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CAN BASEL II ENHANCE FINANCIAL STABILITY?

A Pessimistic View

L. RANDALL WRAY

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Preface

Even as the United States enjoys an economic expansion, there is an undercurrent of concern among economic analysts who follow financial markets. Some feel that the expansion of the credit derivatives markets poses the threat of a crisis similar to the Long-Term Capital Management debacle of 1998. Credit derivatives allow banks to share risks with holders of the derivatives, which are often mutual funds and other nonbank financial institutions.

The Basel II accord, now being implemented in many countries, is hailed as a good form of protection against the risk of a series of bank failures of the type that might cause problems in the derivatives markets. Basel II represents a more sophisticated and complex version of the original Basel Accord of 1992, which set minimum capital ratios for various types of bank assets.

The new accord rests on three pillars: minimum capital requirements, supervisory review, and market discipline. The first pillar is more flexible than capital requirements in the earlier accord, allowing for many more risk categories, and making some room for the use of modern models of risk. The second pillar allows closer cooperation between banks and their home-country regulators and gives supervisors some authority to impose higher capital requirements if conditions warrant them. The third pillar seeks to give investors and depositors the information they need to avoid risky institutions.

As L. Randall Wray argues in this brief, staving off financial instability in a modern economy is a very tall order and probably cannot be accomplished through regulations of this type. Wray espouses the view of our late colleague Hyman P. Minsky that financial fragility arises spontaneously during the course of the business cycle and is an inherent feature of modern capitalism. Certainly, the new regulations are benign; an adequate level of capital can

reduce the risks of certain types of bank failures. However, a bank's ongoing profitability provides its main cushion against insolvency or illiquidity.

Moreover, that transparency can ensure market discipline is also not clear. Wray argues that this proposition relies heavily on assumptions about the availability of information, the markets' ability to process that information, and its ability to act accordingly. When the incentive of a high return is present, bankers and investors sometimes overlook the level of risk they are taking on.

In addition, banks are very vulnerable to pressures that develop because of unfavorable macroeconomic conditions. One example is high interest rates, which can cause events such as the Latin American debt crisis of the 1980s. It is probably safe to say that this crisis would have taken place even in the presence of Basel-type regulations.

There are more promising strategies to lessen financial fragility, Wray points out. Minsky endorsed policies to restrict the sorts of assets banks are allowed to hold, forcing them to use short-term liabilities to finance short-term positions. He even endorsed a plan for making depository banks hold reserves equal to 100 percent of deposits. Other proposals, seemingly unrelated to banking, might help, too. As the recovery of the major commercial banks in the 1990s shows, progrowth policies can work wonders for the health of the banking system. Finally, a more generous Social Security system might help to compensate for the risks taken on by private pension funds, and a national health insurance scheme might alleviate the nation's number one cause of personal bankruptcies.

Minsky always believed that the health of the banks, and of the financial sector more generally, was crucial for the performance of the economy. In today's complex financial environment, with its many exotic instruments, he might have been even more concerned with the potential for financial fragility. Wray's brief makes clear that the Basel II reforms are welcome and helpful, but of only limited potential effectiveness. He points the way to an agenda that is far more ambitious, but that offers a more realistic chance of achieving stability.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
May 2006

Can Basel II Enhance Financial Stability?

Introduction

Over the next few years, the banking systems of most countries will come under the requirements of Basel II, which will replace the 1992 Basel Accord. This brief examines the contributions that Basel II might make toward reducing banking risk and financial instability.[1] The brief argues that risk-weighted capital requirements and greater reliance on external ratings agencies will not do much to reduce the likelihood or costs of financial crises. Rather, these crises result from other national and international sources of instability; the national and international financial environment is more important for the stability of financial institutions. The brief concludes with some policy recommendations to complement Basel II.

