# Banking controls and monetary growth

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Almost immediately after the financial crisis broke the monetary authorities in many countries reacted by announcing plans to increase the capitalisation of banks. But they also wanted banks to increase their lending following the freezing of interbank markets. These policies are surely in conflict. Together they have consequences for monetary growth. This paper looks at some historical experience that suggest a different path.

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## Introduction

The recent financial crisis of 2007/08 and beyond was a major shock to the monetary authorities and the financial markets alike. Before that, at least in most of the OECD, financial stability had been around for so long that it had been taken for granted. In the United Kingdom apart from the relatively minor disturbance in the secondary banking sector in the 1970s, and another small-banks problem at the beginning of the 1990s, the banking system had been widely regarded as utterly secure for generations. There had been no threat to the payments system in living memory. But the events of 2007/8 shattered the complacency. Wide-ranging investigations followed and many proposals for reform were introduced.

The argument of this paper is that while the main diagnoses of the problems were correct some of the main remedies being advanced are in conflict. The first part of the diagnosis was that the banks had failed by being over-leveraged. They must therefore be far-better capitalised in the future. The second part of the problem was that the interbank market had frozen in the crisis (was the crisis) and banks have been nervous of lending since. But they are being pressed to lend. The problem has been that advocacy of better-capitalised banks is in conflict with advocacy of greater lending. They cannot both be done at the same time. While all might readily agree with that, in the on-going discussion there must either be some misunderstanding over terms or the nature of the proposals.

This article focuses primarily on British historical experience. It will argue that British bankers found their own way to appropriate capital and liquidity ratios consistent with profitable lending. Regulation upset the balance and distorted the process. It would be preferable to return to a situation where bankers decide for themselves how much capital to hold and what lending to do. But at the same time it must be clear there will be no bail-outs. Banks must be able to fail. It is to designing satisfactory resolution regimes that ensure that can happen that the authorities' efforts should be (and is being) directed.

## Reform of banking

Following financial crises there are usually calls for reform, and this time has been no different. After a few years of considering the questions the British Parliamentary Commission on Banking standards published its report in July 2013. The report runs to 570 pages and ranges over all kinds of behaviour and governance. It has commonly been the case that following a financial crisis the knee-jerk reaction

has been to impose new regulations. Something has clearly gone wrong and so it must be stopped, prevented from happening again, and barriers put in place to ensure that this is done. There seems to be little thought given to the fact that it might be regulation that has been the cause of the crisis. Almost as soon as the crisis broke in September 2008 there was an announcement by the government of a plan to recapitalise the British banking system. The Bank of England called for a major recapitalisation of the UK banking system of at least £50 billion, deemed a necessary condition for regenerating confidence in the financial system.

It was not always the case that regulation was the automatic response. For example, in Britain in the nineteenth century it tended to be the opposite. There were many financial crises in England in the first two thirds of the century. In 1825 there came what many called the first great crisis of financial capitalism. There followed several others: in 1836-39; in 1847; in 1857; and in 1866 yet another, the worst since that of 1825.

After each of these the response was to deregulate. The climate of the times - the age of laissez-faire, the consequence of the revulsion against the 'old corruption' - was that there must be impediments that were preventing the system working properly and these needed to be addressed. After 1825 the rules preventing the establishment of joint stock banks were partly removed. A little later they were removed altogether. And at the same time the Usury laws were relaxed thus allowing the Bank of England to begin to perform its proper function of lender of last resort. In the 1840s the gold standard was better defined and after the 1847 crisis it became clear that holding to the standard would not be insisted on in a crisis. In the 1850s limited liability was permitted. There were no regulations on the amount of

capital a bank was required to hold. There followed a long period of a lightly regulated banking sector in which the banks found their own way to the kinds of capital/asset, liquid/asset, and cash/asset ratios they wished to hold, and as a matter of interest it was a long period of remarkable stability.

But following the recent crisis it has been widely concluded that banks in many western countries have been badly undercapitalised and need to be recapitalised quickly. A great deal of focus has been placed on the capital position.

