


BOOK REVIEWS

Book Review: A Modern, European *Lombard Street*

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JEL Classifications: B53 Austrian, E58 Central Banks and Their Policies, G28 Government Policy and Regulation

<https://doi.org/10.35297/001c.125875>

Quarterly Journal of Austrian Economics

Vol. 27, Issue 4, 2024

The Evolution of Banking Regulation in the European Union: An Economic Approach

Nikolay Gertchev

Lanham, Md.: Lexington Books, 2023; xi + 173 pp.

In the mass of modern writing on banking and banking regulation, one sometimes gets the impression that economists no longer know what banking actually is. It is Nikolay Gertchev's great achievement with this book to not only give a detailed account of banking regulation, but explain its nature and evolution from first principles. Dr. Gertchev (2023, 6) compares his approach explicitly to Walter Bagehot's (1873) classic *Lombard Street*, but Gertchev's book is in some respects a greater accomplishment. It builds on the theoretical advancements in monetary theory by Ludwig von Mises and his followers, and it successfully presents the modern European banking system in a manner intelligible to the reader. Given the greater complexity and much more bureaucratic nature of the European banking system compared to the British money market that Bagehot described, this is no mean accomplishment.

The Essence of Banking

Dr. Gertchev sees the essential nature of banking as the ability of banks to create money (credit intermediation is also essential to banking but does not lead to instability). Modern banking is fractional-reserve banking, and it is the fractional reserve that makes banking inherently unstable. This inherent instability leads to the development of regulation, first in the form of liquidity-based regulation—that is, central banking. Since this does not cure the underlying causes of bank instability but rather enables a wider credit expansion, the problems of recurring crises and financial turmoil are aggravated. Additional regulations are then introduced to make the individual banks less crisis-prone and the banking system as such more resilient, as well as to prevent the danger of financial institutions' becoming "too big to fail"

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(TBTF). This logic of bank regulation gives the book its basic structure: chapter 1 explains the monetary nature of banking, how banks engage in credit expansion, and how central banks regulate said credit expansion. Dr. Gertchev in this chapter also explains how the traditional system of regulation through the scarcity of reserves changed into an abundant-reserves system. Chapter 2 then covers the growth of microprudential regulation. Here the Basel Framework and the Basel Accords provide the regulatory framework in the EU and elsewhere. The basic principle of a given ratio of risk-weighted assets to equity was introduced with Basel I in 1988 and remains foundational, but the regulations have accumulated greatly since then. Chapter 3 details macroprudential regulation, which deals with system-wide factors of instability in the financial system. Chapter 4 finally deals with the problem of TBTF institutions, its causes, and attempted solutions.

The book analyzes the European situation in particular, but it is not without interest to non-Europeans. The basic issues of fractional-reserve banking and central banking are the same in all countries, and the regulations are similar. This is partly due to coordination through the Basel Committee—as Dr. Gertchev details, international capital flows and instability in international capital markets were the reasons for setting up the committee—and partly due to the global dominance of the same intellectual error: a fundamental failure to understand that money creation is at the center of banking (154–55). One immediately sees that Dr. Gertchev is an expert, as he effortlessly explains the bewildering growth of regulations and regulatory agencies, especially since the great financial crisis. The lay reader is nevertheless in danger of getting lost in the jungle of bureaucratic abbreviations. One is well advised to keep a notebook handy and write the abbreviations down to avoid becoming confused and, for example, mistaking the EFSF for the NSFR. Despite the clarity of analysis, it is impossible for Dr. Gertchev to avoid all bureaucratese as he details the mountain of regulations. While chapter 1 serves as a good introduction to European banking and its present state, the later chapters are thus only for the serious student.

The Evolution and Failure of Regulation

Dr. Gertchev (23–28) first describes the evolution and inherent instability of fractional-reserve banking. Characteristic of a mature banking system are two tiers of money production: monopolistic central banks can produce fiat money at zero marginal cost; and fractional-reserve banks participate in the production of money in the broader sense. The creation of money by private banks, which ultimately relies on the willingness of the central bank to supply the banks with reserves, and the redistribution of resources (Cantillon effects) consequent on money production provide the basic rationale for liquidity-based regulation of banks.