The Basel Accord and the Basel II Reform

The original Basel Accord, which took effect in 1992, aimed to set a uniform minimum capital standard equal to 8 percent of assets. The two main objectives were a) to enhance soundness and stability, and b) to level the competitive playing field for the international banking system (RMA 2001; Kregel 2006). One of the most important justifications for adoption of the Accord was the recognition that transnational banking had rendered national banking supervision and regulation ineffective, and this had played a role in generating the less-developed countries' (LDC) debt crisis of 1982–87 (Guttman 2006). Hence, the Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements developed risk-weighted capital requirements to be imposed on banks and their subsidiaries. The idea was that raising capital is costly and that linking required capital ratios to riskiness of assets would force banks to make proper risk-return calculations. Thus, a bank could choose either to purchase safer

assets or to accumulate more capital against riskier assets. The more capital held against earning assets, the lower the bank's profitability (return on capital), but the greater its ability to absorb losses. The Basel Accord provided for three broad asset classes: G-10 sovereign debt, G-10 bank debt, and all other debt. (The G-10, or Group of 10, is made up of most of the major Western industrialized countries and Japan.) The risk weightings were zero percent for the first asset class, 20 percent for the second, and 100 percent for the riskiest class (Guttman 2006).

One problem with this scheme is that it tends to encourage banks to hold the riskiest assets in each class. For example, given that all corporate loans as well as non-G-10 government debt carried a 100 percent risk weighting, banks would tend to prefer the assets in this class that promised the greatest return after expected losses on defaults. Banks would thus game the regulation—effectively taking advantage of "mispricing" that resulted from regulations that adopted overly broad definitions of asset class. All else equal, this would mean a riskier portfolio. Further, banks have been increasingly adopting complex internal risk-management procedures, while developing hedging instruments to protect them from risk. Thus, it was believed that the Accord's risk weightings could deviate significantly from the banks' own calculations of risk. In the parlance of the BCBS, the "regulatory capital" required to meet the Accord deviated from the "economic capital" actually needed to protect banks against losses.

For these reasons, the BCBS began to develop reforms that eventually became Basel II. The new regulations are quite complex, but rest on three pillars: minimum capital requirements, supervisory review, and market discipline (Guttman 2006). Each of these pillars, in turn, has several components. To simplify, pillar one allows greater flexibility in establishing required capital ratios. It creates many more risk classes than were defined in the 1992 Accord, and it allows larger banks to adopt "internal ratings–based approaches" and to rely on external ratings agencies to assess riskiness of assets. Calculated risk ratings are used, in turn, to calculate capital requirements. The largest banks will be encouraged to use their own models, pursuing what is known broadly as the "advanced approach" to assess credit risk (default probability, and losses in the event of default), market risk (risk that asset prices fall), and operational risk (risk of losses from internal mismanagement, or from unforeseen external events).

These models will be subjected to stress tests to estimate worst-case loss scenarios.

Pillar two addresses host-country supervision. Supervisors are supposed to work closely with their banks to monitor risk-assessment practices; they can require extra capital beyond Basel II's minimum if they believe that domestic economic conditions warrant it. Finally, pillar three seeks to increase the force of the market to discipline banks. Riskier banks will have to pay higher interest rates on their liabilities and will face lower equity prices. Basel II tries to increase transparency, specifying what information banks must provide to the market, a precondition to increasing market discipline (Guttman 2006).

In sum, the Basel II reforms create finer classifications of risk and give banks greater freedom to generate their own risk estimates. The reforms represent an impressive synthesis of market discipline and well-designed rules and regulations to guide supervisors, while at the same time increasing cooperation between bank management and government supervisors. Most importantly, Basel II brings "regulatory capital" more closely in line with "economic capital"—which is believed to reduce the incentive to game the regulations while also economizing on "scarce capital" (RMA 2001). While the original Basel Accord adopted minimum capital standards for all banking organizations, Basel II allows well-managed banks to *optimize* capital. The ultimate goal of Basel II is to more closely align capital requirements to the bank's internal risk-rating system, while also allowing greater use of external credit-rating agencies.

Interestingly, the United States has decided to postpone implementation of Basel II, with a three-year transition period beginning in 2009, and to limit its application to between 10 and 20 of the largest banks—those with total assets of at least $250 billion or with foreign exposure of $10 billion or more (Cole 2006). U.S. banking regulators have been concerned with the possible creation of competitive advantages and disadvantages that could negatively impact the numerous small- to medium-sized banks that make up the vast majority of U.S. banks. Further, as will be discussed below, initial analyses of the impacts of Basel II on U.S. banks have yielded anomalous and disparate results. For these reasons, the United States has proposed a modified version of Basel I that would create additional risk classes but otherwise leave the original provisions mostly intact. Thus,

with the exception of the largest U.S. banks, the U.S. banking system would be subject to an only slightly reformed Basel Accord (Bernanke 2004; Bies 2005c). As in so many other areas, the United States would largely exempt itself from international consensus.

