The ‘New Economics’ and Policies for Financial Stability

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1. Introduction

The purpose of this paper is to consider the policy implications of ‘new economics’, a new way of thinking about economics as postulated in Arestis and Sawyer (2010). More precisely, the focus of the paper will be on financial stability in addition to other policies examined below. In doing so we also address the question of whether there is not a better paradigm and set of economic policies that can lead the economy to a better economic performance in view of the experience with the ‘great recession’. In doing so we discuss our theoretical framework before moving to economic policy questions; it is in terms of the latter that we argue that an important policy dimension, which has been ignored in the past, is financial stability.

However, it is important to stress that this contribution is acutely critical of the New Consensus. Despite its great technical sophistication in its conceptual essence, mainstream economics is still subjected to considerable criticism in terms of both its theoretical premise and economic policy implications. We have made relevant critical remarks on both the micro and macro aspects of these schools of thought. We have been particularly critical of the basic assumptions of these theoretical frameworks, namely the intertemporal optimisation assumption of the representative agent, also that of rational expectations, and their implications, as well as that of a long-run Phillips curve and the monetary policy rule relationship.

We have already produced a number of arguments in previous assessment exercises of the New Consensus Macroeconomics (NCM) framework and of the Inflation Targeting (IT) policy as implemented in a number of countries (Arestis and Sawyer, 2008; see, also, Angeriz and Arestis, 2007a, 2007b, 2008; Arestis, 2009;)

It is worth summarizing the arguments that are relevant here. Low inflation and price stability do not always lead to macroeconomic stability. There has been insufficient attention paid to the effects of varying interest rates on the exchange rate and asset prices. There is a lack of evidence for a long-run vertical Phillips curve. There is insufficient evidence that any form of the NAIRU is unaffected by aggregate demand and economic policy and the view that lowering of the NAIRU comes from having more flexible labour markets is dismissed. Countries that do not pursue IT policies have done as well as the IT countries in terms of the impact of IT on inflation and locking-in inflation expectations at low levels of inflation. There is insufficient empirical evidence to support the downgrade of fiscal policy; indeed, there is insufficient evidence to validate the NCM theoretical propositions in more general terms. The IT policy framework can only pretend to tackle demand-pull inflation but not cost-push inflation. The financial crises starting in the second half of 2007 has vividly testified to this problem of the NCM economic policy aspect. Three further criticisms are of particular importance: the absence of banks and monetary aggregates in the NCM theoretical framework; the heavy reliance of the NCM theoretical framework on the ‘efficient markets hypothesis’ (EMH), which assumes that all unfettered markets clear continuously thereby making disequilibria, such as bubbles, highly unlikely – witness the credit crunch of August 2007; and with the use of the equilibrium real rate of interest as in monetary
policy rule of the NCM model, a notion which even the monetary-policy makers are not clear about (see, for example, Weber, et al., 2008).

The theoretical framework upon which we base our policy conclusions tries to avoid all the problems just enumerated. It represents in this sense ‘new thinking in economics’ along the lines of the current conference. We propose to briefly summarise the basis of this ‘New Economics’ in section 2 that immediately follows this introductory section. Section 3 proceeds to discuss the main policy implications, the focus of this paper. It concludes by suggesting that financial stability should be a new focus of monetary policy amongst other implications. Section 4 looks into two case studies, that is two recent attempts at financial stability. A final section 5 summarises and concludes this contribution.

2. Main theoretical elements of ‘New Economics’

The general background to the theoretical framework is the emphasis on an economy of a monetary production type, in which finance and credit play a significant role. It relates to an economy which has degrees of instability, in the sense of being subject to the ups and downs of the business cycle and prone to crisis. The theoretical framework which underpins the analysis of this contribution draws on four propositions: (i) aggregate demand is important for the level of economic activity; (ii) distributional effects matter; (iii) money is endogenous and credit driven; and (iv) appropriate government deficits do not present financial risks. Fiscal policy is important along with monetary and exchange rate policies. We briefly discuss the five blocks to begin with, followed by a discussion of the economic policy implications of the model that emerges.

The theoretical framework, which is the background to this contribution, draws on the following main elements (see Arestis and Sawyer 2009). In terms of the demand-side of the economy, which relates to expenditure, income and employment, the focus is on the level of economic activity, which is set by aggregate demand. No market-based mechanism exists to propel the level of aggregate demand to any specific level of output. Aggregate demand has a dual characteristic in this model: it is a relatively volatile component and it is also a potential promoter of productive potential. This establishes the interdependence of demand and supply, which is closely related to path dependency in macroeconomics with the path of demand influencing the evolution of the supply potential of the economy.

