{ BANKING REFORM }

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Iceland has come up with a new way to manage money, but will it work?

Extreme disasters, it seems, make for extreme solutions. With its population of just 325,000, Iceland made an unlikely frontrunner for the wider financial crisis that swept major economies in the winter of 2008/9. Yet few countries were worse affected.

All three of Iceland's privately owned commercial banks collapsed in the crisis, leaving the country and its citizens with liabilities that dwarfed the size of the economy. Indeed, relative to GDP, Iceland's was the largest systemic banking crisis in history.

It should, therefore, come as no surprise to learn that the Icelandic government, rather than following the sticking-plaster solution to financial reform pursued internationally, is toying with the idea of something much more far-reaching and revolutionary – removing the power of commercial banks to create money and handing it to the central bank instead.

To understand the significance of what is proposed, it is first necessary to explain how money is created, and thereby fuels the boom and bust of the banking cycle.

It is remarkable how few people properly appreciate this – even in the higher echelons of banking – but every time a new loan is made by a bank, an equal and opposite amount in deposits is created somewhere in the banking system. For example, when you borrow the money to buy a house, the vendor gets the proceeds of that loan and deposits it somewhere else. The loan in essence creates the deposits.

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The Icelandic government is toying with the idea of something revolutionary

In the run-up to the crisis, this process of money creation, normally checked by the amount that banks put aside as reserves in combination with natural risk aversion, got completely out of hand. In Iceland, commercial banks expanded the money supply nineteen-fold in the 14 years prior to the crisis, or approximately nine times more than was justified by domestic economic growth.

A government-commissioned report published in March, *Monetary Reform: a better monetary system for Iceland*, proposes moving away from the old model of 'fractional reserve banking', a system widely acknowledged to have encouraged this reckless balance-sheet expansion, to one of so-called 100% reserve banking – or a sovereign money system – which removes the money-creation privilege from bankers and gives it to the central bank and government instead.

I've got four major problems with this system's wider application. Credit allocation is one. Market-driven credit allocation is not necessarily incompatible with such a system, yet the scope for abuse by politicians is obvious.

Second, I see no reason to believe that governments, even when restrained by worthy committees of economists, would be any less prone to excess than bankers. They might even be worse, given the freedom to spend implied.

Third, it is very hard to see how such a radically different system of banking could operate in isolation, given today's global financial markets and the scope for growth in shadow banking.

But, most importantly, why change a system that, despite the chaos of repeated financial crises, has over the long sweep of history plainly delivered?

The explosive growth in living standards of the modern age corresponds almost exactly with the development of fractional reserve banking, and the easy access to credit it provided. This is surely more than mere coincidence.

Warts and all, the system works. A sovereign money system would be unlikely to deliver the same creation/destruction that drives economic progress as the boom and bust of the credit cycle.

Iceland should be commended for the radicalism of its thinking, but it's hard to see 100% reserve banking gaining wider traction.

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