Basel II and Banking Risk

It is difficult not to applaud the energy of the framers of Basel II, even while doubting the reform's effectiveness. In some respects, it reminds one of the spirit of international cooperation that went into the formation of the European Union, and it is probably subject to some of the same critiques. One expects that, when push comes to shove, individual banks and nation states will pursue their own interests even when those clash with the spirit of the Accord. There are several reasons to doubt that the reforms will reduce banking risk.

Basel II is extremely complex, a result of several inherent forces. As Cornford says in his comprehensive review, "Much of this complexity has been due to the attempt to set global standards for the regulatory capital of banks at different levels of sophistication" (2005, p. 2). Further, any attempt to regulate behavior across a hundred nations generates charges of favoritism—probably at least some of which are justifiable—which then lead to exceptions, alternatives, and more complexity. Also, complexity is increased in response "to continuing rapid financial innovations and evident weaknesses of existing regulations, which have led to some proposed rules whose variety and esotericism sometimes match those of the practices they are intended to regulate."

By their very nature, rules and regulations are backward looking, trying to deal with past innovations and scandals, and cannot reflect future experience (Greenspan 2005). Much of Basel II seeks to codify current rules of thumb that guide good banking practice. This is supplemented by the introduction of market assessment of risk, in the apparent hope that external (private sector) credit-rating agencies can be counted on to deal with the changing financial environment and practices. The problem, of course, is that these agencies assess risk based largely on recent historical experience, and they can easily get caught up in current fad and fancy and whirlwinds of optimism and pessimism. As Cornford (2005) notes, the

credit-rating agencies did no better than public supervision in predicting recent crises such as the Asian Tigers crash. Internal ratings assessment, including stress testing of models, is similarly backward looking and subject to judgment calls regarding worst-case scenarios. Models, of course, are no better than the parameters fed into them and are not designed to deal with unforeseen events.

Clearly neither capital nor risk-weighted capital, alone, is necessarily a good indication of the likelihood of bank failure. Though the macroglobal environment in which banks operate may be the most important factor, the return on assets or equity can be second most important, ranking higher than a capital ratio. It has long been recognized that "the bank with the higher level of ongoing profitability and not the bank that currently has a higher absolute [loan-loss] reserve" is in "a superior position to maintain an adequate valuation reserve over time, assuming similar loss experience" (McConnell 1981, p. 357). While McConnell was referring to loan-loss reserves, the same can be said of capital—a bank with a currently lower (risk-adjusted) capital ratio but higher returns on assets will be better able to weather unexpected losses. This might be accommodated by the dynamic, enterprisewide perspective adopted by the largest banks in their risk assessment models. Further, the higher returns might allow the institution to issue more equity and thus build up its capital quickly. What is more problematic is the possible perverse incentive set up by higher capital requirements. As Minsky (1986b) argued, competitive pressures force banks with higher capital ratios to seek higher returns—to increase return on equity. If this is adequately captured through higher risk weightings, there is no advantage for the bank that increases return on equity by purchasing riskier assets. However, that is a big "if." To the extent that risk weightings do not eliminate the higher net returns, all things equal, banks with more capital need higher returns and thus riskier positions.

In any case, it is also questionable whether capital is the proper contingency against losses. As McConnell argued, banks typically cover losses out of earnings, not out of either loss reserves or capital reserves. After examining several historical cases, Kregel (2006) concludes that higher capital ratios have not provided better protection against loss. For example, a detailed analysis of the statements of Florida banks following that state's financial crisis of 1922–28 found that the banks that failed had *higher* capital ratios

than did the banks that survived. He cites a Citibank study showing that between 1962 and 1972, after-tax bad loan charge-offs averaged just 6 percent of annual earnings, evidence in support of McConnell's contention that banks can meet normal losses out of earnings.

Governor Bies similarly recognizes that expected losses should be covered by earnings and argues that losses above earnings should be absorbed by capital (Bies 2005c). On the surface this appears reasonable: capital is the cushion that protects the bank's creditors. However, capital cannot meet *unexpected* losses in the event of a major systemic financial crisis—which because it is unexpected cannot be incorporated into stress tests of internal models. Nor should banks be required to *individually* set aside provision for such systemic events, whether the provisioning is in the form of loan-loss reserves or capital, since such events are outside the control of the individual institutions and can only be resolved through government intervention. Indeed, many (most?) systemic crises might be blamed on mismanagement of the economy by the government, and, Kregel argues, it would make little sense to lay responsibility for their abatement on financial institutions (Kregel 2006). For example, the Asian Tigers crisis was largely triggered by insufficient international reserves held by nations operating with exchange rate pegs. Currencies collapsed, foreign-currency-denominated debt service exploded, and domestic income and employment suffered sharp deterioration. In those circumstances, there was no reasonable capital ratio that would cover banks' losses.