So for example, in Britain the newly founded Financial Policy Committee (FPC) has recommended that British banks should have sufficient capital to cope with future risks. Some banks they say will therefore need to raise their capital asset ratios. But the head of the regulatory authority (PRA) of which the FPC is a sub-set, believes that concerns that this will harm lending are misguided. 'Capital supports lending and does not substitute for it.' He says capital, 'is not money that has to be stashed away for a rainy day'. (Andrew Bailey, *Sunday Times*, 5 May 2013, pB9) But that is surely precisely what it is. It is held precisely for the purpose of covering unanticipated losses.

The FPC concluded in March of 2013 that banks should have an equity capital ratio of at least 7% of risk-weighted assets by the end of 2013. Basel III argues similarly if for a lesser amount. The *Financial Times* journalist, Martin Wolf says, 'Policymakers need to ensure that banks are robustly capitalised. If they do not do so, it is highly unlikely that banks will expand their lending'. (Financial Times, 7 June 2013) Even the highly acclaimed recent book on banking makes puzzling statements: 'For society, there are in fact significant benefits and essentially no cost from much higher equity requirements.' And further, 'Banks whose shares are traded on a stock exchange can

raise money by issuing additional shares and selling them to investors. If the additional funds are used to make loans, the higher capital requirements will actually allow the banks to lend more rather than less.' (Admati and Hellwig, pp. 98,99.)

There is it seems, at the very least, a need for a clarification of terms. In particular there is often an ambiguity over 'reserves' and on which side of the balance sheet they appear. For British banking a highly simplified balance sheet looks like that shown in Figure 1. Liabilities comprise equity capital and deposits (or funding, both retail and wholesale). And assets are made up of cash, short-term investments, and the balance is loans. It has been common for a long time to talk of a 'reserve/asset ratio' or alternatively a 'cash/asset ratio' and thus to think of reserves as being an asset. That is entirely legitimate if clearly understood. But a long tradition in British banking allowed banks to hold hidden reserves. These were in effect profits that had not been transferred to the balance sheet or had been disguised in the balance. But profits, of course, belong to the shareholders and just like equity capital they belong on the liability side of the balance sheet. Thus when banks are urged to increase their reserves there could be confusion over whether they are being asked to improve their liquidity position or their capital position.

**Figure 1 Traditional retail bank balance sheet**

| Liabilities | | Assets | |
|---|---|---|---|
| Capital | 10 | Cash | 10 |
| Deposits | 90 | Liquidassets | 30 |
| | | Loans | 60 |
| Total | 100 | Total | 100 |

## Capital in British banking

Capital has always been important to British banks. Indeed it was considered so important that the government and the Bank of England accepted the public interest argument that allowed the concealment of true profits and capital until as quite late in the twentieth century. Banks face a tension between having too much capital and too little. Strong capital positions are designed to give depositors confidence. But the greater the capital the lower will be the return on capital and so there is a trade-off between depositor confidence and shareholder satisfaction. And of course the quality of the assets is key to any calculation.

In the first half of the nineteenth century there were several hundred banks in England. Before 1826 these were all unlimited liability partnerships of no more than six. After 1826 joint-stock banking was permitted and banks gradually adopted that form.

In the periodic financial crises that appeared many banks failed or suspended payment for a time or merged or were taken over. There were no regulations as to what proportion of the balance sheet their capital or any other liability or asset might be. And across the middle two quarters of the century what regulations that were in place were gradually removed - such as the usury laws and unlimited liability. The banks therefore had to find their own way to the appropriate balance sheet shape and also allowed to choose whatever form of governance they wanted. Following the repeated financial crises in 1825, 1836, 1847, 1857, and 1866 the banks began cautiously with very high capital/asset ratios and similarly high liquid assets ratios. But these gradually came down as trust and understanding developed. And additionally, when after the 1870s it also became clear that the Bank of England had assumed the role of lender of last resort there was

an added reason for well-behaved banks to let their capital/asset and other ratios fall slightly further.

