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'Without fear and without favour'

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Iceland's daring raid on fractional reserve banks

Reykjavik considers wresting money creation from financial sector

Few states have a smaller population than Iceland. Even fewer operate their own monetary system. Economies such as the US or Japan have no difficulty persuading the world to hold dollars or yen. For Iceland – population 300,000, gross domestic product about $15bn – the sales pitch for the krona is rather less obvious.

Yet between 1994 and 2008 the global supply of Icelandic krona erupted by 900 per cent. This was not caused by soaring demand for fish, aluminium or geothermal heat. Instead, after the deregulation of its banks in 2001, this tiny nation turned itself into a highly leveraged financial centre. Buccaneering Icelandic banks harvested deposits from around the world, to deploy on amassing a trove of foreign assets.

After the spectacular bust, Iceland is willing to contemplate any action that would prevent a repeat debacle. Having decided against scrapping its currency, the government in Reykjavik now mulls a complete ban on its banks creating krona when they issue new loans. Growth in the money supply would become a matter of government policy alone.

The official report exploring this idea examines the tools that were meant to have kept a lid on Icelandic monetary growth. All are found wanting. Capital requirements do not bite when asset markets are bubbly. The Basel rules give too much leeway for optimistic valuations. Higher interest rates do little to deter speculation. The report finds that only "sovereign money" can inoculate the economy against the uncontrollable Viking spirits of its banking class.

In this system the state has a complete monopoly on legal tender. Banks can only lend what they have previously gathered in state money. Money created "out of thin air" – the devilish secret at the heart of fractional reserve banking – becomes a relic of the past.

This is not a new idea; in the 1930s, a group of US economists called for banks that were backed by 100 per cent reserves. As well as bringing the credit cycle to heel, they claimed this would consign bank runs to history (a natural preoccupation in the Great Depression). Other advocates see sovereign money as a way of diverting credit from pointless speculation towards worthy business investment.

This proposal may give Reykjavik more reliable monetary tools, but provides it with no guarantee that they will be well used. Iceland has a dismal monetary history, including a bout of inflation so severe that the old krona was replaced with a new one in the early 1980s. Sovereign money may force banks and their shareholders to think harder about the loans they issue, but does not on its own dispel the spectre of speculative excess. Money is whatever is widely accepted, be it gold, bitcoin or the immovable circular stones of Yap in Micronesia. After all, the Icelandic banks' most spectacular raiding party took place in Britain, where they hoovered up billions of sterling deposits from credulous local authorities, only to waste them on an array of overpriced retail assets. The krona played little role in that particular saga.

In recent years Scandinavian central bankers have shown the same dauntless appetite for exploration that once saw Nordic ships fan out across the globe. In this spirit Reykjavik should give sovereign money a shot. Nations far bigger and meaner than Iceland have struggled to come to grips with financial excess through conventional means. As well as showing other countries a potential way forward, by bringing the axe down on fractional reserve banking the Icelanders might just regain some control over their economic destiny.

Letter dated April 13th 2015

Iceland's proposal dates back to 1933

Sir, The proposal from Iceland ("Iceland's daring raid on fractional reserve banks", editorial, April 10) is indeed an old idea that surfaces from time to time. It dates from 1933, goes under the name of the Chicago Plan and was inspired by (the little known) Henry Simons.

The concern is with periodic excesses as banks become overleveraged in a business cycle upswing. The most notable supporter was Milton Friedman, who wrote in 1985 that he had "not given up advocacy of 100 per cent reserves", but he was "very sceptical" of it ever becoming politically possible.

The practical problem, now as when stated by Simons, is "the reappearance of prohibited practices in new and unprohibited forms". In modern parlance, "shadow banking" takes the role denied to *bone fide* commercial banks.

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