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RESEARCH SUMMARY

Governing the Financial System: A Theory of Financial Resilience

The 2008 financial crisis has sparked a renewed discussion of ways to combat financial instability. In "Governing the Financial System: A Theory of Financial Resilience," Alexander W. Salter and Vlad Tarko argue that a system of multiple, interlocking financial regulatory institutions—a polycentric system—could be a more effective policy tool for combating potential instability of financial and banking systems, which are largely governed today by top-down regulatory institutions (a monocentric system).

LESSONS FROM FREE BANKING SYSTEMS

Institutional resilience is key to stable governance and is defined by robustness (the ability to absorb and recover from shocks) and adaptability. Contrary to their reputation for instability, banking systems in which banks issued their own money and operated without oversight from a central bank (free banking systems) were remarkably resilient, in large part because of three nested mechanisms:

- *The distinction between the medium of redemption and the medium of exchange*. Today, money created by the central bank is the medium of redemption, but it can also be spent in the economy as the medium of exchange. In a free banking system, each bank printed its own currency but held the medium of redemption (historically, gold or silver) in its vault. Since an inability to fulfill withdrawal (redemption) requests would require a bank to sell its assets to meet demand, this encouraged banks to maintain adequate liabilities in circulation to meet the needs of trade.
- *The interbank clearinghouse* enforced minimum-quality standards, cleared liabilities, and provided emergency loans to minimize transactions costs.
- *The hard budget constraint*, or the fact that the amount of money in circulation was finite, was the result of *extended liability,* which made the owners of banks liable if banks couldn't meet their obligations. These mechanisms provided strong incentives to banks to avoid taking on too many risky assets.

USING DESIGN PRINCIPLES TO UNDERSTAND ROBUST GOVERNANCE

Whether or not a transition to a fully polycentric banking system is plausible or contemplated, lessons from free banking can improve understanding of what makes polycentric financial regulation resilient, which, in turn, can provide guidance for more effective financial regulation.

Salter and Tarko build upon the broader literature on polycentric governance and institutional resilience, and adapt the Nobel laureate Elinor Ostrom's "design principles" for robust governance institutions to the problem of financial stability. Accordingly, they argue that in a successful system,

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- *Boundaries are clearly defined*, such as those established by clearinghouses and financial exchanges.
- The price system and bankruptcy *match benefits with costs* as banks compete for customers by offering lower prices, but will remain in business only if they can earn enough to cover their costs.
- *Those affected by the rules have the ability to change them*. In free banking systems the banks were self-regulating, whereas currently they do not play a direct role in rulemaking.
- *Those who monitor and enforce the rules are accountable*, such as through members contesting the actions of clearinghouses.
- The price system and the rules for settling property and contract disputes under the common law provide *gradually increasing penalties for breaking the rules*.
- *Low-cost options for dispute resolution* encourage banks to solve disputes without costly legal battles under free banking.
- *Outside authority respects the rulemaking rights of the community*, a major challenge for a financial system with a single, external regulator.
- *Responsibility for governing the system is dispersed through nested levels of governance through the entire system*, allowing free banking systems to accommodate the wide variety of services offered in the financial system in a way that is difficult for top-down regulation.