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Stock Exchanges as Lighthouses

Abstract: Over the years, it has frequently been argued by economists that lighthouses need to be provided by the state. Ronald Coase demonstrated, in fact, that they could be provided privately. The same is true of financial regulation. Though many economists, using blackboard economics, argue that financial markets need to be regulated by the state, it is found that regulatory mechanisms evolve in the market which are effective and stable. It is feasible that a central bank could also evolve as a private institution to regulate the banking sector. Nevertheless, there could be legitimate concern that such institutions will become concentrations of market power or will require legal privileges to operate. In fact, this was one of the concerns that was expressed in relation to the private provision of lighthouses. The analogy between private regulatory institutions such as stock exchanges and lighthouses is therefore remarkably close.

Keywords: the lighthouse in economics, blackboard economics, stock exchanges, central banks, financial regulation

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Before 1986, securities and investment markets in Britain were regulated by a combination of private structures and some ad hoc bodies established for tightly defined purposes.¹ There was no over-arching system of state financial regulation that sought to control and regulate the markets. These informal organisations and non-state bodies had characteristics that Ronald Coase might well have admired. They were then replaced by statutory bodies that use the theoretical economics of the textbook – in Coase’s words, “blackboard economics” – to determine rules and regulations.

¹ For example the Takeover Panel which was a quasi-statutory body.

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This paper will begin by describing the story of the lighthouse and how Coase discovered that lighthouses were adequately provided in England despite relatively minimal government intervention. The regulatory structures in relevant parts of the financial markets before 1986 will then be discussed and related to the lighthouse story. This will be followed by a discussion of the changes in regulation that took place from 1986. Finally, there will be a brief discussion of how a central bank can be organised pragmatically as a broadly private institution in a way that could restrain the development of arbitrary and intrusive bureaucratic regulation of the banking sector.

There are four insights in this paper. The first is that, just as in the case of lighthouses, regulation can develop in financial markets without state bodies being established. Secondly, there may be some circumstances in which private forms of financial regulation are facilitated by legal privileges or exemptions from laws which are applied to other sectors of the economy. Thirdly, in the case of both lighthouses and financial regulation, incentives are more appropriately aligned if the functions are undertaken privately. Finally, there may be problems with centres of market power developing when private bodies provide regulation just as this may also be the case with lighthouses. In the spirit of Coase, we conclude that economists should make judgements about whether private or state institutions better perform the desired functions – in other words they should ask what are the best institutional arrangements?² This is preferable to simply assuming away the possibility of private bodies operating in these fields or developing state regulatory bureaus that try to perfect the market using blackboard economics.

1 Lighthouses – what does not work “in theory” works in practice

At the beginning of his paper *The Lighthouse in Economics*, Coase (1974) mentions a number of leading economists who had proposed that the state should provide lighthouses. Mill, for example, held this view on the basis that, without state help, navigation aids would not be provided because enforcing payment and excluding those who did not pay would be impossible. Pigou made a similar point. Samuelson, took the argument further. He argued that, even if payment for lighthouse services could be enforced, it should not be required. The light

² Dowd and Hutchinson (2014) ask exactly this question in relation to the supervision and provision of support to the US banking system before the development of the Federal Reserve.

from the lighthouse had zero marginal cost and, as such, excluding a ship from the services of lighthouses would be inefficient if the benefit to that ship were greater than zero. In effect, Samuelson was arguing that lighthouses were a pure public good.

Coase investigated the historical provision of lighthouses in England and demonstrated that they were, in fact, provided and that lighthouse fees were actually charged. Furthermore, Coase found that, in practice, the charges were levied in such a way that few ships would have been deterred by the charges at the margin, quite contrary to Samuelson's prior view. In addition, few ships would have benefited from the services of the lighthouse from which a charge was not collected, but from which it would have been feasible to collect a charge, even if the government had been directly responsible for doing so.

Thus, the institutional mechanism that existed in practice for the building and funding of lighthouses solved the problems identified by economists in a reasonable and practical way. The economists who said that lighthouses should be provided by the government according to blackboard economics should have first investigated the historical facts. There was no evidence that the provision of lighthouses was more effective in those countries where the government was responsible. In short, lighthouses in England seem to have had the characteristics of club goods rather than of public goods. Lighthouses were not obviously under-provided and mechanisms that economists believed could not work in theory did work in practice.