Turning to the supply side of the economy, the following characteristics are important to the argument. The supply side is viewed in terms of the interaction between production decisions of firms in the light of the expected level of aggregate demand and the consequent decisions on employment. It is also viewed in terms of the relationship between prices and wages.

In terms of the inflationary process, inflation is viewed as multi-causal and the sources of inflationary pressure vary over time and economy. The range of factors which impact on the rate of inflation includes: struggle over income shares, the level and rate of change in the level of aggregate demand, and cost-push factors emanating notably from the foreign sector, namely changes in import prices and the exchange rate.

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1 An early attempt to construct and estimate a model along similar lines as described in the text was undertaken in Arestis (1989). For a more recent attempt along similar focus see Arestis and Sawyer (2010).
The money, credit and finance sector is also an important element to this way of thinking about the macroeconomy. Money is endogenously created within the private sector, with loans provided by banks themselves generating bank deposits. The central bank sets the key policy interest rate, which governs the terms upon which the central bank provides the ‘base’ money to the banking system.

The foreign sector is viewed as another relevant and significant constituent element of the model. A relevant aspect of this importance is that imports and exports are included in the aggregate demand equation, reflecting the effects on demand – and hence employment – of variations in the exchange rate.

Cycles and fluctuations in economic activity occur frequently and full employment is, at best, a rather infrequent occurrence. Changes in economic activity impact the rate of change of prices and wages, and consequent changes in the distribution of income between wages and profits. Changes in the distribution of income have effects on the level of aggregate demand, with the nature of the effects depending on whether there is a wage-led or a profit-led regime. These interactions contribute to the generation of cycles.

Distributional effects are always very important to account for but more recently they have been even more urgent in this regard. For it is the case that inequality was a root cause of the ‘Great Recession’. There is relevant supporting evidence provided, as for example in the study by Philippon and Reshef, 2009, in the case of the US: over the period 1980-2005, inflation-adjusted financial sector profits grew at 800 percent, compared with the 250 percent for the non-financial company profits. A further relevant statistic is the pronounced above average rise in the salaries of those employed in finance. Relative wages, the ratio of the wage bill in the financial sector to its full-time-equivalent employment share, enjoyed a steep increase over the period mid-1980s to 2006. What explains this development is deregulation in a causal way, followed by financial innovation (see, also, Arestis and Karakitsos, 2011).

The deregulation impact accounts for 83% of the change in wages. Indeed, wages in the financial sector are higher than in other sectors, even after controlling for education. Between 1980 and 2007, while productivity increased by 80 per cent in the US, real wages increased by less than 40 percent (see Lawrence et al., 2009, for wage developments in the US over the period under scrutiny); similar developments took place in the UK over the same period (Arestis and Karakitsos (2011). Also, but less pronounced developments, are relevant in continental Europe and elsewhere (Canada and Japan are typical examples). In China financial intermediary shares to GDP increased from 1.6% in 1980 to 5.4% in 2008 (Greenspan, 2010, p. 15).

3. Economic Policy Implications of ‘New Economics’

A first policy implication which we draw from the ‘new economics’ is that the focus on monetary policy to meet the single objective of inflation should be abandoned, and that monetary policy should focus much more on financial stability. This is an argument which we have deployed for a number of years, and support from mainstream writers is welcome! IMF (2009), for example, is clear on this score, “We must learn lessons from the events of the past two years. …First, price stability does not guarantee stability of the economy as a whole. Second, the instruments used to pursue financial stability are in need of sharpening and refining” (p. 5; see, also, Blanchard et al., 2010). IMF (2010a) goes a step further to suggest that financial stability in the form of macro prudential policies is the way forward.
Indeed, the same publication suggests that if the current low interest rates were to produce excessive risk-taking or bubbles, these should be addressed through macro-prudential policies and not through the interest rate policy measure. IMF (2010c) suggests a macro-prudential approach to contain systemic effects of ‘too-important-to-fail’ institutions, including now non-bank institutions. Also, Bean et al. (2010) suggest that macro prudential policy is a better policy to prevent asset and credit bubbles than monetary policy; the latter “seems too weak an instrument reliably to moderate a credit/asset price boom without inflicting unacceptable collateral damage on activity” (p. 32).