The focus of the book is the EU, and Dr. Gertchev shows how the Eurosystem (the European Central Bank [ECB] and the national central banks of the eurozone) have steered monetary policy. However, this monetary policy itself has broken the system: in the aftermath of the great financial crisis, expansive monetary policy and quantitative easing (in the form of asset purchases by the Eurosystem) flooded the banking system with liquidity. In a normal banking system, banks have a structural liquidity deficit: they need to borrow or otherwise acquire reserves from the central bank in order to engage in credit expansion, and the central bank can thus effectively steer the size of said expansion through the terms at which it provides reserves. Since late 2008, however, European banks have had a permanent excess of liquidity that as of late 2022 reached the sum of about €4.5 trillion. This means that liquidity-based regulation has de facto become irrelevant in the Eurosystem (33–35). Even in the absence of this contingent historical development, however, other regulations would still appear desirable. Banks can circumvent the regulations imposed by the central bank and thereby engage in unsupervised credit expansion. We will return to Dr. Gertchev's account of how this functions below in the next section. Additionally, even when the central bank successfully controls the amount of credit expansion, it cannot prevent the negative effects of said expansion in the form of crises and financial instability. So-called microprudential regulation—of banks' balance sheets, business strategies, and so on—therefore appears desirable or even necessary to the regulator.

It is in this light that the Basel regulations must be seen. Basel lays down requirements for the structure of the balance sheets of banks. Banks must keep a minimum of 8 percent of capital against their total risk-weighted assets (plus various buffers and supervisory add-ons). The Basel regulations further stipulate what risk weight different asset classes have. While this may in some cases appear sensible—cash, for instance, has a 0 percent risk weight—it contradicts economic science to attempt to assign objective risks to various assets. It negates entrepreneurial decision-making and substitutes strict bureaucratic rules for flexible market discipline (74).

Naturally, banks tend to invest more in assets with a low risk according to Basel, as this allows them to leverage their capital and maximize profit. The regulations therefore serve to steer investment into specific channels. Government bonds with a high rating carry, according to Basel, zero risk (all EU governments are riskless according to EU regulations). High-rated corporations carry a 20 percent risk, and loans secured on mortgages a 35 percent risk. Loans to unrated corporations carry a 100 percent risk, and retail exposures 75 percent. Naturally, banks therefore give more loans to governments, well-established corporations, and real-estate investors. Less-productive activities are favored over more-productive activities (72–73).

Dr. Gertchev's analysis of macroprudential regulation (chap. 3) is similarly incisive and illuminating. Again he shows the many intellectual errors that plague the theory and practice of regulation. Notions such as "fire sales," "credit crunches," and "systemic risk" are neither theoretically well-founded nor consistently applied (106–8). "Fire sales," where a bank in trouble throws financial assets on the market in large quantities, leading to rapid price falls, are considered a cause of systemic risk—but if so, then why are "rocket purchases," where banks and other financial actors invest large sums, pushing up prices, not considered such as well? As Dr. Gertchev notes, there is a consistent bias in the literature toward maintaining bank credit expansion.

A discussion of the TBTF issue crowns the book (chap. 4). Here too Dr. Gertchev's analysis is incisive. The regulations and agencies that have been set up to deal with this issue end up being contributing causes. Moral hazard is grounded not in any kind of market imperfections, but in the very nature of fractional-reserve banking. New institutions such as deposit guarantee funds and new rules on dealing with a failing bank effectively privilege large, TBTF banks (128). Dr. Gertchev's treatment of the European Stability Mechanism (ESM) set up after the great financial crisis shows how the reforms strengthen the bigger financial institutions and reinforce the ties between states and finance, which is the opposite of their stated purpose. Instead of relying on market finance and market discipline, European governments (Spain, Portugal, Ireland, and Greece) were bailed out by the ESM, which thus effectively bailed out the holders of government bonds. The ESM also allows governments to avoid hard reforms, since the terms imposed with aid from the ESM—the infamous "austerity"—are biased in favor of higher taxation. If not for the ESM and other European interventions, national governments would have faced market discipline and would have had to focus austerity on spending cuts. Finally, the ESM did not really stabilize the receiving governments' finances—the ECB did this by again accepting their bonds as collateral for liquidity-providing operations under cover of aid from the ESM. This, and the subsequent asset purchases (quantitative easing) of the ECB, drove strong demand for government bonds.

