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HEARD ON THE STREET

Central Bankers Versus the Market: Who Would Lend Better?

A radical idea from the 1930s about controlling credit growth is being put to a vote in Switzerland

By Paul J. Davies

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Imagine giving a committee of central bankers direct control of how much lending happens in an economy.

Sound disruptive? Vulnerable to political meddling? Well, Swiss voters could make it happen on June 10 in one of the country's many referendums.

A vote in favor would transform how banks function and likely cut profits on lending. But local bankers aren't hyperventilating yet. The Swiss tend to reject crazier popular initiatives. In recent years, for instance, they voted against proposals to force the central bank to hold 20% of its assets in gold bullion and ban financial speculation on food.

However, the banking proposal isn't completely mad. Since the 2008 crisis, several countries have discussed similar ideas as a way to tame boom-and-bust credit cycles. Some mainstream media have promoted such changes, including the Financial Times.

A member of the sovereign money initiative sprays a slogan in front of the Swiss National Bank in Bern, Switzerland, on April 27. The slogan reads: "Please remember why we founded you." **PHOTO:** DENIS BALIBOUSE/REUTERS

Full-reserve banking means all instant-access deposits, like checking accounts, are backed by central bank reserves, so people's money is always safe. The U.S. came close to introducing full-reserve banking in the 1930s as a way to stop bank runs. Ultimately, it created deposit insurance instead, as have other countries, including Switzerland.

Swiss campaigners are more interested in preventing credit bubbles. Their proposal would mean banks can decide who gets to borrow and how, but they would have to back loans with longer-term funding—like peer-to-peer lenders do. Banks couldn't lend money they don't have, which is how they create money today.

Instead, only the central bank could create money, giving it control over the amount of lending. Today, central banks control the price of money through interest rates, but let the market (in the form of banks and borrowers) work out how much money the economy needs.

One worry is that the central bank could be slow to respond to demand for credit, restricting supply. Bankers, driven by profits, may be quicker to act on moneymaking opportunities.

The proposal would likely hurt lending profits because longer-term funding is more expensive than ultracheap ordinary deposits. That said, it wouldn't affect private banking or international operations, so the biggest Swiss banks, Credit Suisse , Julius Baer and UBS , would be somewhat protected.

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A change wouldn't crimp lending straight away because, by chance, Swiss deposits are currently more or less matched by central bank reserves. That is a side effect of all the money printing done to hold down the once-soaring Swiss franc and promote inflation. Switzerland could turn on full-reserve banking tomorrow and banks overall would roughly meet the requirements.

The real risk isn't that credit growth could be slow in an improving economy, but that it might be harder for the central bank to restrict lending when things get too hot.

The Swiss central bank is independent, like its equivalents in the U.S. and U.K. But if it has to decide when to turn credit off—which could directly cut growth and cost jobs—the temptation among politicians to step in would likely be too great to resist. There is no guarantee that politicians or central bankers make better decisions than the market.

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