Macro prudential policy acts more directly on the source of the problem. At the same time, though, monetary and financial stability policies (as well as other macroeconomic policies) should be coordinated. Financial stability policy measures should “include capital requirements and buffers, forward-looking loss provisioning, liquidity ratios, and prudent collateral valuation” (IMF, 2010b, p. 3). Still, though, in this view price stability “should remain the primary objective of monetary policy” (p. 3); interestingly enough, though, the argument is not for price stability to be the single objective of economic policy. It is also suggested that “changes to central bank liquidity operations and broad crisis management frameworks are needed, including to address moral hazard. Changes to enhance the flexibility of central bank operational frameworks will improve the resilience of the system. Institutions and markets that are potential recipients of liquidity support in times of stress should be monitored and regulated” (p. 3). So the focus seems to be on systemic financial stability. All these changes, IMF (op. cit.) argues, “should be done in a way that preserves central bank independence” (p. 4).

King (2009) also suggests that “price stability does not guarantee stability of the economy as a whole” and that “Inflation targeting is a necessary but not sufficient condition for stability in the economy as a whole” (p. 5; see, also Bean et al., 2010). The conclusion from this discussion is then that financial stability should be the responsibility of the central bank. This means of course that central banks would have an additional objective to that of price stability, this being financial stability. Such an additional objective, though, raises the issue of how to incorporate financial stability in the loss function of the central bank in view of the fact that it is impossible to measure such a variable. Blinder (2010) raises the issue and wonders “whether the right loss function is actually lexicographic, with financial stability logically prior to the other goals” (p. 4). This is a serious challenge for those central banks that use the ‘New Consensus Macroeconomics’ modeling framework (see, for example, Arestis, 2009; Arestis and Sawyer, 2008). Nonetheless, this raises the question of how in this framework the need for additional instruments would be dealt with, when more than one objectives are evident.

We agree that monetary and financial stability policies should be coordinated. But we go further and argue that it is vital for full coordination of both policies with fiscal policy, along with discretion in applying them. Fiscal policy should be used both in the short term and in the long term to address demand issues. In this respect, relatively frequent adjustments to fiscal stance in the light of macroeconomic developments are necessary. The main objective of macroeconomic policy is the achievement of full employment of the available labour force. Achieving such an objective would require, inter alia, the maintenance of a high level of aggregate demand consistent with full employment of labour. Also, the provision of sufficient productive capacity to enable the achievement of full employment; where sufficient is to be interpreted in terms of quantity, quality and geographical
distribution. In this sense, industrial and regional policies are required to enhance supply. Public expenditure, particularly investment, can also be structured to ease supply constraints.

In terms of the inflationary process, inflation is viewed as multi-causal and the sources of inflationary pressure vary over time and economy. The range of factors, which impact on the rate of inflation, includes: struggle over income shares; the level and rate of change of the level of aggregate demand and cost-push factors emanating notably from the foreign sector (change in import prices and the exchange rate). It is also the case that the evidence on the relationship between inflation and output suggests that it is not necessarily negative for at least single figures (Ferguson, 2005 summarises the argument; see, also, Ghosh and Phillips, 1998; Fisher, 1993; Bruno and Easterly, 1996; Khan and Senhadji, 2001). The control of inflation, therefore, should be regarded as a side issue unless inflation is once again exhibiting tendencies to continue to rise and to exceed double figures. Under such circumstances, an incomes policy should be developed when inflation reaches high levels that can cause problems to the real economy.

Interest rate policy should be set so that the real interest rate is in line with the trend rate of growth, although this may be constrained by world levels of interest rates and the country’s exchange rate. Still, it is important to recognise that monetary policy needs further elaboration and investigation. Miles (2010), for example, suggests that “The argument that the aims of monetary policy need to be broadened beyond a focus on inflation is one that deserves to be taken seriously because the damage done by extreme financial instability is great” (p. 3). However, the main operations of any Central Bank should be directed towards financial stability. The events leading to the ‘great recession’ testify to this important requirement. Financial stability has attracted renewed interest and focus as an instrument of monetary policy. As such it requires further investigation especially so in view of the recent initiatives by the President of the US and the Basle III proposals; both of these discussions are discussed below. King (2009), for example, argues that “the instruments used to pursue financial stability are in need of sharpening and refining” (p. 5). It is further the case that “using the interest rate as a tool to maintain the stability of the banking system” is “a strange assignment of policy tools to target”; for it is the case that “changes in interest rates have an uncertain impact on financial stability; often it would be unclear in which direction to move interest rates to help make the banking sector more robust” (Miles, 2010, p. 19). This is a very welcome sign. Indeed, we would take a step further and argue that the Central Bank policy instruments for financial stability would be much more extensive than interest rate. It is also a question of whether any attempt should be made to use interest rate policy for financial stability or because of possible adverse side effects interest rate should be ‘parked’ and set in line with growth rate. We turn our attention to this development in what follows. ²