Dr. Gertchev deals with these and many other issues in great detail. As an overall conclusion, European finance now appears almost completely bureaucratized. The privileged nature of fractional-reserve banking constitutes a coercive intervention in the market order (125), and the various regulations and agencies set up, as well as the centralization of supervision at the European level, constitute rounds of further interventions to remedy the defects of the system. Rather than describing this interventionist history in more detail, however, let us turn to examine two of Dr. Gertchev's important theoretical contributions.

Ways of Escaping Central Bank Control

Central banking and liquidity-based regulation of banking alone are not enough to contain the problems of fractional-reserve banking. Dr. Gertchev shows how, as a matter of contingent historical fact, the Eurosystem has created a situation where classic monetary policy is not possible, but he also argues that commercial banks can escape the liquidity-based regulation imposed by the central bank. There are two ways in which this is possible: through the interbank market and through the process of securitization. Dr. Gertchev (2009, 2012) has developed the theory of both in previous publications and now integrates them in his book.

The Interbank Market

On the surface, it may seem that banks are constrained by the amount of liquidity the central bank provides. However, Dr. Gertchev (2023, 36–38) shows that the interbank market can greatly reduce banks' dependence on the central bank. If a bank experiences an outflow of reserves to another bank, it needs to finance this outflow. One possibility is applying at the central bank for liquidity, but it can also borrow the needed reserves from the other bank. The other bank is willing to provide the loan, since it requires the goodwill of other banks when it itself experiences a drain of reserves. In the normal run of business, it is normal for a bank to have an inflow of reserves at one point in time and an outflow at another. Providing a loan to a bank suffering a shortage of reserves amounts to recognizing the fiduciary media of the other bank as money and accepting the other bank as part of the system; the banking system could hardly function if the banks were not willing to routinely accept other banks' issues.

The result is that the banking system can engage in credit expansion without having to rely on the central bank for liquidity. Only insofar as money flows out of the banking system as a whole will external liquidity be needed. So long as bank customers are content to keep their money in the banking system, the amount of reserves available constitutes no limit on credit expansion. Dr. Gertchev shows how the interbank market played a huge role in the European setting up to and even beyond the great financial crisis.

More fundamentally, the banking system as such is unstable even in the absence of central banking. While other banks may exercise some control over aggressive banks through clearing, this control is not as strong as proponents of free banking assume (Selgin 1988; White 1999). Through the interbank market, an expanding bank shares the profits of expansion with the banking system and thus signals to it that a lower reserve ratio is more profitable. Only if the optimal reserve ratio were somehow given to the system from outside could the banks say that the expansion was an overexpansion. However, it is not given, but rather something the bankers have to assess and determine in the course of business. Since the reserve ratio is not set for all eternity,

how can the bankers distinguish between a case of overexpansion and the case where one of their number has correctly determined that a lower reserve ratio is optimal? In the former case, the expanding bank should be reined in; in the latter case, the bankers' best option is to profit from the expansion through the interbank market (and to expand themselves).

Securitization

Securitization is the process by which nonmarketable loans are turned into marketable securities, so-called asset-backed securities (ABSs) (Gertchev 2023, 39; cf. 2009). When they securitize loans, banks transfer loans to special purpose vehicles (SPVs), which are financed by issuing securities. Formally, we may say that the SPVs “buy” the loans from the bank, as they transfer a sum of money (of fiduciary media) in return for the loans.