2 Financial regulation – what does not work “in theory” works in practice

Economists have argued in favour of state regulation of financial markets just as they have argued in favour of state provision of lighthouses, though with some differences between the reasoning in the two cases. For example, it is often argued that financial markets need government regulation because of pervasive information asymmetries; because “market confidence” has externality effects; because of the problem of “moral hazard”; and because of systemic risk that can lead the financial system to fail if an individual financial institution fails.³

Akerlof (1970), in particular, highlighted the problem of information asymmetries in markets. However, it is worth noting that Akerlof's normative conclusions were rather tentative. Akerlof concluded that information asymmetries

³ See, for example, Llewellyn (1999).

may lead to a situation where government intervention could improve matters, but he also pointed out that private institutions could arise to deal with the problems he identified whilst mentioning that such institutions may themselves give rise to problems such as concentrations of power. This view is reasoned and rational and, as we shall see, leads in a Coasian direction that requires economists to evaluate which is the best of alternative institutional arrangements. This view can be contrasted with the rationale put forward by financial regulators for state regulation of financial markets. In one publication by the UK financial regulator in 2003 (the Financial Services Authority – FSA) it was stated:

In meeting our objectives in a manner consistent with the principles of good regulation, we have adopted a regulatory approach based on correcting market failure ... There are, however, numerous cases where unregulated financial markets will not achieve the best outcome due to some form of market failure, making action on our part necessary. (FSA, 2003)

Starting from this perspective, there is no effective limit on the amount of financial regulation that can be justified because a market can never be perfected and is always subject to what some economists describe as “market failure”.

It would be instructive for “blackboard economists” in this field to examine the forms of regulation that actually developed historically within financial markets. Institutions important in creating a stable order in financial markets included independent professions (see, for example, Booth, 2007; Bellis, 2000)⁴; the development of intermediaries and trustee bodies to deal with information asymmetries; special corporate governance arrangements (such as customer-owned firms and banks with double or unlimited liability for shareholders) to address conflicts of interest; and the use of “reputation” to distinguish between good and bad firms (Macey, 2013) have all been important.

In addition to the above institutions that regulate behaviour in finance, markets can develop their own comprehensive regulatory institutions. Though it is the intention of this paper to examine what happened in practice rather than tie the issues into a body of theory, it is worth noting that these regulatory institutions operated on a club-like basis.⁵ They developed rules to which their members had to adhere. Adherence to the rules came with a cost because the rules involved

⁴ With regard to professions, some of these were effectively products of the market and entirely independent of government, others had government protection. It is because of the prominence of the latter in so many areas that professions have tended not to get praise from supporters of a market economy (see, for example, Friedman, 1962). As we shall see, this issue of government protection and market power is important in the debate about the lighthouse.

⁵ See Buchanan (1965) for the theory of the club good.

the prohibition of certain practices that may have been remunerative to individual members of the club. However, the rules also had a benefit because, if they were obeyed by all members of the club, adherence would enhance the reputation of all the members. In other words, market confidence and trustworthiness can be thought of as a club good and the price of obtaining that good is adherence to the rules (in addition to any membership fees). It is important that free riders cannot operate under the protection of the private regulatory body without obeying the rules: that is, it must be possible to exclude rule breakers.

Below we will examine two such mechanisms in financial markets: stock exchanges and central banks.

3 Private regulation and stock exchanges

In Britain, modern stock exchanges first developed in coffee shops, such as Jonathan's coffee house in Change Alley where a group of 150 brokers and jobbers formed a club in 1761 superseding more informal arrangements that had existed since 1698. This club developed into the first formally (though privately) regulated exchange in 1801 and, the following year, the exchange moved to Capel Court. The characteristics of the stock exchange included restrictions on membership, the publication of prices and lists of stocks that were traded, and the potential for the development of a rule book.

In the early years, the exchange was regulated by convention, reputation and informal rules. For example, when delayed settlement was introduced to increase liquidity, those who did not settle their accounts would be labelled "lame duck" on a board and could be prevented from acting as brokers. It is also worth noting that, in common with other exchanges at various times, the London exchange succeeded in the 1730s in enforcing orderly transactions that were unenforceable in a court of law (Kynaston, 2012, p. 14). This was also the case in Amsterdam, where the exchange facilitated the exchange of forward contracts and short sales that were prohibited by government and therefore unenforceable in law (Stringham, 2003). There were unlicensed brokers in Amsterdam, as elsewhere, that provided competition, but reputation was important in governing business on the market (Stringham and Boettke, 2004).

