

Wrong doctrine

Tim Congdon warns that the removal of risk from bank balance sheets may aggravate deflationary pressures

Banking is full of paradoxes. Governments and regulators are on a drive to make banks safe, so that the current crisis can never happen again. The catchphrases are that assets should be “de-risked” and balance sheets “deleveraged”, while President Barack Obama has openly applauded the “shrinking” of the financial sector. The US Treasury’s *Principles for Reforming the US and International Regulatory Capital Framework for Banking Firms* includes the stark observation that “higher capital requirements for banking firms are absolutely essential”.

But further shrinkage of bank balance sheets – if taken too far and conducted too quickly – would intensify the most severe global downturn since the 1930s. This may sound odd, but it is as inevitable as the equivalence of the two sides of an accounting identity. The result is a paradox of excessive regulation, that the removal of risk from bank balance sheets (which is supposed to make banks safer) may aggravate deflationary pressures (which will add to the dangers of banking).

Come hell or high water, assets and liabilities must always be equal. The trouble is that in most countries, roughly 90 per cent of banks’ liabilities are to depositors. As far as depositors are concerned, claims on banks have an important advantage over other types of wealth. Because deposits can be used to make payments, they are money. It follows that – to the extent that programmes of “de-risking” and “deleveraging” reduce bank assets, to the extent that such programmes eliminate “toxic assets” and lead to the calling-in of bad loans – they also lower banks’ liabilities and destroy money.

Further, the more zealous regulators are in eliminating risk from bank balance sheets, the more rapid is the destruction of money balances. Economics may be a controversial subject, but virtually everyone accepts that in a recession the rapid destruction of money balances is madness. In the US’s Great Depression of the 1930s, the quantity of money tumbled by 35 per cent in less than four years, or by roughly 10 per cent a year. In the present Great Recession a recurrent pattern across all the major economies is that money growth has fallen and

companies are strapped for cash. If slow money growth is now replaced by outright contractions in the quantity of money, the recession will continue.

The official pressure for higher bank capital/asset ratios and for the related shrinkage of the financial system is having a profound effect on the behaviour of US banks and their customers. In the six months to September, US commercial banks’ “loans and leases” (i.e., their lending to the private sector, more or less, and usually over 70 per cent of banks’ non-cash, non-inter-bank assets) fell from \$7,129bn to \$6,797bn, or at an annualised rate of almost 10 per cent.

Is it too late to restrain the regulators? They undoubtedly see themselves as following the path of righteousness. When Dominique Strauss-Kahn, IMF managing director, proclaims that a “speedy recovery” depends “on cleansing banks’ balance sheets of toxic assets”, he is listened to with respect.

But he has drawn the wrong conclusion. The message of all financial crises is that the priority must be to stop the quantity of money falling and, ideally, to get it rising again. If Strauss-Kahn intends that banks must shed

assets and shrink their balance sheets, he is proposing an agenda that will lower the quantity of money and aggravate the recession.

In the early-1930s, Andrew Mellon, US Treasury secretary, advised: “Liquidate labour, liquidate stocks, liquidate the farmers, liquidate real estate.” The doctrine of liquidationism was exactly the wrong response to the Great Depression. The pressure on banks to de-risk and to deleverage is the modern version of liquidationism. It is potentially just as dangerous. Of course, banks must over time recognise their mistakes and take losses. But the right moment to announce losses is when the recovery is established and banks are making good profits. It would be a tragedy if the paradox of excessive regulation – that the search for safety at individual banks can cut the money supply and aggravate demand weakness in the whole economy – intensified global disinflation in 2010.

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