In this process, Dr. Gertchev (2023, 40) argues, the bank reduces the size of its balance sheet, since both assets (loans) and liabilities (outstanding deposits) contract: “Banks adopt [securitization] because it allows them to sterilize the monetary impact of their bank credit expansion.” Any increase in the money supply consequent on credit expansion is thus only transitory, it would seem.

This explanation of securitization and its role in the financial system does not appear quite right to me. It looks as though money creation is no longer really at the core of banking and is no longer the cause of financial instability. After all, if Dr. Gertchev is correct then any amount of reserves and any size of bank balance sheets could theoretically originate any amount of ABSs without changing the money supply. However, although securitization has the effects Dr. Gertchev shows for the individual bank, on the systemic level, there is arguably still a monetary cause at work. Insofar as the process of securitization does the work Dr. Gertchev ascribes to it, it does so because money creation takes place somewhere else in the economy.

In order to understand this, consider how a bank could deem securitization viable and profitable. There must be demand for ABSs in the market in order to fund the SPVs. Now, this demand cannot come from the banks' own creation of fiduciary media, since these media were transferred to the borrowers. The bank has an interest in reducing its balance sheet the way Dr. Gertchev describes, but it will only transfer its loans to the SPV if it can get a reasonable price for them. If an SPV issues securities in the market, this increases both the demand for present money and the rate of interest, reducing the amount of funds it can raise with any given nominal issue. The SPV can therefore not pay the nominal, book price of the bank assets, and the bank may therefore find that the most profitable option is to keep the securities on its books. (If banks engaged in round after round of securitization, the prices of ABSs would fall and the amount of loans banks could transfer off their balance sheets would quickly fall.) It thus appears that securitization must be funded by a nonbank source of money creation.

The essential question would then be what this source of money creation is. Shadow banking is an apt term for the process of securitization and the realm of ABSs, since both financial assets and the process of money creation are moved out of the traditional banking system and into the shadows. This review is not the place to investigate the question of how money is created in the shadow banking system at great length. However, it would appear that repurchase agreements (repos) function as fiduciary media in the shadow banking system (Gabor and Vestergaard 2016). International Monetary Fund research has also pointed to the role of repos and rehypothecation leading up to the great financial crisis (Singh and Aitken 2010; Singh 2011). Insofar as money creation has shifted to this realm, traditional banks have moved closer to being intermediaries, since they are no longer the only (or even the most important) locus of money creation. The role of shadow banking would also explain one difference between the US and the Eurosystem that Dr. Gertchev notes; namely, that securitization is used much less in Europe. In the US, the shadow banking system is more developed, both in terms of repo markets and securitization.

Whatever the case may be, securitization cannot stand alone. Unless we want to abandon the monetary explanation of business cycles and financial instability, a source of money creation is needed *somewhere* in the system.

Conclusion

The possible shortcomings of Dr. Gertchev's argument concerning securitization sketched above are not meant to detract from his achievement. *The Evolution of Banking Regulation in the European Union* offers a great overview of the nature and causes of banking regulation. Fractional-reserve banking is bound to lead to financial instability and is therefore bound to trigger more interventions so long as economists and regulators remain unaware of the essential nature of banking and its effects. This is above all an intellectual error, but it has real consequences: the causes of financial stability have not been removed, and banking has become increasingly bureaucratic under the impact of regulation and supervision. Rather than developing into a decentralized and resilient banking system, banking has become ever more centralized and ever more uniform, as all banks are shaped by the same regulations and supervised by the same authorities. If it continues down this path, the Eurosystem will soon arrive at de facto full nationalization of credit. The recent introduction of the EU taxonomy, where the EU grades banks according to bureaucratic standards of greenness (among other issues) is a further serious step in this direction. To bankers, regulation is the price they have to pay for the privilege of creating money; for Europeans at large, it is destructive of their incomes and capital and of harmonious social and economic development.

Submitted: October 02, 2024 CDT. Accepted: October 18, 2024 CDT. Published: December 12, 2024 CDT.



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