4. The Objective of Financial Stability

It is true that financial stability has not been at the forefront of monetary policy to say the least. The belief in the efficiency of financial markets prevented a realistic and necessary approach to financial stability (IMF, 2010c). As a result, both the supporters of the New Consensus Macroeconomics

² All the policies discussed in this sub-section should also include ‘green elements’. Especially since ‘green fiscal measures’ in the form of ‘green investment’, as well as ‘green-efficiency’, measures are most suitable and feasible under current circumstances.
framework and policymakers have ignored “the implications for systemic stability of financial market imperfections, including those stemming from international frictions, moral hazard and other distortions to incentives, such as externalities and herding” (IMF, op. cit., p. 7). As a result potential systemic risk was ignored and financial regulation and supervision “were increasingly light-touch and reliant on self-correcting market forces” (IMF, op. cit., p. 7); and, indeed, in the case of the ‘shadow banking’ it was completely absent.

The focus of financial stability should be on proper control of the financial sector so that it becomes socially and economically useful to the economy as a whole and to the productive economy in particular. Banks should serve the needs of their customers rather than provide short-term gains for shareholders and huge profits for themselves. In order to achieve these objectives a number of prerequisites should be in place. To begin with, the core function of banking should be re-stated. This should be to facilitate the allocation and deployment of economic resources over time and place to socially useful purposes. It should also be to maximise long-term financial and social returns under conditions of uncertainty. In order to achieve these objectives a number of reforms should be undertaken. The most important, perhaps, is the separation of commercial banking from investment banking. Commercial banking sits at the moment uncomfortably with the risky activities of the investment banking; and most commercial banks have moved into investment banking in search of quick profits. Separation then should allow investment banks to go bust, if necessary, thereby instilling greater discipline and avoiding moral hazard.

A second reform should be the break up of banks that are ‘too big to fail’. Allowing banks that are big to fail creates moral hazard: banks pursuing high risk activities confident that the public will have to bail them if and when things go wrong. Also banks need to be broken up both to reduce costs and risks to the taxpayer, and also to improve the quality and range of services. A further reform is to tax the financial sector and, also, introduce a financial transactions tax. These would need to take place on a worldwide basis and used to slow financial speculation, one of the main causes of the credit crunch. Better regulation should be introduced. Banks should hold more capital, in the form of leverage and liquidity requirements, particularly in booms when risks are by far greater. This proposed requirement, which forces banks to hold more capital, could push the countries concerned into depression. This can come about since stringent capital requirements may leave the banks with insufficient funds for lending purposes. Due care and attention are, therefore, vital when constructing the relevant new rules. Above all, though, it is high time that banks, and financial institutions more generally, should operate along the more familiar, and healthy, lines: direct credit as needed and in the process support enterprise; and be part of the system that generates investment and innovation for a healthier and more prosperous economy. Big banks should be brought back to a healthier size and, of equal importance, limit their capacity to speculate. Of equal importance is the need to curb the power and influence of the credit rating agencies. All in all, we need a smaller and safer banking industry.

