On the paradox of excessive bank regulation

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Since the collapse of Lehman Brothers in September 2008, the Delphic Oracles, politicos and chattering classes of all stripes have been working overtime to make the world safe from banks and, yes, bankers. From many quarters we hear the same refrains: "shrink the banks," "put the bankers in straightjackets" and so forth.

Although less colorful, official pronouncements echo the messages heard on the streets. For example, the U.S. Treasury's Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms (2009) stated that "higher capital requirements for banking firms are absolutely essential." Not surprisingly, the other twenty-six member countries of the Bank for International Settlements in Basel, Switzerland agreed with the U.S. Treasury. In the interest of making banks safer, Basel III was finalized in September 2010. This, among other things, will require banks in member countries to hold more capital than

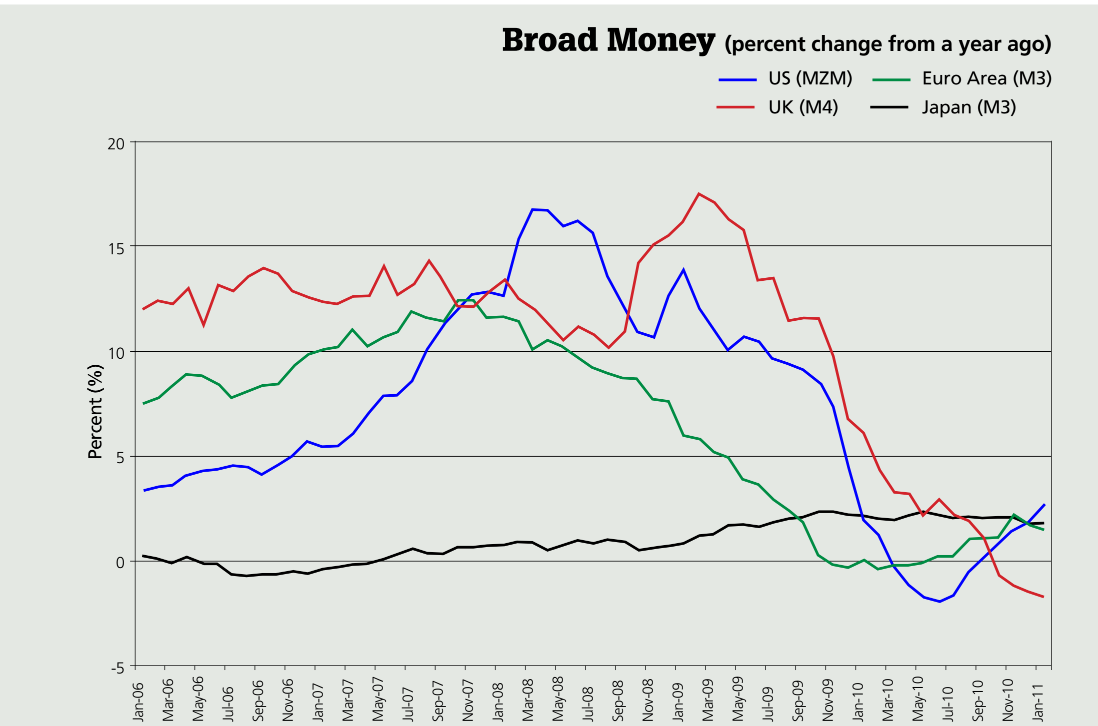
Money and Nominal GDP in the U.S.

Compounded Annual Increase

	M2	Nominal GDP
1960s	7.0%	6.9%
1970s	9.5%	10.2%
1980s	8.0%	7.7%
1990s	4.0%	5.6%
2000s	6.1%	4.0%
Whole Period	6.9%	7.0%

Sources: Bureau of Economic Analysis and Federal Reserve Bank of St. Louis.