As Stringham (2014) writes in criticising those who believe that regulation has to come from the government:

But the Amsterdam traders were cleverer than the blackboard theorists... who assert that financial markets emerged because of government. We can see how markets actually worked by analyzing some firsthand accounts, the best of which was published in 1688

by stockbroker, Joseph Penso de la Vega. Written in his native Spanish in the form of a dialogue, *Confusion de Confusiones* is a sort of seventeenth century frequently asked questions, most likely for people looking to get into the stock market. In the book de la Vega describes numerous transactions including short sales, forward contracts, option contracts, and other transactions that occurred even though they were unenforceable in courts of law.

Regulation by reputation is common-place in markets. What was different about stock exchanges, however, was their ability to develop codified rules. This happened in two ways. Firstly, there were rules governing behaviour of members and the quotation of stock prices. Secondly, there were rules for companies listed on the exchange. The latter type of regulation developed rather later. These are precisely the forms of financial market regulation that it is commonly thought necessary for the state to provide and which the state now does provide.

The first codified rule book covering topics such as default and settlement was developed by the London exchange in 1812. This rule book included provisions for settlement, arbitration and dealing with bad debts. There were also rules about general behaviour designed to increase transparency (for example, partnerships amongst members had to be listed publicly) and about the quotation of prices (Davis *et al.*, 2004). Davis *et al.* (2004, p. 12) also reports how the exchange absorbed collectively losses from an event of market manipulation and the inappropriate use of insider information in 1814 whilst ensuring that those who attempted to profit did not gain.⁶ These are now matters that are entirely handled by government regulation.

In 1844 it became a requirement for securities to be sanctioned by the stock exchange committee before being listed on the exchange (Davis *et al.*, 2004). In effect, this was the introduction of the other important aspect of regulation provided by exchanges – rules for the quotation of a company's shares. Indeed, rules for the quotation of a company's shares complement rules in relation to the behaviour of members. Without an orderly market, companies will not seek a listing, and, without reasonable listing rules, investors will be discouraged from trading on the market. At the turn of the twentieth century, these listing requirements then became more onerous.

Until all-encompassing regulation was developed by bodies reporting to the UK government under the 1986 Financial Services Act, regulation remained entirely a private matter. After the Second World War, various Companies Acts were passed which mandated information provision by companies, but, even then, the stock exchange imposed additional requirements on companies quoted on the exchange such as the requirement for interim reports (see Goff, 1982).

⁶ Those gaining from the activity were fined their profits which had to be paid to charity.

The ability of the exchange to determine its own membership and to set the rules by which members work was crucial. The members incurred the costs and reaped the benefits of a well-functioning rule book because it helped to create an orderly market and enhanced the reputation of the exchange. The companies quoted on the exchange also reaped the benefit of an orderly market through, for example, a lower cost of capital and, in later years, companies had to pay for the benefit of being listed. The benefits of those rules were excludable in that the benefits would not be obtained by companies not quoted on the exchange or by those involved in exchanging stocks and shares who were not members of an exchange with a good reputation. Similarly, the costs of the rules would be borne by those trading in the form of membership fees and in the form of the non-pecuniary costs of self-restraint. The costs of self-restraint could be considerable. For example, from 1909, members were prohibited from performing broking functions if they also traded on their own book⁷ – something which reduced the likelihood of conflicts of interest.

A Royal Commission enquiry in 1877–78 illustrates two features that seem to be important in the regulation of securities business. The first is the influence of a small number of important players on the rules that were developed (Kynaston, 2012, p. 91). The second is confirmation of the club-like nature of the exchange. In reporting the outcome of the Commission, Kynaston comments (p. 92):

Pre-allotment dealings remained the norm; settlement and quotation remained wholly within the Committee's jurisdiction; the Stock Exchange remained a self-regulating decidedly unincorporated body; and would-be public spectators remained excluded for another three-quarters of a century. The club, in short, preferred to stay just that [...]

