

King, Mervyn – The End of Alchemy

Little, Brown, 2016, [*Economics*] Grade ★★★★★

The scope of this book is ambitious. Mervyn King, the former Governor of the Bank of England, aims to explain the financial crisis and the state of the global economy today, he proposes a reset of the construction of the banking sector and attempts to transform the understanding of economics to better function as a practical tool for central bankers and politicians. The book targets the “interested general public” and while the language is unpretentious and simple enough some background knowledge of economics is advisable.

After a very promising and interesting introductory chapter covering the standard story of the financial crisis minus the blame game, a teaser of what King refers to as the alchemy in the banking sector plus a number of observations on today’s economic situation the book separates into two parts – the first addressing banking in chapter 2 to 7 and the second economic policy in chapter 8 and 9.

The discussion on banking is coherently structured but also a bit longwinded. The author presents a number of textbook type chapters on subjects like what money is, the function of financial markets, how a bank works, the role of a central bank and the relationship between nations and money. The chapters are eloquently written and it is obvious that the learned King enjoys expressing himself well and as a true Brit he’s using a fair amount of colonial dry humor.

At the same time the texts are nothing out of the ordinary. If you know something about for example maturity transformation in banks, optimal currency areas etc. this is pretty much how you would describe it. You cannot help but feeling that these chapters are there only as a long introduction to the author’s proposal around the banking system and when we get to this in chapter nine the book is already 250 pages long. The most interesting point in this “second introduction” is the emphasis on money and markets as tools to handle the fact that people due to “radical uncertainty” cannot foresee and plan the future.

Mats Larsson, November 13, 2016

In chapter 7 the text picks up pace. King suggests that Central banks should take on the role of “the pawnbroker for all seasons” for a banking sector with considerably lower leverage and that would be incentivized to hold more liquid assets. The main problem with banks, as the author sees it, is the inherent conflict between the leverage used in a fractional reserve system and the liquidity risks of these depository institutions. At the same time, we today have a situation of massively inflated central bank balance sheets coupled with an ineffective money multiplier. If the multiplier would normalize there could be a distinct risk of inflation and central banks would have to dismantle their balance sheets as a reply. If however bank leverage was reduced when the propensity to spend increased the central banks could sit on their inflated balance sheets indefinitely.

The less leveraged banks would still face some liquidity risks and the “pawnbroker” is there as a last resort but only as banks pay an “insurance fee” upfront and with significant risk adjusted haircuts. This would transfer much of the bank supervision and regulation from the legislator to the central bank – not an unexpected opinion from a central banker. The problem with the suggestion is in my view that the ROA of banks today is so low that to be viable as businesses using lower leverage they would have to double or triple fees and interest rates – not what the economy needs.

The ending chapters on economic theory present a more humble view of central banks as King suggests that the models used to understand and steer economies are wrong. In a way these chapters are less well structured and a bit repetitive but in my option more noteworthy. It is not everyday a senior central banker deviates from economic orthodoxy in this way and I wholeheartedly agree on the mixed blessings of today’s monetary policy. It is always a privilege to take part of the ideas of a man who has spent plenty of time to think deep and new on hugely important topics. You don’t have to agree to enjoy King’s important book.