This should not be interpreted as an argument against capital requirements. U.S. experience during the thrift crisis showed that as capital approached zero and then fell into negative territory, managers were induced to "bet the bank" by trying to increase assets extremely quickly, with special attention given to those investments with a high risk and return profile. Many thrifts actually achieved rates of growth as high as 1,000 percent per year (Wray 1998a). Most of those bets failed, and the ensuing bailout bankrupted the FSLIC, necessitating a Treasury-financed rescue. This experience also led to a policy of "prompt corrective action" adopted by U.S. banking regulators: as capital declines, closer supervision is required. In theory, a bank would be closed before capital reaches zero, so that liabilities could be covered without cost to government. In practice, things are not so neat, because it is difficult to calculate asset values (many

are not "marked to market") and off-balance-sheet commitments can be hard to track down, making it difficult to calculate capital. Further, even banks with negative equity but good prospective returns can turn things around. For example, a widely circulated study (Vaughn and Hill 1992) claimed that virtually all of the nation's largest banks were technically insolvent at the end of the 1980s; however, the steep yield curve of the early 1990s as well as the long Clinton expansion restored their health. Resolving them in the early 1990s would have been an expensive mistake. Further, that experience shows how important the macroeconomic variables (e.g., Fed interest rate policy, growth of GDP) are for banking profitability. Still, capital levels and ratios can provide important signals of potential problems to supervisors. It is possible that the relationship between capital and risk aversion is nonlinear—with capital positions that are too low encouraging risk-taking to restore equity, and with capital positions that are too high encouraging risk-taking to increase return on equity.

One of the advantages of discretionary supervision over rules is that supervisors can try to deal with innovations that are not foreseen. As Greenspan argues, supervision can be flexible, carried out on a case-by-case basis, unlike regulations that prescribe and proscribe, largely responding to past problems (Greenspan 2005). However, supervisors can be captured by the financial services sector or constrained by politicians. Perhaps more importantly—particularly in developing countries—inadequate training and low pay can be a huge problem. As Cornford notes, implementation of Basel II will require training for about 9,400 supervisors in non-BCBS nations, almost 25 percent of their supervisory staff. This will "put a formidable strain on limited human resources in the form of bank supervisors and internal controllers in banks themselves" (2005, p. 26). Higher pay in the private sector draws many of the best and brightest out of the public sector—obviously a continuing problem even in the highly developed nations. Basel II provides guidelines for external supervisors as well as internal controllers while also bringing in credit-rating agencies, all of which might help banks to resist temptation; however, that comes at a cost of reducing flexibility to deal with unforeseen situations.

Basel II itself seems to provide a compromise between government supervision and market discipline, but with something of a bias toward the currently fashionable beliefs that markets work better than government

and rules work better than discretion. This may well be truer of banking than of other economic activities. The U.S. experience during the 1980s thrift crisis demonstrated that there is a nearly unavoidable and synergistic attraction between politics and financial institutions: U.S. politicians used the thrifts as their own personal piggy banks, while the thrifts paid politicians (and, notably, future Fed chief Alan Greenspan) to protect them from supervisory agencies (Wray 1998a). Still, Basel II might rely a bit too heavily on the faith that depositors, borrowers, and investors will react to market signals such as risk ratings and interest rate differentials. The notion that depositors and equity market investors will carry much of the burden of supervising their financial institutions requires rather heroic assumptions about availability of information, capacity to process that information, and ability to act on knowledge. And the reliance on independent risk ratings and market-driven interest rate differentials to punish excessively risky behavior appears quaint after the U.S. thrift experience, when depositors flocked to the riskiest institutions to reap higher interest rewards, and the institutions sought ever-riskier assets so they could service their costly liabilities. To be sure, Americans might have more reason to believe that implicit government guarantees lie behind even uninsured bank liabilities than do depositors of other nations. Still, the U.S. government does not stand alone in its desire to protect its financial system, a factor that reduces the incentive of liability holders to closely monitor financial institutions.