The Royal Commission noted that the exchange's rules "had been salutary to the interests of the public" and that the exchange had acted "uprightly, honestly, and with a desire to do justice" (Royal Commission on the London Stock Exchange, 1878, p. 5 – see Stringham, 2014). It further commented that the exchange's rules were "capable of affording relief and exercising restraint far more prompt and often satisfactory than any within the reach of the courts of law."

Not only were the benefits of the club rules excludable, it was possible for non-members to form a competing exchange with different rules. In practice, however, competition was limited. Developments in technology from the beginning of the 1980s did, however, change this and there is now considerable

⁷ The rules surrounding this issue evolved but were clarified and made explicit in 1909 (see Burn, 1909, and the article reproduced therein from *The Times*, pp. 134–136). This rule involved considerable restraint on behalf of some members, as was made clear in *The Times*' article, but it was considered that it benefited the reputation of the exchange.

competition between exchanges on an international level. Competition also came from other markets that were effective in providing capital to companies. For example, before the stock exchange “club” was broken up in 1986, the euro bond markets had developed without any centralised exchange or regulatory body (whether private or state) and the euro bond markets were an important alternative source of capital to local equity markets for large companies (see Kynaston, 2012).

The state regulation of UK securities markets began in 1986. The state regulation of the US stock exchange occurred well before that of the UK. However, Paul Mahoney (Mahoney, 1997), mainly describing the development of the New York Stock exchange but referring also to others, said:

[I]n summary, many stock exchange rules in the era before governmental regulation were premised on the idea that to attract investors, the exchange had to provide elementary protection against defaults, forgeries, fraud, manipulation and other avoidable risks. Thus stock exchange rules dealt with most of the broad categories of issues with which modern securities regulations are concerned.

Indeed, the reputation for trustworthiness on the London exchange was such that, in 1923, when it received its coat of arms, its motto was: “my word is my bond”.

4 “Big bang” and so-called “deregulation”

In 1986, the stock exchange system of private rule making was broken open and the London exchange opened to foreign banks. At the same time, the separation of broking and dealing functions was ended. This was known as “big bang”.

The motivation for reform was a belief that the restrictive practices on the stock exchange were causing it to lag other international exchanges (see Creaven, 1992). The sweeping away of the various restrictive practices (limitations on entry to the market, fixed commissions and the separation of trading and broking) followed an agreement with the government that led to the suspension of a 6-year-long enquiry by the Office of Fair Trading which had previously had its powers extended to include service industries.

Big bang is widely regarded as a process of “deregulation”. That the so-called deregulation of the City of London arose as a result of challenges to the existing structures from the competition authorities is significant. Whether this action was right or wrong, Akerlof can be thought of as being rather perceptive

in identifying the issue of market power as a potential problem in privately provided systems designed to deal with information asymmetries in markets. Essentially, in 1986, the competition authorities removed from the private institutions that regulated the market their ability to exclude members and their ability to set rules (such as commission levels, separation of trading and broking, etc). This breaking up of private regulation was followed by the development of government regulatory agencies which had arbitrary and more-or-less unlimited powers to regulate to correct what many perceived to be market failures.

There are many similarities between the regulatory situation in securities markets in 1986 and Coase's observations regarding lighthouses. Two are perhaps especially noteworthy. Firstly, it is widely thought amongst economists that state regulation of securities markets is necessary – in other words that the market cannot provide regulation through institutions that arise from within the market. The assertion that state regulation is necessary tends to be justified through the application of blackboard economics in exactly the same way as it was argued that lighthouses were a public good according to economic theory. Secondly, there seems to be a lack of curiosity amongst mainstream economists about the history and economic nature of regulation in financial markets. In the same way that Coase's paper on lighthouses described the situation that actually existed in practice after other authors had said that lighthouses could not be financed privately in theory, there seems to be general denial of the most basic facts regarding financial regulation in the UK up to 1986. What is often described as a process of "deregulation" to promote free markets in 1986 was, in fact, a process of prohibition of private regulation and its replacement by state regulation.

Even though the state has taken over regulatory oversight in all developed countries, exchanges still do exist to provide different and competing regulatory environments for listing and trading though all have to enforce state regulation. Especially in the field of listing requirements for companies, there is still some discretion for exchanges to develop their own requirements. For example, the Alternative Investment Market (AIM) is a relatively lightly regulated market in the UK (see Stringham and Chen, 2012), and there are markets that perform similar functions in the US such as NASDAQ. Indeed, a number of companies that are quoted on AIM are small enough for statutory regulatory requirements not to apply to them. And yet, as Stringham demonstrates, AIM is successful as a regulatory environment. At the same time, there are markets which have much more detailed and onerous rule books for quoted companies (in addition to the requirements of statutory regulators) such as the London stock exchange main market.

