

BANK RECAPITALISATION COULD ENDANGER THE ECONOMY

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A central theme of the Great Recession is that officialdom has put pressure on banks to operate with higher capital/asset ratios than in the past. The push for more bank capital has been largely at the international level, where the impetus has come particularly from the Bank for International Settlements (BIS) and the International Monetary Fund.

However, some nations have decided to go further. One of the Vickers Commission's most conspicuous recommendations was that British retail banks maintain even higher capital/asset ratios than those prescribed in the 'Basel rules'.

Opposition to the drive for more bank capital has been expressed, sometimes vehemently, by the banking industry. If the banks' target rate of return on capital is a given, it must be true that an increase in their capital requirements obliges banks to charge a wider margin on their loans. In general, bankers want to get on well with their customers and dislike having to widen margins for no obvious reason.

Most economists have little sympathy with the bankers. Indeed, economic theory is notably silent on the optimal structure of the financial system, with an obvious feature of real-world banks – namely their very high gearing (that is, low ratios of capital to assets) – being difficult to explain with the standard tools of neo-classical analysis. Moreover, the overwhelming majority of macro-economic pontification nowadays ignores the role of money and banking in the determination of asset prices and expenditure, and sees no connection between officialdom's demands for highly-capitalised banks and the persistent sluggishness of demand that has marked the Great Recession.

The argument here may therefore come as a surprise. Its main point is that the various exercises in bank recapitalisation are themselves largely to blame for the onset of the Great Recession in late 2008 and the shaky, unconvincing character of the recovery over the last two years. Basic to the argument is a standard proposition in macro-economic theory that the equilibrium levels of national income and wealth (in nominal terms) depend on the quantity of money.

Controversy has arisen about the particular definition of money relevant to this proposition. For current purposes the assumption is that the important money aggregate is a broadly-defined one which embraces all (or nearly all) money-type assets in an economy, but particularly the deposit liabilities of the banking system.

Because deposits are money and because they typically constitute over 85% of banks' total liabilities, and because a bank's assets and liabilities are always the same, any course of official action which causes a contraction of the banking system's assets is likely also to cause a contraction in the quantity of money. This is simply a logical matter, the result of setting out a handful of identities. It follows that, when officialdom raised capital/asset ratios in late 2008 and obliged banks to shrink their assets, officialdom was – perhaps unwittingly – taking steps that would lead to the destruction of money balances.

Alternatively, suppose that governments and regulators realise that money destruction due to banks' asset shrinkage is undesirable in a recession, and ask that the increase in capital/asset ratios be achieved by a round of capital-raising. The amount of capital is to change, rather than the amount of banks' assets. This process sounds much more benign. But – in fact – when someone invests in bank equity, that person has to pay a sum of money from his or her bank account over to the bank in order to register for the newly-issued shares. Evidently, bank deposits in private sector hands must decline so that the quantity of money goes down.

The observations being made in this note may startle. For the last four years the prevailing view has been that bank recapitalisation makes banks safer and less vulnerable to financial instability. That might be so in a long-run context, when banks and their customers have had time fully to reorganise their balance sheets. But – in the short run – bank recapitalisation can be highly deflationary. Recapitalisation should not be forced through at such speed as to precipitate a collapse in the quantity of money.

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