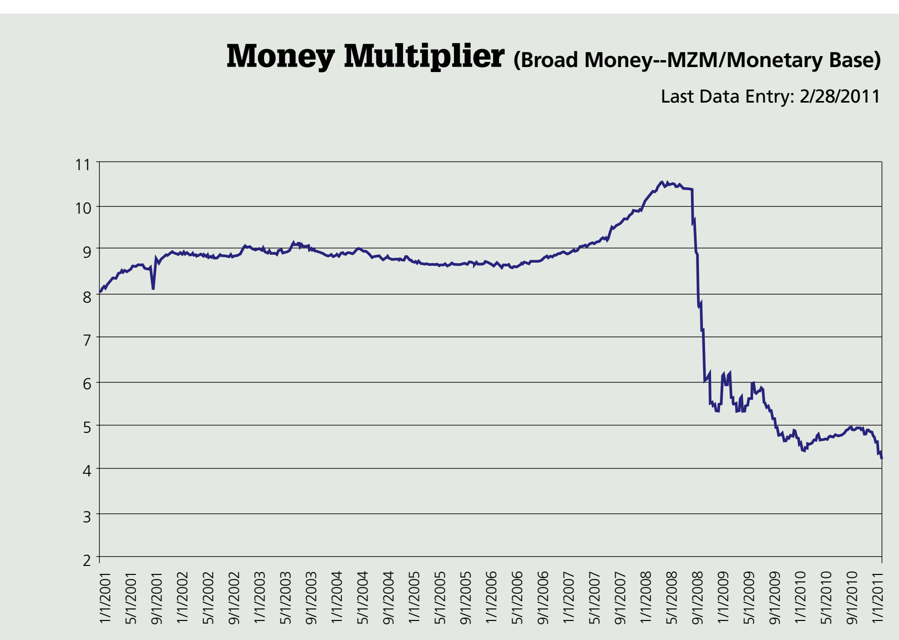
by Steve Hanke



Sources: Federal Reserve Bank of St. Louis, Bank of England, European Central Bank and the Bank of Japan.

under the prevailing Basel II regime.

But Prof. Tim Congdon – the authority on broad money – convincingly argues that Basel III qualifies as "overregulation." Prof. Congdon demonstrates that a paradox accompanies excessive bank regulation. While the higher capital-asset ratios that are required by Basel III are intended to strengthen banks (and economies), these higher ratios destroy money. In consequence, higher bank capital-asset ratios contain an impulse – one of weakness, not strength; hence, the paradox of excessive bank regulation is observed.