5 The further development of statutory regulation

Soon after big bang in 1986, there was a huge extension of the regulation of securities markets as a result of the Financial Services Act 1986 which came into operation in 1988. Goodhart in Seldon ed. (1988) suggested that just one rule book that was developed as a result of the 1988 Act, on one aspect of regulation, weighed around two kilograms. The Act itself is reproduced in 230 pages (not including the associated regulations) in the standard textbook by Wedgwood *et al.* (1986).

The Financial Services Act 1986 established that the Securities and Investment Board (SIB) would be responsible to the Secretary of State. The act followed the Gower Report, *Review of Investor Protection*, published in 1984. The SIB's powers were very wide-ranging. It authorised businesses, intermediaries and individuals and gave recognised status to professional bodies whose members could carry on limited *de minimis* regulated activities under the supervision of their professional body. Matters which were previously governed by common sense, ethical codes, private stock exchanges or professional bodies became regulated activities under the Financial Services Act.

In describing the transition Sir Kenneth Berrill, first chairman of the SIB, said that the City was no longer a place “where you look after yourself according to a code of honour or conduct. It is a tough regulatory system” (Hilton, 1987, p. 48). Lomax (1987) stated: “There is a substantial risk, in fact, that we now have massive overkill of the supervisory structure in the financial industry” (Chapter 3, section 9).

The market moved from polycentric and largely private systems of regulation, to a system of regulation that allowed rules to be spurned with little accountability. Goodhart, commenting soon after the Financial Services Act (in Seldon ed., 1988), felt that standards could have continued to have been maintained in most areas through the use of “clubs” with perhaps some small role for the state in regulating entry standards where this was not effectively done.

Since 1986, financial regulation has become even more centralised and, arguably, the powers of the regulator have become more arbitrary. In 2001, the FSA was given power to regulate the whole UK financial sector, and it is impossible to perform any function in securities markets without being regulated by that body.⁸ There are probably millions of paragraphs⁹ of financial

⁸ Regulatory functions were re-organised in 2013.

⁹ It has been calculated that there are 4,000,000 words from one of the bodies alone that succeeded the FSA (see: <http://www.conservativehome.com/thecolumnists/2014/10/lord-flight-regulation-the-collectivist-wolf-in-sheeps-clothing.html>).

regulation and in the last year of its operation (before the regulatory functions were divided between different statutory bodies) the FSA had a budget of £547m.¹⁰ By 2013, the body had accrued powers to regulate areas of financial activity, such as mortgages and non-life insurance, that had been entirely free of regulation in the past and in relation to which there had been no clear problem that required statutory regulation. Bank of England Chief Economist Andrew Haldane noted: “In 1980, there was one UK regulator for roughly every 11,000 people employed in the UK financial sector. By 2011, there was one regulator for every 300 people employed in finance.” (Haldane, 2012). There has been a similar trend in the US, where it is commonly suggested that the regulations arising from the Dodd Frank Act enacted following the financial crash will run to around 30,000 pages (see, for example, Dowd and Hutchinson, 2014).

As noted above, the FSA justified its approach according to the blackboard economics concept of “market failure”. However, statutory regulation effectively displaced the evolution of institutions within the market that could have improved the workings of markets, perhaps in a more satisfactory way. We know from the historical evidence that institutions of regulation can evolve within securities markets. One interesting issue, in the wake of the financial crisis, is whether the same could happen with regard to the regulation of banks. In the next section we look briefly at this.

6 Could bank regulations be provided by market institutions?

As Coase taught us in *The Economics of Lighthouse*, it is important to look at the past in order to discover what actually happened, rather than rely on our textbooks to tell us about what can only happen in theory. It is also important to consider conceptually how we might apply our economic knowledge to solve new problems. In this section we consider briefly the possibility of understanding central banking and banking regulation as a club good.