It should be noted that outside a handful of highly developed nations, external credit-rating agencies are virtually nonexistent (Guttman 2006). For most nations adopting Basel II, the external rating will be done by the central bank. For this reason, it is possible that market discipline will be *least* effective in precisely those nations that could benefit most by external evaluation, because they will be forced to rely on government regulators with lower competence and independence.

Further, as Wojnilower (2005) has always argued, "price signals"—in this case, interest rates and differentials—have never played a significant role in allocating credit nor in determining how much credit is created. The demand for credit is highly—perhaps nearly perfectly—insensitive to interest rate changes (at least at critical moments), and successful financial institutions find ways to meet that demand until some sort of institutional constraint is reached. Credit supply is thus inexorably cyclical—nothing

can prevent lending in a boom, and nothing can encourage it in a bust. The framers of Basel II recognize this problem, but as Cornford (2005) concludes, at least some of the Basel II procedures for estimating risk will actually *increase* the procyclical nature of bank lending. In sum, does Basel II provide a more effective constraint on excessively risky credit growth than a simple 8-percent capital rule? Probably. Will Basel II encourage safer practices? Perhaps. Will Basel II reduce the cyclical nature of credit supply? Probably not.

The Importance of the Financial Structure

A more important question is this: Can Basel II substantially inhibit the creation of a fragile financial structure and tendency to crisis? Almost certainly not. There are forces working at both the national and international levels that lead to endogenously created fragility. As noted, Basel II cannot do much to counter the effects of success and euphoria that will reduce perceptions of risk simultaneously among borrowers, lenders, investors, regulators, and private credit-rating agencies. Many of the risk assessment practices in Basel II require calculation of default risk and cost of default based on the previous five (in some cases, seven) years of experience. Of course, this will provide misleading guidance precisely near the peak of the most dangerous speculative booms (real estate, high tech, capital investment), which can take five to ten years to run their course. The force of the market induces participants to underestimate assessed risk at the most dangerous time; those who try to buck the speculative trend not only face lower returns but also doubts of their management skill and profit drive.

As Minsky (1975, 1986b) argued, even in the absence of obvious speculative excesses, there is a natural tendency for fragility to increase over an expansion, as innovation is rewarded and success breeds more risk-taking. This is why he put so much emphasis on "Big Government" and the "Big Bank" (central bank) to constrain the boom and soften the slump. Countercyclical movements of the budget would help to constrain swings of income—especially profits—and spending. Big Government deficits would fill private portfolios, including those of banks, with safe assets. Big Bank supervision in the boom, and lender-of-last-resort intervention in the bust, would help to stabilize financial institutions. New Deal–style

institutions such as deposit insurance and separation of banking functions would help to protect depositors when financial institutions fell. Above all, Minsky insisted that continuously adapting regulation and supervision would be necessary to attenuate the tendency to fragility that is paradoxically generated by financial stability.

Basel II really does not adequately address such issues, since it focuses exclusively on risk assessment, as if the biggest threat to banks lies in the riskiness of assets purchased. That is debatable. It is probably true that banks do fail individually and perhaps collectively because they have purchased too many assets in high-risk classes or too many assets with highly correlated returns. Occasionally it might be possible to assess the riskiness of asset positions *ex ante* and thereby use rules and risk assessment to prod banks toward safer positions, although one suspects that even with Basel II, risky positions will be discovered mostly *ex post*. Still, one cannot fault Basel II for trying to improve risk assessment and trying to increase the capital cushion for those cases in which problems can be discovered only after the fact.

The bigger leap of faith is the presumption that risk weighting and capital exposure play a dominant role in the safety and soundness of financial systems. This brings us back to the national and international financial environment in which national and international banks operate. When this environment is favorable, banking is easy. During the U.S. "golden era" of the 1950s and 1960s, when financial institution failures were practically unknown, the rule followed by management was "three-six-three": pay three percent on liabilities, earn six percent on assets, and hit the golf course by three o'clock in the afternoon. This was so simple that even presidential offspring could have enjoyed a successful career in banking. That began to change markedly in the 1970s. As a handbook for bank managers put it: "The decade of the seventies proved to be a very unsettling one for many bankers. Not having been in banking during the depression period of 1929–40, most lending officials had become accustomed to the relative economic stability that prevailed for more than twenty years following the Korean War" (McConnell 1981, p. 351). During the stable period, "Losses on commercial loans never became a significant problem for bankers. Indeed, bankers were mostly complacent concerning the risks inherent in their loan portfolios." In the "more tumultuous economic environment of the 1970s,"

