Introduction

This book aims to offer “a general theory of the financial sector rent.” (8, 186) The specific objective, however, appears to be to reduce bank fragility. The writers take it for granted that fragility is not caused by poor management or fractional reserve banking, but by insufficient bank profits. It follows, therefore, that increasing bank profits should solve the problem of bank fragility:

bank rent opportunity, mainly created and maintained by the regulatory framework, should be given to banks as an incentive mainly for absorbing the transaction cost. Furthermore, the rent opportunity would function as a buffer or cushion to absorb the unexpected loss arising from uncertainty. (183).

It is not stated why “transactions expenses” or “unexpected losses” of banks ought to be paid for using “bank rent” rather than from general bank revenue known as “interest income.” Neither is it made clear why government is particular should use government regulations to increase bank profits by “giving” bank rent opportunities to banks.

This is surprising. What is equally surprising is the way the writers propose to raise bank profits. For they suggest raising bank earnings not by attaining higher efficiency, which is the standard way of raising profitability, but rather by way of government legislation:

Governments can create rent for privately managed banks by setting the ceiling for deposit rate and the floor for lending rate (if required). At the same time, rents should be maintained by limiting excess competition because
fierce competition among financial institutions in the developing stage of finance may create financial fragility ... Rent, thus created and maintained, should function as a managerial incentive toward monitoring borrowers and expansion of financial infrastructure. (185-186).

In other words, ensuring bank rent for banks should take place by the use of price floors and price ceilings. There should be a minimum rate for lending, and a maximum rate on savings. The minimum rate for lending should be higher than before while the maximum rate for saving should be lower than before. In other words, higher profits for banks would be ensured by widening the gap between the two rates, known as the “interest rate gap.”

This extra profit of banks would not be normal profit. The authors refer to this “extra profit” as “bank rent.” Profits referred to as “rents” are typically earned in industries where competitiveness is restricted, such as monopolies and oligopolies. However, there are problems with this proposal.

First, referring to “profit” as “rent” is unhelpful. For there is a difference between “rent” and “profit.” Secondly, the proposal to ensure higher bank profits by means of government intervention is that normally, protection in the form of price ceilings (maximum prices) or price floors (minimum prices) is extended to the poor.

The authors propose to guarantee “extra” profits to banks, whose shareholders already tend to be wealthy. This appears to be the case of “taking from the poor and giving to the rich,” a reverse of welfare as it is typically understood.

The book has nine chapters, an Introduction and a Conclusion. It comes with References and an Index. The first four chapters explain “bank rent” while the last five consist of empirical case studies from Sri Lanka, Bangladesh, Malaysia, Indonesia, Pakistan, China, and Japan.
**Definitions**

The way key expressions are employed in this text tends to be problematic. Rent is payment for the temporary use of an asset. Not only is it not used in this sense by the authors of *Banking and Economic Rent in Asia*; it is defined in different ways in different places. For example, “rent” is defined as “interest rate spread” on page 79.

Now “rent” and “interest rate spread” are very different things. Moreover, on pages 3 and 181 “rent” is defined in yet another way, as “excess income.” There is a difference between “rent” and “excess income.”

The definition of “bank rent” fares no better. “Bank rent” is defined as the “spread margin” on page 158, but on pages 24 and 182 it is defined as “extra profit.” To make matters worse, not only is the term “rent” used interchangeably with “profit,” the term “rent” is also used *interchangeably* with the term “bank rent.” Such confusion in the use of key terms is hardly helpful in understanding this book.

It appears that what the writers have in mind by “bank rent” is “economic profit.” Economic profit is earned in an environment of restricted competition. The “economic profits” of the banks are represented by graphs (17 and 18).

**New Institutional Economics**

The authors base their work upon the “New Institutional Economics,” (NIE). This model:

advocates for creating (*sic*) and maintaining sufficient ‘rent’ for banks. ‘Rent’ is defined as excess income which does not exist in a new classical competitive market. Excess income is supposed to work as incentive for undertaking prudential screening and monitoring … (2-3)
Ensuring higher profits for banks is to be realized by regulatory fiat, through raising borrowing rates and reducing savings rates by legislating price floors and ceilings, as well as by restricting competition in the banking sector:

In effect, the authors propose reducing bank fragility by increasing bank profits. This is fine, but to do so through regulation seems to be more than a little problematic. For price controls disable the price mechanism and thereby impair the efficient allocation of resources, in this case capital. Moreover, to restrict competitiveness in the banking industry is to facilitate the emergence of monopolies and oligopolies.