The widespread belief in the efficiency and essential stability of financial markets prevented a realistic and necessary approach to financial stability (IMF, 2010). The focus has been on the emphasis given to the ‘efficient market hypothesis’ (EMH), namely that all unfettered markets clear continuously thereby making disequilibria, such as bubbles, highly unlikely. Indeed, in terms of the EMH framework, economic policy designed to eliminate bubbles would lead to ‘financial repression’, a very regrettable outcome in this view. Ever since the early 1970s, when governments attempted and succeeded in
implementing financial liberalization initiatives, especially in the US and UK, the focus has been on creating financial markets completely free from any policy interference. This is based on the belief that liberalised financial markets are very innovative, and sure enough they were! Over the period prior to the ‘great recession’ and after the intense period of financial liberalisation especially in the US, great strides were seen in the development and extension of new forms of securitisation and use of derivatives. This was a financial engineering practice, which led to the growth of collateralised debt instruments, especially so in the form of collateralised mortgages. As a result, both the supporters of the New Consensus Macroeconomics framework and policymakers have ignored “the implications for systemic stability of financial market imperfections, including those stemming from international frictions, moral hazard and other distortions to incentives, such as externalities and herding” (IMF, op. cit., p. 7). Consequently, potential systemic risk was ignored and financial regulation and supervision “were increasingly light-touch and reliant on self-correcting market forces” (IMF, op. cit., p. 7); and, indeed, in the case of the US ‘shadow banking’ it was completely absent.

The experience with financial liberalization is that it caused a number of deep financial crises and problems unparalleled in world financial history, both in terms of their depth and frequency. However, most important for the purposes of this contribution, it was the experience of the US with financial liberalization that is most telling in terms of the cause of the current crisis. Financial liberalization alone cannot fully explain the crisis. The size of the financial sector is also important. In this respect, it is important to note the enormous redistribution that had taken place in the countries at the centre of the crisis. This was a significant redistribution from wage earners to the financial sector had materialized prior to August 2007. That redistribution along with the financial liberalization attempts produced the new financial engineering rooted in the US, which led to an extraordinary mispricing of risk, were the main causes of the crisis.

We would argue, therefore, that financial stability, rather than inflation targeting, should become the central objective of the Central Bank. Buiter (2008) indicates that in practice “financial stability means (1) the absence of asset price bubbles; (2) the absence of illiquidity of financial institutions and financial markets that may threaten systemic stability; (3) the absence of insolvency of financial institutions that may threaten systemic stability” (p. 10). It can be noted that the recent Banking Act 2009 in the UK establishes that “an objective of the Bank [of England] shall be to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom (the ‘Financial Stability Objective’)”, with the Bank working with other bodies, such as the Treasury, to establish a Financial Stability Committee. At present this is placed alongside the monetary stability objective under the heading of inflation targeting. This could be seen a significant step away from the operational independence of the Bank of England and from the single inflationary objective. Our argument here is that the financial stability objective should be the prime objective of Central Banks and their operational independence should be abolished. The ‘great recession’ coming from the financial crisis of 2008/09 and more generally the record on financial crises (see, for example, Laeven and Valencia, 2008, for details of crises over the past three decades and their costs) indicate that the substantial costs are associated with a lack of financial stability (which would far outweigh any costs associated with inflation). Thus, there is a strong

case for the objectives of macroeconomic policies (and others) to include the promotion of financial stability.

In terms of the general multiple instruments, a multiple objectives framework it may not be possible to uniquely assign each instrument to a specific objective. Nevertheless, it may be possible to link an instrument mainly with a specific objective, recognising that co-ordination in the use of instruments is advantageous. In this context, the argument is that the main link should be monetary policy and financial stability. On this score we would agree with Goodhart (2007), who in fact suggests that “[i]n so far, therefore, as the central bank has a prime concern for systemic financial stability, it should want to promote a program of counter-cyclical prudential regulations, where these latter become restrictive during asset price bubbles and relax during asset price downturns. Unfortunately the system of financial regulation is developing in a manner which will have exactly the reverse proclivity” (p. 68). The argument here relies on the removal of inflation targeting as the main stabilization instrument and instead worry about unemployment and other macroeconomic goals.

There is an element here of the end of monetary policy, and its replacement by (or incorporation into) financial stability policy. Monetary policy is about money and involves banks since they are those financial institutions whose liabilities are regarded as part of the stock of money. Monetary policy in the simple IS-LM type framework is viewed in terms of the (policy) rate of interest and the stock of money and the notion that Central Bank could set one of the variables and then had to accept the consequential value of the other variable. In the endogenous money framework the Central Bank sets the policy interest rate as the terms on which it will supply reserves (monetary base). One of the key roles of the Central Bank has been viewed as the lender of last resort, which would involve supplying liquidity to the banking system as and when required. With an objective of financial stability, the Central Bank would become more like a Central Financial Agency (CFA). It would be responsible for policies, which seek to influence the credit and lending policies of the full range of financial institutions by, for example, targeting private sector net wealth as one of us has argued elsewhere (Arestis and Karakitsos, 2009).

