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Relief For Bank Regulatory Madness Might Be On The Way

Steve Hanke

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The economic recovery from the financial crisis of 2008 has been one of the slowest in history. Bank regulations spawned by the crisis (read: the Dodd-Frank Wall Street Reform and Consumer Protection Act) are the main culprit. Indeed, bank regulations have been ill conceived, pro-cyclical and fraught with danger. In consequence, bank regulations have pushed the U.S. down, not pulled it up. And they have made us less, not more, safe.

To understand why, we must revert back to John Maynard Keynes at his best — specifically, his two-volume 1930 work, *A Treatise on Money,* a work that no less than Milton Friedman wrote about approvinglyin 1997.

In particular, Keynes separates money into two classes: state money and bank money. State money is the high-powered money (the so-called monetary base) that is produced by central banks. Bank money is produced by commercial banks through deposit creation.

Keynes spends many pages in the *Treatise* dealing with bank money — not surprising given that, as Keynes makes clear, bank money was much larger than state money in 1930. Well, not much has changed since then. Today, bank money accounts for 82% of the total broad money measure, M4.

So bank money is the elephant in the room. Anything that affects bank money dominates the production of money, broadly measured. And changes in money and credit set the course for economic activity.

We have prepared the stage – now for the play. For politicians, as well as central bankers, the name of the game is to blame someone else for the world's economic and financial troubles.

In the wake of the 2008 crisis, their accusatory fingers pointed at banks and bankers. The establishment asserted that banks were too risky and dangerous because they were "undercapitalized" and “underregulated.” It is, therefore, not surprising that the Dodd-Frank Act passed with flying colors, and that banks are now burdened with more than 22,000 pages of new regulation — and counting. This resulted in a damaging pro-cyclical policy stance in the middle of a slump — just what U.S. did not need. Indeed, all this anti-bank regulatory zeal created a credit crunch.

The U.S. monetary stance has been wrongheaded and schizophrenic. When it comes to the big elephant in the room – bank money – the stance has been very tight. But when it comes to state money, the stance has been ultra-loose. The end result has been one in which state money exploded after the crisis while bank money initially contracted and then stagnated. In consequence, broad money (Divisia M4), which is the fuel for the economy, is growing at a modest 4.8% annual rate.

What makes the post-crisis regulatory zeal so absurd is that it is based on a myth — one identified by John Allison, one of the country's top bankers. Indeed, in his book *The Financial Crisis and the Free Market Cure*(McGraw-Hill, 2013), Allison shines a light on the myth that the banking industry was deregulated during the administration of George W. Bush and that this was a major cause of the financial crisis. As Allison documents, this argument is nonsense. There was a massive increase in regulations that affected banks during the Bush years. The financial industry was not deregulated, but misregulated, with the likes of the Privacy Act, the Sarbanes-Oxley Act, and the Patriot Act, to name but three.

If we return to the regulatory madness associated with Dodd-Frank, we see that, while all financial institutions were put in a vice, community banks were put in a super-squeeze.

Just what constitutes a community bank? For the answers, there is no better source than a Harvard Kennedy School working paper, "The State and Fate of Community Banking," by Marshall Lux and Robert Greene (February 2015):

The full picture of community banking in the U.S. is quite complex. We found that although community banks' share of the U.S. bank-lending market and of U.S. banking assets has declined by about 50 percent in the last two decades, the sector continues to play a vital role in key lending segments. Community banks provide 77 percent of agricultural loans and over 50 percent of small business loans. Agricultural lending, in particular, is a specialty that requires a knowledge of farming, often very specific to the region, to the farm or to the farmer, and a longer-term perspective; agricultural cycles are fairly long. Community banks also play a major role in local real estate lending, particularly for housing, another business where knowledge of local conditions and borrowers is necessary. In 2013, the default rates for loans secured by oneto four-family residential properties ran at 3.47 percent for small community banks (banks with $1 billion or less in assets) versus 10.42 percent for banks with more than $1 billion in assets.

Lax and Greene make it clear that the community banks took a disproportionately big hit as a result of the passage of the Dodd-Frank Act. Indeed, Dodd-Frank created what some community bankers quip is a class of banks that are "too small to succeed."

Fortunately, relief might be on the way. In the next few days, the Senate will vote on the Economic Growth, Regulatory Relief and Consumer Protection Act. It is co-sponsored by a bipartisan group of Republicans and Democrats who have done their homework. Yes, there are a few loud progressives — like Senator Elizabeth Warren (D-Mass.) and Sherrod Brown (D-Ohio) — who have never seen a bank or banker that they didn't love to hate; nonetheless, it looks like the legislation will pass muster in the Senate.

This will be good news for community banks, their customers and the economy. After all, the legislation will, among other things, exempt banks with less than $100 billion in assets from the Federal Reserve's annual stress tests. So for community banks and credit unions, relief from the onerous regulations spawned by the Dodd-Frank Act appears to be just around the corner.

Steve H. Hanke | Professor | Economist | Author | Currency Expert | White House Alum. Steve Hanke is a professor of applied economics at The Johns Hopkins University and senior fellow at the Cato Institute. Over four decades Hanke has advised dozens of world leaders from Ronald Reagan to Indonesia's Suharto on currency reforms, infrastructure development, privatization, and how to tame hyperinflation. He also trades currencies and commodities and was the president of the world's best performing mutual fund in 1995 (+79.25%). He wrote a regular column in Forbes Magazine from 1993 to 2010. He and his wife reside in Baltimore and Paris. You can follow him on twitter @steve_hanke.