however, "loan losses soared at many institutions," and many banks "experienced a tripling if not a quadrupling in losses compared to their historical average" (p. 353). As McConnell argues, use of five-year averages for calculation of loan-loss reserves had made banks highly vulnerable to an unexpected spike of losses. At the end of 1974, each of the largest 100 banks had "attested to the adequacy of its particular reserve level. Within 12 months, 18 of these banks were to report net charge-offs equaling or exceeding the yearend 1974 valuation reserve, while another 10 were to sustain losses equal to at least 85 percent of the reserve" (p. 356).

By the 1980s, in the topsy-turvy national and international environment, many financial institutions failed. To be sure, mismanagement, fraud, and financial deregulation were involved in the 1980s thrift and banking crises. The thrift crisis is more famous and required an open bailout, but the mostly unrecognized banking crisis was actually more dangerous. As discussed above, a bailout was averted only by the 1990s' large interest rate spreads and long economic expansion. Even if the Basel Accord and Basel II had been in place in 1980, it is not evident that this would have made any difference for the outcome of the worst U.S. financial sector crisis since the 1930s.

The high interest rates during the U.S. and United Kingdom experiment in monetarism at the beginning of the 1980s, the following deep recession, the second energy crisis, the LDC debt crisis, the sharp appreciation of the dollar, the devastation of U.S. agriculture and manufacturing sectors, and other national and global economic disruptions played a more important role than capital or reserve levels.

One can legitimately claim that Basel II's goals are more modest: to develop standards for risk weighting, to increase disclosure so that supervisors and credit-rating agencies can assess risk, and to establish a more level playing field for international competition in the financial services sector. Unfortunately, some are claiming much more for the Basel accords and hoping that Basel II will go even further. For example, the Risk Management Association reports, "The minimum capital standards have been widely credited with enhancing the stability of the international banking system" (2001, p. 1). In the early 1990s, banks had been "under tremendous pressure. Large banks were heavily burdened with LDC debt, the S&L crisis was unfolding, and record numbers of smaller institutions

were failing." The implication is that the Basel Accord played an important role in putting banks back on the road to good health. The reality is that the global economic environment since the mid 1990s certainly has been more favorable to banking, and if that environment turns negative, the best laid plans of mice and men may not prevent banking crises.

U.S. banking regulators have been conducting a series of detailed analyses of the impact that Basel II would have on calculation of regulatory capital. The final analysis, called the fourth quantitative impact study (QIS4), found that application of Basel II to U.S. banks would lead to a significantly larger reduction of regulatory capital than expected (Bies 2005a, b, c). Further, the new procedures would have had widely varied impacts across banks. Kregel (2006) reports that the differences across institutions would have ranged from a decrease of minimum required capital by 47 percent, to an increase of requirements by 56 percent. Closer analysis has led U.S. regulators to conclude that the divergence across banks is due to differences in "risk-ratings philosophy"—the internal ratings procedures adopted by the banks (Bies 2005c). Regulators attributed the larger-than-expected average reduction of capital requirements to the favorable business climate in the United States at the time. In other words, the economic expansion reduced assessed risk sufficiently that banks had become overcapitalized for regulatory purposes.

Both of these findings are rather troubling. Bies (2005a) praises the advances made by banks in risk assessment practices, concluding that, "A fundamental premise of Basel II is that, for these major banks, neither supervisory nor market discipline can be effective unless banks' own systems can be relied upon to measure and manage risk taking and capital adequacy." Yet, the QIS4 finds that practices diverge significantly across banks, which will make it difficult to reconcile internal procedures with any semblance of uniform treatment by regulators. Further, if risk assessment for the purposes of the application of Basel II is so dependent on the stage of the business cycle, it is probable that banks will find themselves highly overcapitalized near a cyclical peak. They will thus be free to reduce capital ratios, and, of course, the process of doing so could fuel the boom at the most dangerous time. If supervision and market discipline are closely aligned to the internal assessment, regulators and the market will be encouraging this reduction!