Interestingly enough there have been attempts around the world to take on board the issue of financial stability. Two proposals that focus on this importance issue are the US Dodd-Frank Act of 2010 and the Basle III proposals. We comment briefly in terms of their importance as potential ways of avoiding crises of the type of the ‘great recession’.

The Dodd-Frank plan contains three important constituent elements.

The first is that size matters. No financial firm should be allowed to become ‘too big to fail’. A financial institution that it is too big to regulate and manage is ‘a systematically dangerous institution’; such institution should not be allowed to grow. Indeed, the motto ‘if you are too big to fail, you are too big to exist’, has become a relevant and recent motto.

The second is essentially to eliminate proprietary investments (namely to prohibit banks that take insured deposits from running their own trading operations) and also ownership of hedge funds by banks. Proprietary trading refers to the amount of financial investments undertaken by banks with their own cash (and thus bearing the risk of trading losses), in addition to their traditional ‘acceptance of deposits and provide loans’ activity. The purpose of eliminating proprietary investments is to avoid the
potential for conflicts of interest when a bank is working on behalf of its customers and making its own investments. In this way, deposit-taking banks will not be able to engage in leveraged proprietary trading (i.e. using own funds in investments in search of excess returns), a highly profitable, but exceptionally risky form of business. Nor will they be allowed to own, invest in or sponsor hedge funds or private equity funds. Institutions, whose downside risk is publicly insured, either directly or indirectly and because they can blackmail the country when they go down, should not undertake this kind of activity. Financial institutions should be limited to investing their customers’ funds.

The third element is that the financial sector must be restructured. There are viable small and medium-sized banks that did not fail by the subprime debacle. The big financial institutions serve no public purpose and they are dangerous. US should restore the protections that helped to secure safety under the 1933 Glass-Steagall Act.

The opponents, the Wall Street institutions lobby, geared up to fight the President’s plan. The Financial Services Forum (FSF) in particular, which represents 18 US top banks, argued that the President’s proposals misdiagnosed the causes of the financial crisis; that the proposed separation of commercial banking from investment banking is too complicated and too costly to achieve; that the proposals put jobs at risk, damage US competitiveness and might even threaten growth in the US economy. It has also been proposed that proprietary trading should be limited to a percentage of overall assets or business. Tackling the ‘too big to fail’ institutions should be undertaken instead through more effective supervision. Establishing a new authority able to wind down failing financial institutions, rather than forcing them to shrink, can achieve this objective. The most frequently used argument against the proposals is that they are by far too complicated. Surely though, they cannot be more complicated than the creation of the securitized assets and discussed in section 2 above. Indeed, compared to the latter assets that caused the crisis, the new proposals are delightfully simple. No longer would the banks be able to blur the distinction between commercial and investment banks. In any case, ultimately there does not appear to be clear reasons why giant banks are important to the US economy.

The question that is central to the debate is the extent to which the ‘great recession’ would have been prevented had the Dodd-Frank Act been in place prior to August 2007. This is an interesting question and it would appear that it has not been debated extensively let alone sufficiently if at all. The focus of the debate has been on the consumer protection it would provide in that it avoids taxpayer-funded bailouts. Our response to the interesting question of whether the Act could prevent another ‘great recession’ is on the negative. On this score the Dodd-Frank Act stopped short of forcing the biggest banks to split up along the lines of the Glass-Steagall 1933 Act. The latter prevented similar occurrences throughout its life. Is that not sufficient evidence on this particular question? A further point to be made is that the Dodd-Frank Act is bound to become the blueprint for banking regulation across the globe. However, given its idiosyncratic US nature and incompleteness, it might not become the template for others. The new law focuses more on large financial groups whose failure would put the whole system at risk. They would have to put aside more capital than before the crisis; the G20 at their June 2010 meeting also signed up to impose more capital on the banks.

The 27-member countries of the Basel Committee on Banking Supervision (BCBS) with the Group of Central Bank Governors and Heads of Supervision at their meeting on 12 September 2010 reached an agreement on the regulatory issues. The so-called ‘Basel III package’ is concerned with bank capital and
liquidity standards. The new ruling will be phased in from January 2013 with full implementation achieved only by January 2019. It requires banks to hold 4.5 percent of ‘core’ capital to ‘risk-weighted assets’ (RWA), from the 2 percent under current standards, along with a ‘capital conservation buffer’ of 2.5 percent to RWA to be built in good times and be used in times of hardship - composed of equity. Banks whose capital falls within the buffer zone will face restrictions on paying dividends and discretionary bonuses. All in all, it brings eventually the total common equity requirements to 7 percent.