Different schools of thought attribute the development of central banking to different origins. On the one hand, it is often suggested that central banks arose from the desire of the state to monopolise the money supply. On the other hand, it has been suggested that they were a natural evolution of a monetary system that needed a “banks’ bank” (see Congdon, 2009). This article does not make a

¹⁰ See, annual report and accounts: <http://www.fca.org.uk/static/documents/annual-report/fsa-annual-report-12-13.pdf>

judgement on that debate though it should be noted that central banks are certainly not a purely private phenomenon, even when they are privately owned and governed – they are given certain statutory powers and monopolies by government. However, in making a comparison with the case of lighthouses in Britain, it should also be noted that lighthouses were also not provided only by a purely private club: Trinity House had certain privileges granted to it by the state.

Central banks have, at some points in history in some countries, had club-like characteristics in their relationship with clearing banks. This was certainly so in Britain in the nineteenth century. Congdon argues that such club-like characteristics could be enhanced by simple reforms which could make both the regulatory system for banks more independent of government, make it more responsive to the needs of participants and also make it more effective. The Bank of England will be used as the example in this section – other central banks have different origins, histories and *modus operandi*.¹¹

In 1844, the Bank Charter Act gave the Bank of England a quasi-monopoly of the note issue though, importantly for our argument, it was privately owned. The Act also restricted the note issue to a fixed amount plus an additional sum that had to be backed by gold. This gave the Bank of England a privileged position (in the literal sense of the word “privileged”) and enabled it to lend against collateral to other banks when they could obtain no other source of finance. The ability to lend in this way was enhanced because, in a crisis, the Bank Charter Act was often suspended (for example in 1847, 1857 and 1866) allowing the Bank of England to extend its note issue.

In effect, the Bank of England became the head of a club of financial institutions. If a member of that club was illiquid but solvent, the Bank of England could come to its rescue by lending against collateral. If the Bank of England considered the behaviour of the club member seeking help to be inappropriate or if it thought that the solvency of the member was in danger then help could be refused. Indeed, that is precisely what happened in the case of Overend Gurney in 1866. Describing this incident, Kynaston (2012) writes:

Should the Bank have stepped in? Once it became clear that Overend Gurney required assistance to survive, it appointed a committee ... to scrutinise the books. The three wise

¹¹ Dowd and Hutchinson (2014) describe a purely private system of support for banks in the US before the development of the Federal Reserve which was not dependent on a central bank at all. Given that the story of the lighthouse did not involve purely private provision with no state involvement, the analogy with the Bank of England in nineteenth century Britain and how it could be reformed today is adequate for our purposes.

men determined that the business was rotten beyond redemption and no helping hand was held out.

Then, relating the refusal of the Bank of England to assist with Overend Gurney's earlier decisions not to play by the implicit rules of the club, Kynaston continues: "Overend Gurney had once very much been members of the club ... but it was a club that would never condone such bear-faced tactics directed against its *ex officio* chairman".¹²

This emphasises what we have noted already in the case of exchanges. There were significant concentrations of market power in this system. In effect, the Bank of England could determine whether a given firm should survive or fail.

The Bank of England was nationalised in 1946, and its role has changed. Indeed, in 1997 it was stripped of its power in relation to the regulation of banks and the issue of government debt, though it has since regained the former. Congdon (2009) proposes not just a return to the principles by which the Bank of England operated before 1946 but an extension and formalisation of that role.

Congdon suggests that the Bank of England should have its capital provided by the clearing banks it regulates.¹³ There thus would be a formal club of banks with the Bank of England regulating its members for their mutual benefit.¹⁴ In return for the banks following the regulation set by the central bank, the central bank would provide lender of last resort facilities on an explicit contractual basis to those banks which became illiquid but were solvent. This would operate entirely privately.¹⁵ The members of the club would own the central bank that sets the rules; the banks would have to follow the rules for the benefit of the whole club to ensure the safety of the banking system; but the members of the club that were short of liquidity would receive support through lender of last resort facilities if they kept the rules. It should also be noted that Congdon argues that those banks that do not wish to submit themselves to the regulation of the Bank of England could choose not to do so and would not receive lender of last resort support. Any counterparty dealing with such banks would be aware of this.

Essentially, Congdon proposes a system that would take a "market failure" problem identified by "blackboard economics" (externalities arising from the

¹² The governor of the Bank of England.

¹³ What follows is my interpretation of Congdon expressed in the language used elsewhere in this paper.

¹⁴ To protect the payments system – classically, the most important reason for regulating banks.