The book proposes “Islamic” bank rent for Islamic financial institutions. But in Islam interest is proscribed. Thus, reducing bank fragility by widening the gap between the rates of interest is not an acceptable response from the Islamic perspective.

The right way to reduce fragility of banks is to utilize equity financing. However, this would require banks to transform themselves into “businesses” that participate and take risk in the real sector.

**Equilibrium in banking?**

The argument that the governments should regulate interest rates because equilibrium “is simply a utopia” (13) is also problematic. Equilibrium fails to take place in banking is because earning a profit in the money market requires two prices, the borrowing rate and the deposit rate. The reason for this is that in banking, debt itself has become an object of trade.

Because loans are traded in banking, the rate required for “selling” it (borrowing rate) has to be different from, and higher than, the price required for “buying” it (deposit rate). Having a single “price” in banking would entail eliminating the gap between the deposit and the borrowing rates.
Without charging higher rates to borrowers than what they pay to depositors, banks would earn little profit. For most bank profit comes from interest income and interest income comes from the difference between the amount of interest the bank receives from borrowers and what it pays to depositors.

Even having a single price does not guarantee that an equilibrium will take place. For equilibrium to take place, the price must be allowed to fluctuate. Equilibrium takes place as follows. If the quantity demanded exceeds quantity supplied, a shortage arises, and the price rises until demand equals supply. For as the price rises, the quantity supplied also rises, but the quantity demanded declines.

If the quantity supplied exceeds quantity demanded, on the other hand, a surplus arises, and the price declines until supply once again equals demand. For as the price declines, the quantity supplied declines with it, but the quantity demanded rises. This process takes place assuming all other factors remain constant.

But in the capital market, there are always two prices: one for borrowers and another, lower price for depositors. For this reason, equilibrium in the debt market becomes not just “elusive” but impossible. For there is no way to bring about an equality between demand and supply in a market where the price for suppliers differs from the price for buyers. For a transaction to take place, buyers and sellers must agree upon the price at which the transaction will take place.

A market with two prices, one for the demand for loans (borrowers) and another price for the supply of loans (depositors) will be in a condition of enduring disequilibrium. The latter would in turn prolong the harmful effects of the disequilibrium on economic activity.
The reason is that having two prices reduces the total amount of funds saved and demanded. This reduction in the amount of funds available for consumer spending and business investment reduces macroeconomic efficiency by reducing spending, production and employment levels.

The way to achieve equilibrium in the capital market would be to eliminate the two prices. But eliminating the spread between interest rates would prevent banks from gaining interest income. That is why the real answer to the problem of a lack of equilibrium in banking is to adopt interest-free finance, where this problem does not arise in the first place.

**Interest and economics**

The presence of interest in economic theory and practice represents what Thomas Kuhn termed an “anomaly,” in *The Structure of Scientific Revolutions* (University of Chicago Press, 1996). This anomaly produces a range of harmful effects. These are unemployment, an inordinate gap between the wealthy and the poor, and reduced economic growth in the long term. These effects represent different types of inefficiency. They also reduce people’s well-being.

Bank fragility, as exemplified by the 2007 financial turbulence, resulted from lax supervision of banks by regulatory agencies. The problem was not poor oversight of debtors by banks, but poor supervision of banks by regulators. Deregulation of banks enabled them to take ever greater risks and thereby earn extraordinary profits.

**Conclusion**

According the Kenneth Rogoff in *This Time is Different* (Princeton University Press, 2009, p. 210), in 2007 the executives of the five largest business banks in America divided among themselves $36 billion in bonuses. Yet the “extra profits” did not save banks from
insolvency. These “extra” profits did not reduce bank fragility. In the end, the banks had to be “bailed out” with taxpayer funds.

The implementation of the recommendation made in this work may bring relief to banks. Higher profits for banks would be welcomed by bank shareholders. However, lenders may be less enthusiastic at the prospect of paying higher interest rates on loans. Similarly, depositors would unlikely be pleased by receiving reduced rates on savings.

The authors acknowledge that raising borrowing and reducing saving rates would represent a “welfare loss to the society.” (25) However, it appears that for the authors of Banking and Economic Rent in Asia in any event, the gains to welfare that would accrue to the shareholders of banks justify the reduction in public welfare resulting from higher borrowing and reduced saving rates.