageous to suggest that bankers rather like the socialization of risk and easy access to others' money, and that their success in this system requires the ears of the right politicians? In contrast to the heroic entrepreneurs of Rand's "Atlas Shrugged," the contemporary financier receives astonishing remuneration for reporting unrealized profits. Meanwhile, he shares in none of the losses inevitable under a system built on fatally flawed models of market behavior. Instead of lending only to people they trust, the current system means contemporary financiers are content to lend to anyone, provided they can pass off the risk to someone else.

Losses have been socialized by the power of the state. Bonuses have been paid at bailed-out banks and support staff think this is justice because they weren't the ones making the deals. Executives who, in another age, would have lost everything as partners with open liability, have instead retired wealthy.

If there is today a class conflict within capitalism, it is not between workers and owner-entrepreneurs, but between taxpayers, bank executives and stockholders. Stockholders have long since given up control of their property and the small investor finds few returns. Meanwhile, finance capitalists gamble other people's money on the basis of models and theories that turn out to be nonsense, all while telling us how much value they are creating and deserve to share. That rare breed, the long-term stockholder, has no recourse after losses or poor dividends, and the taxpayer is compelled to pick up the outstanding tab.

This sketch is incomplete and most of the players involved in this system do not intend to exploit others. But exploitation it is when one group is compelled to cover the losses arising from bad bets made by a second group with money belonging to a third. This system of relationships is not healthy. That ancient golden rule, "do as you would be done by," has indeed been cast aside for "do unto others before they do unto you." We ought to ask if this is how we want to live.

The enemies of freedom portray the financial crisis as a failure of capitalism. In reality markets do not grant legal privileges such as fractional reserve banking—politicians do. The legal privilege of fractional reserve banking destroys the sound capitalist mechanisms of property and contract law. Today we hope to end it.

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