¹⁵ Though it should be noted that the ability of the central bank to play this role depends on its legal privilege as a central bank that can print money.

risk to the whole banking system of an individual bank failure) and proposes a solution that involves all parties agreeing to an institutional arrangement that would internalise the externality (to use the jargon of modern economics). This is not, itself, a “blackboard economics” solution dreamed up by Congdon, but a proposed evolution of arrangements that arose in the market in the nineteenth century, albeit encouraged by the legal privilege given to the Bank of England. It would, it should be noted, give substantial market power to the Bank of England, though in principle it would be constrained by the club members who provided the capital and determined the governance of the organisation as well as by the competitive threat from banks who chose not to join the club. As we shall see in the conclusion, there are several analogies with the lighthouse here.

7 Conclusion

In the story of the lighthouse, Coase showed that a system that blackboard economists believed to be not possible in theory actually developed in practice. There is a similar, though not identical, situation in financial markets. It is widely believed by economists who use a blackboard, market-failure-type approach that financial markets require state regulation. However, if we look at the historical practice, we find that financial markets regulated themselves. Furthermore, it is possible that banking regulation could be provided by an independent, privately-owned central bank without direction from the state. It is worth noting that there are still several examples of club-based financial regulation operating internationally (for example, the International Swaps and Derivatives Association) and also examples of private regulation – though very much under state supervision – such as the UK’s AIM.

There are several further interesting parallels between the examples found from financial markets and the study of lighthouses.

1. In the case of both lighthouses and the central bank in Britain, legal privileges were given to key players and this might have been necessary for the system to work effectively.¹⁶
2. In the case of lighthouses, Coase notes that, if lighthouses were financed by direct taxation, their building, administration and operation would not necessarily be carried out in the interests of lighthouse users. Congdon

¹⁶ Bertrand (2006) argues that the system Coase identifies as being successful relied on special privileges granted by the state. It should be noted there were no privileges granted by the state in relation to stock exchanges.

makes an exactly analogous point in justifying the provision of capital to the central bank by the banking sector that the central bank regulates. And the same argument could be made in relation to private versus state regulation of securities markets.

3. In all three cases – lighthouses, central banks and exchanges – issues of market power arise. It is interesting to note that, as early as 1801, those brokers who were excluded from the stock exchange petitioned parliament to ask the government to force the exchange to be opened to all members of the public (Stringham, 2002). However, the opponents of a bill that was drafted to that effect argued that private rules had to be enforced if the institution was to thrive. In this context, it is also important to note, as is discussed in Burn (1909), that it was possible to deal in stocks through non-members of an exchange – there was no monopoly, though only member brokers and dealers (jobbers) were considered as being beyond reproach. Indeed, it was a competition enquiry which ended the stock exchange's role in financial regulation in 1886. Also, when the Bank of England acted as a banker to the club of banks, it was in a position where it could use its power to decide whether to allow a bank to fail (or otherwise). It is also the case that the provision of lighthouses became gradually more centralised under the jurisdiction of Trinity House. In this context, it is worth highlighting again the concern of Akerlof (1970) that institutions that develop within the market to deal with problems such as information asymmetry might accrue significant market power to which there might be objections.

Indeed, this point is perhaps the key issue for discussion. The debates surrounding financial regulation have tended to assume that markets cannot develop their own regulatory institutions. We should not be debating this question because the history demonstrates that they can. It is, however, worth debating two different questions. Firstly, the empirical matter as to whether private financial regulation is better than state regulation. Secondly, there is the question of whether private regulation, in certain circumstances, gives rise to an undesirable concentration of power in private markets. This is precisely the point that Akerlof makes.

As it happens, in financial markets the concentrations of power were in the process of being dispersed at the very moment the state stepped in after nearly 300 years of private regulation (Kynaston, 2012 pp. 567–568). Furthermore, since the power to regulate financial markets moved from the clubs to the state, the regulator has accrued power with few checks, grown its budget and grown the number of employees at a rate that few would have anticipated in 1886. At best, concentrations of power within the private sector have been replaced by concentrations of power in state bureaucracies.

Nevertheless, there is a debate about which of the alternative institutional mechanisms is desirable. This is a debate which Coase would have believed it important to conduct. What economists should not do is assume that what clearly has happened cannot happen – whether this be in the City or the sea.

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