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The Chattering Classes' Deadly Cocktail
Steve H. Hanke | October 06, 2011

In my columns of April, July, August and September 2011, I warned that the international push to implement Basel III, which mandates increases in bank capital-asset ratios, is a deadly cocktail to ingest in the middle of an economic slump.

The global sovereign debt crises, and the Greek fiscal crisis, are bad enough on their own. Basel III is just making things worse. If I may summarize past arguments, under the purview of Basel III, banks in the United States, as well as those in the eurozone are shrinking their risk assets relative to their equity capital. The accompanying chart clearly shows the picture in terms of the banks' assets. Risk assets in the United States have all declined since May 2008, while banks' holdings of "risk-free" government securities and cash have soared.

As a result, broad money growth (M3) for the euro area is barely growing and moving sideways, while the U.S. M3 year-over-year growth rate is an anemic 2.3%. And Greece, which is at the epicenter of Europe's current crisis, is facing a rapidly shrinking money supply. These money supply numbers will ultimately be the spike that is driven into the heart of the Greek economy and the false hopes of a peaceful resolution of Greece's fiscal woes (see the accompanying money supply chart).

Not long after I warned of these developments in my September column, the chairman of Deutsche Bank, Josef Ackermann, weighed in during a Frankfurt speech with a blistering attack on raising capital-asset ratios in the middle of a slump. He was armed with heavy artillery — an 123-page special report, titled "The Cumulative Impact on the Global Economy of Changes in the Financial Regulatory Framework," produced by the Institute of International Finance (IIF).

The report from the IIF, which represents 400 of the world's largest banks, concluded that forcing banks to add up to $1.7 trillion in capital to their balance sheets would reduce growth and undermine job creation at a time when the world needs more of both. The loss in GDP in Europe, North America, Japan and the United Kingdom could total 3.2% over the next five years and forgone employment of 7.5 million.

Another banker, Jamie Dimon, chief executive of JPMorgan Chase, has gone even further than the IIF report. In the Financial Times of 12 September 2011, Mr. Dimon suggested that the new Basel III capital requirements are anti-American and that the United States should consider pulling out of the Bank for International Settlements in Basel, Switzerland: "I think any American president, secretary of treasury, regulator or other leader would want strong, healthy global financial firms and not think that somehow we should give up that position in the world and that would be good for our country."

Both Mr. Ackermann and Mr. Dimon are right. The cheerleaders for the imposition of higher bank capital requirements in the middle of a slump, like U.S. Treasury Secretary Timothy Geithner and Fed chairman Ben Bernanke, are wrong.

We can demonstrate the validity of this conclusion with ease. Higher capital-asset ratios are deflationary. If we hold the level of a bank's capital constant, an increase in its capital-asset ratio requires that the level of its assets must fall. This, in turn, implies that the banking system's liabilities (demand deposits) must contract. Since the money supply consists of demand deposits, among other things, the money supply must, therefore, contract.

Alternatively, if we hold assets constant, an increase in the capital-asset ratio requires an increase in capital. This destroys money. When an investor purchases newly issued bank shares, for example, the investor exchanges funds from a bank deposit for the new shares. This reduces deposit liabilities in the banking system and wipes out money.

If Mr. Geithner, Prof. Bernanke and other members of the official chattering classes insist on higher bank capital-asset ratios, the United States might, unfortunately, revisit 1937, when an unexpected recession — a double dip — followed the Great Depression. One contributor to that double dip was an increase in reserve requirements imposed on U.S. banks by the Federal Reserve.

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