Policies to Enhance Stability and Sustainability

As alluded to above, greater transparency, better risk assessment, and improved supervision of banking are desirable but will not do much to enhance financial stability. The improved financial position of banking systems in many nations in recent years is due more to favorable national and international environments in which the financial institutions operate. Above all, they have benefited from the growth of U.S. imports. Continued improvement of developing economies, generally, will be much easier in the context of robust global economic growth. As Minsky (1979, 1986a) argued, the United States acts as the world's banker in the sense that its dollar-denominated liabilities operate as the asset for ultimate net clearing for many international transactions. This, in turn, requires the United States to run current account deficits to supply dollar assets. Of course, the United States is doing just that, on an unprecedented scale. The problem is that current account deficits might be unsustainable—not for the usual reasons given (U.S. solvency), but because they rely on deficit spending by the U.S. private sector (Wray 2006; Godley 2005). If U.S. households scale back spending, countries that rely on export-led growth could be in trouble. If their exports falter, their banks could experience rapidly deteriorating asset values.

The typical orthodox policies, such as lower costs, improved productivity, and freer trade, mostly redistribute shares of the global pie ("beggar thy neighbor"), helping one country at the expense of another. Only an expansion of the global pie will allow one country to improve its position without hurting another's. Increasing the growth of the pie will require relaxation of fiscal and monetary constraints around the world. This, in turn, is generally easier in the framework of flexible exchange rates. While a few mercantilist nations can accumulate dollar reserves sufficient to guarantee an exchange rate peg (or, even, to dollarize their economies), most nations cannot succeed at that game. In the absence of sufficient reserves, an exchange rate peg holds domestic fiscal and monetary policy hostage to the exchange rate. Depending on reserve holdings, a free float (which requires minimal reserves) or a dirty float (which requires substantial reserves) provide a degree of freedom for the conduct of domestic policy. Unfortunately, conventional wisdom holds that nations with "funny monies" (as Dornbusch 2000 impolitely put it) ought to abandon

independence and adopt the dollar (or some other key currency) to eliminate the possibility of using discretionary policy. If economies were naturally stable, such a policy—combined with the sort of rules, regulations, transparency, and proper supervision provided in Basel II—might work. However, if economies naturally trend toward fragility in the absence of government intervention, this could be a recipe for crisis. Instead, floating rates and independent fiscal and monetary policy can provide the context for growth that conventional policies do not.

Basel II–type reforms are not likely to reduce U.S. fragility, as that fragility mostly resides outside the banking system. A lot of the household debt accumulated during the real estate boom is held, for example, in pension funds. Similarly, the ongoing commodities-prices boom (best known as an oil-price boom, but really an across-the-board speculative boom in the prices of most commodities) seems to be fueled by hedge funds and pension funds. On top of all that, the real estate boom is cooling. While bank exposure to such risks is not negligible, it is more likely that banks will be hit by secondary effects of a U.S. slowdown rather than by direct effects of loan defaults. Indeed, the direct effects of financial crises will be felt by nonbank financial institutions, such as pension funds. Banking system problems might be easier to resolve—through lender-of-last-resort activity, federal deposit insurance that socializes losses, and the creation of a mechanism for bailouts (such as a Reconstruction Finance Corporation), if that becomes necessary. By contrast, large haircuts (or debts written off) have been, and would continue to be, required in the case of widespread failures of hedge funds or pension funds, especially since the Federal Pension Benefits Guarantee Corporation is already massively insolvent. Ultimately, protection of the U.S. financial system requires complementary policies that address sources of instability that arise outside banks and that, at least in the United States, are more dangerous.

For the United States, policies to increase domestic employment, including policies to replace jobs lost to foreign competition, are necessary to restore income growth—a first step to reduce excessive reliance on debt-financed spending. Minsky advocated an employer-of-last-resort program, not as a temporary expedient to deal with the high unemployment that comes during deep recessions or depressions, but rather as a permanent policy to fight unemployment and poverty in a noninflationary manner

(Minsky 1986b; Wray 1998b). Such a program would also have strong countercyclical influences, with spending on the program rising when the private sector sheds workers. Further, it would provide an effective minimum wage. (Minsky always insisted that in the absence of true full employment, the effective minimum wage is zero because those without jobs cannot get any wages at all.)