Source: U.S. Federal Reserve System *Calculations: S.H. Hanke*

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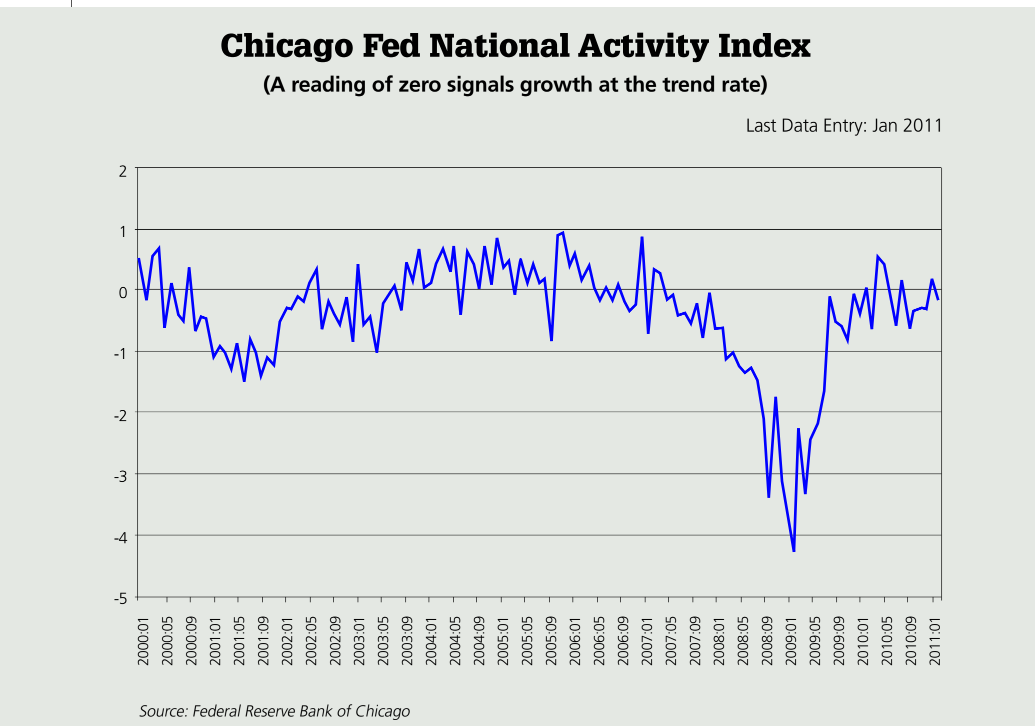
To demonstrate why the paradox exists, we only have to rely on a tried and true accounting identity: assets must equal liabilities. For a bank, its assets (cash, loans and securities) must equal its liabilities (capital, bonds and liabilities which the bank owes to its shareholders and customers). In most countries, the bulk of a bank's liabilities (roughly 90%) are deposits. Since deposits can be used to make payments, they are "money." Accordingly, most bank liabilities are money.

Under the Basel III regime, banks will have to increase their capital-asset ratios. They can do this by either boosting capital or shrinking



assets. If banks shrink their assets, their deposit liabilities will decline. In consequence, money balances will be destroyed. So, paradoxically, the drive to deleverage banks and to shrink their balance sheets, in the name of making banks safer, destroys money balances. This, in turn, dents company liquidity and asset prices. It also reduces spending relative to where it would have been without higher capital-asset ratios.

The other way to increase a bank's capital-asset ratio is by raising new capital. This, too, destroys money. When an investor purchases newly-issued bank equity, the investor exchanges funds from a bank deposit for new shares. This reduces deposit liabilities in the banking system and wipes out money.

As banks ramp up in the anticipation of the introduction of Basel III in January 2013, we observe stagnation in the growth of broad money measures. Given the paradox of excessive bank regulation, this is no surprise. As we can see in the accompanying table, the quantity of money and nominal national income are closely related. Therefore, overzealous bank regulations, such as Basel III, constitute bad economic news because they drag down broad money growth and economic activity.

To appreciate how broad measures of money have stagnated, and at relatively low levels, we present the money growth rates for the United States, the United Kingdom, Europe and Japan in the accompanying chart. And if we want a more dramatic depiction of what is occurring in the U.S. (where quantitative easing has been improperly conceived and implemented), contemplate the sickly-looking money multiplier chart. The Fed is getting very little bang for the high powered base money it produces.

The anemic money multiplier can be laid squarely at the feet of Basel III, as well as new domestic bank regulations. When we move from the international sphere of Basel III to the purely home-grown variety of bank regulations, we find a real monster. This past summer, a 2319-page Dodd-Frank financial reform bill was signed into law by President Obama. This law will be accompanied by a plethora of new regulations and armies of new regulators. How many? No ones knows because the complex rule-making process that is associated with such a Byzantine law has hardly begun and will take years to complete. Talk about generating unnecessary uncertainty!

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President Obama and Ben Bernanke, the Fed's chairman, both champions of Basel III and more bank regulation, would have us believe that a boom is right around the corner. But, don't hold your breath. Government failure plunged the world into the greatest slump since the Great Depression, and overzealous bank regulation – yes, another government failure – has put a damper on broad money growth. In consequence, we can expect a period of modest trend-rate growth, at best. And that is just what the Federal Reserve Bank of Chicago's National Activity Index, which is made up of eighty-five indicators, is signaling.

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