The Basel II proposals also contain liquidity standards in the form of a Liquidity Coverage Ratio (LCR) and a Net Stable Funding Ratio (NSFR). LCR aims to ensure that internationally-active banks have up to 30 days to guard against a run on their wholesale liabilities, including secured funding. LCR is defined as the ratio of stock of high quality liquid assets to net cash outflows over a 30-day horizon, and it is required to be at least 100 percent. Eligible liquid assets include level 1 assets (cash, central bank reserves, and high-quality sovereign debt) and level 2 assets (high-quality corporate and covered bonds of nonzero weighted sovereign debt subject to haircut and a cap). It will be implemented in January 2015 after an observation period beginning in 2011. The NSFR refers to the availability of stable funding relative to the need created by the ownership of long-term assets. It is thought to enhance ‘funding liquidity’ since it limits the degree of maturity transformation of banks. It should be noted, though, that not much progress has been made on developing a macro-prudential approach. This is needed to dampen the tendency of financial institutions to behave procyclically and to properly account for the systemic risks posed by individual financial institutions.

A problem with this proposal is that unlike the US Dodd-Frank Act, which provided relevant regulations in the case of banks migrating to the ‘shadow banking’ sector and to the lightly supervised non-bank financial services companies, Basle III does not contain such provision. There is, thus, the possibility of a significant transfer of heavily taxed operations in terms of capital requirements to the ‘shadow banking’ sector, outside the scope of regulation and supervision. Financial stability would, thereby, seriously threatened. The BCBS approach to tackle such issues is for a new liquidity policy called ‘the net stable funding ratio’, which has been delayed until at least 2018.

Nor does Basel III address the ‘too big to fail’ syndrome. The new rules do not provide a firm solution to the authorities’ conundrum in the case of financial and economic turmoil in terms of their decision to accept it and let institutions to fail or inject tax-payer money to help them. There is, however, the possibility that national regulators would be able to impose extra charges on systemically important institutions. This is designed to prevent institutions from becoming too important, or too complex, to fail. It is also designed to avoid bailing out institutions at taxpayers’ expense. A further problem concerns the definition of the capital ratio. It is defined in relation to RWA, not to total assets. Clearly this implies that the ratio of capital to RWA is smaller than the ratio of capital to total assets. The leverage ratio refers of course to the latter definition, so that in effect high leverage ratio is possible. The further implication being that toxic leverage is highly probable, so that when the RWA is a small proportion of total assets, then the exposure of the banking sector to risk would be very high indeed. Clearly, then, Basel III has failed to correct the mechanism through which the main cause of the ‘great recession’, as discussed above, emerged. Under such circumstances it should not be surprising for another similar crisis to take place. All in all, and given the key role of Basel III in the global regulatory system, it would appear that financial stability remains unresolved and elusive.
6. Summary and Conclusions

We have argued in this paper that the monolithic concern of economic policy through inflation targeting should be abandoned. Our new approach to macroeconomics suggests that we need discretionary and well-coordinated economic policies and a new way of conducting monetary policy in the shape of financial stability. In this new way of pursuing and conducting monetary policy, it is, indeed, of considerable importance, and high time, that banks, and financial institutions more generally, should operate along the more familiar, and healthy, lines: direct credit as needed and in the process support enterprise; and be part of the system that generates investment and innovation for a healthier and more prosperous economy. Big banks should be brought back to a healthier size and, of equal importance, limit their capacity to speculate. Of equal importance is the need to curb the power and influence of the credit rating agencies. All in all, we need a smaller and safer banking industry. For it is the case that actually “Of all the many ways of organising banking, the worst is the one we have today” (King, 2010b, p. 18). Indeed, “What we cannot countenance is a continuation of the system in which bank executives trade and take risks on their own account, and yet those who finance them are protected from loss by the implicit taxpayer guarantees. The difficulty is in finding the right practical way to achieve that” (King, op. cit., p. 18). We have argued that current attempts to introduce financial stability have not been successful. What is perhaps needed is the introduction of a system along the lines of the Glass-Steagall 1933 US Act, which when in place over the period 1933 to 1999 in the US ensured that financial difficulties of the type of the ‘great recession’ never occurred.

References