To further spur income growth, complete revamping of the national health care system is necessary. Employers cannot afford wage increases when health care costs are rising so quickly, except by pushing health care costs onto workers. Health care costs also displace other public expenditures, especially by state governments—reducing spending on infrastructure, social programs, and education. Further, health care costs are the single most common cause of household bankruptcies. As briefly mentioned, pensions and pension funds are another potential source of instability. The United States has moved to defined-contribution plans that do not provide guaranteed retirement income; at the same time, competitive pressures have encouraged pension funds to increase their exposure to risk. Workers are faced with an uncertain retirement, and retirees must live on reduced income. Pension reform, including more generous Social Security benefits, is needed.

At various times Minsky also advocated policies that would reduce inequality and lower the advantages enjoyed by the biggest firms and banks. Among other proposals, he backed a community development banking initiative that would increase the supply of financial services to underserved communities. He supported policy to favor small- and medium-sized banks, on the argument that their preferred habitat is small-to-medium-sized firms, while big banks serve big firms. Minsky favored policy to encourage consumption, while policymakers typically favor investment. Minsky believed that a high-investment economy is naturally prone to inflation and, more importantly, to instability. He also favored to-the-asset financing—linking specific liabilities to appropriate assets: "If banks concentrate on to-the-asset financing, then the short-term debts of business will lead to payment commitments that are consistent with business cash receipts. The bank debts of firms would be part of a hedge-financing relation" (1986b, p. 321). Elsewhere, he endorsed Levy Institute colleague Ronnie Phillips's (1995) revival of the "100 percent money"

Chicago Plan. This plan would eliminate risk by forcing depository banks to hold 100 percent reserves against deposits. Essentially, this would go even further than New Deal–era reforms that separated commercial banking from investment banking, by creating another class of banks that would issue deposits but make no loans. Minsky also suggested that a uniform 5-percent asset-equity ratio for banks is desirable, not only to increase safety, but also to level the playing field. This proposal is consistent with Basel-type goals, although Minsky did not explicitly endorse risk-adjusted capital requirements.

Not all of Minsky's proposals retain relevance in today's international environment, in which even the largest corporations in America face bankruptcy, unable to compete with newer and lower-cost producers in developing nations. Nor would Minsky's proposals necessarily apply to situations faced by other countries. Selective tariffs on imports, excise taxes, and direct controls, including capital controls, might be desirable for some nations, at least temporarily. Neoclassical economics assumes away most of the problems associated with international trade—assuming, for example, that all resources are always fully employed. In the real world, increased cross-border trade is not necessarily in the interests of all nations. Policy that favors domestic production and puts barriers in the way of foreign production can help the domestic economy while hurting other nations. Because of the U.S. role as banker to the world, barriers to trade that are designed to reduce the U.S. current account deficit will have significant negative impacts on many other nations, especially on those with dollar debts. Nor, in general, are trade barriers necessary or desirable for the United States, a huge nation of vast wealth. With proper policy it can mitigate individual and sectoral domestic costs that result from imports, in order to reap the net social benefits of a trade deficit. Thus, unlike the case of developing nations, there is little justification for U.S. trade barriers, except on the basis of ethical considerations—"fair trade" to protect worker and human rights abroad.

This is not to deny that continued (and perhaps growing) U.S. trade deficits might lead to dollar devaluation. Given that U.S. debts are almost all denominated in dollars, devaluation would not be likely to have large direct consequences on the ability of U.S. households and firms to service debt. Assuming, as is likely, that devaluation has little impact on U.S.

imports, to the extent that import prices rise, there could be some financial pressure on U.S. debtor households and firms. There could be other knock-on effects of a devaluation for the United States, but these are not likely to be so significant that we would have to revise our analysis. While individual households and firms might have to default on debt, and while this could generate additional pressures on the dollar, the central bank and Treasury would be able to step in to prevent any snowballing debt deflation process. Further, gradual depreciation of the dollar will not create large problems for other nations, so long as U.S. imports are not affected.

In conclusion, Basel II represents an ambitious international attempt to reduce risk in banking and to decrease unfair competitive advantages across nations that could result from laxer banking standards. The accord could enhance national and international financial stability, although the effects are likely to be relatively minor, not because Basel II is poorly designed, but rather because it does not and cannot do much about the primary sources of financial instability. Complementary policies, including both microindustrial policies and macrostabilization policies of the sort that Minsky advocated, are needed to address the real potential sources of instability. Further, given increasing integration of global finance, it is impossible to ignore the importance of the performance of the global economy. And that is probably the most difficult nut to crack.

Note

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