The maintenance of 'inner' or 'hidden' reserves allowed banks to smooth their reported profits, reassuring depositors and shareholders by presenting a picture of financial soundness and prudent behaviour thereby contributing to financial stability. The practice of maintaining hidden reserves had been prevalent from the mid-nineteenth century - the Midland Bank had, for example, first established a hidden reserve in 1866. By the beginning of the last quarter of the century the published capital ratios had settled at around 15 per cent with little variation across banks, and by the end of the century that figure had slipped to around 10-12 per cent. (Discount Houses operated with much lower levels for good reasons.)

In the inflationary conditions of the First World War the ratios fell further. In the years between the two world wars there continued to be remarkable stability in the banking sector and the ratios slipped slightly further. In the 1920s and 1930s they had settled at around 7 per cent. The point needs stressing that English/British banks were remarkably strong through these years and no doubt contributed to the stability in the economy and the avoidance of a great depression. In the Second World War the banks' capital ratios fell sharply. They were around 3 per cent. Their balance sheets expanded with government debt while private lending fell away. But as the ratios fell so too did the risk since the bulk of the balance sheet was made up of gilts. This continued to be the case in the long period of adjustment following the war. In fact the ratios reached their all-time lows in the 1950s when they were down to between 2 and 3 per cent. Raising capital after the war was not easy with the restrictions placed by the Capital Issues Committee.

This particular restriction on the banks began to tell and bank

chairmen spent a lot of time in the 1950s lobbying the Bank of England for support in allowing them to raise new capital. A note for the Chief Cashier made the problem clear, '··· it will be seen that the capital structure of the Clearing Banks is far from sound ··· At present it is clear that in times of trouble they must either put footnotes in their balance sheets - which we deplore - or lean on us for financial aid which would be disastrous ··· The banks, [if] freed from restriction, should pursue energetically the implementation of a programme which, for good reasons, is long overdue. (Quoted in Billings and Capie 2007 p.145.)

But as normality was restored and private lending came back to the position it had formerly occupied and gilt holdings were correspondingly reduced the capital/asset ratios slowly came back to around 4 or 5 per cent in the 1960s. There were still no regulations of any kind on capital in place.

All these figures are what were presented to the public in the banks' balance sheets. It was well understood that the banks had further reserves. And these hidden reserves did more than alluded to above in allowing a smooth picture of business to be presented. They meant that the banks were in fact a good deal stronger than was presented.

When the true positions are calculated all of the figures given above can be raised by at least one percentage point so that the lowest point of the 1950s would be closer to 4 per cent. When risk weightings of the Basel type are applied the figures would be dramatically higher reflecting the quality of the assets the banks held across most of this period. Thus the figures for the 1920s would show ratios of around 14 per cent. Those of the Second World War would turn out to be the highest of all time being even higher than 14 per cent. And in the 1960s the ratios were of the order of 13 per cent.

But as the Lloyds' Bank chairman commented in the 1950s: 'there is no rule of thumb method of deciding the size of the capital funds which a bank needs in order to carry on its business. The guiding principles are that the resources as a whole must be sufficient to provide absolute security for our depositors and the reserves sufficient to meet fluctuation in our trading from year to year ··· provision must ··· be made against the difficulties associated with the fluctuations in the market price of gilt-edged securities.' (Lloyds Chairman Report)

Only one official report of the period considered capital explicitly and that was the Prices and Incomes report of 1967. It concluded, 'There do not appear to be any concerted views among the banks about the appropriate level at which these [reserves] should be maintained. The banks do however, tend to consider their reserve requirements ··· in relation to total deposit obligations.' They believed that they had restored their desired capital position at the time of the report.

However, as inflation then took hold the banks were looking to raise their capital base further. But that unfortunately coincided with the biggest stock market fall of all time to date in Britain from 1972 to 1974 - the FT index fell from 533 in May 1972 to 160 in January 1974. Bank shares fared worse than most and some fell by as much as 70 per cent. It then became extremely difficult to raise new capital.

There was no particular threat to the main retail bank sector but there was a crisis in the secondary banking sector in the mid-1970s and that led to legislation (in 1979). The Banking Act passed that year placed limits on individual exposures to ensure appropriate diversification. Exposures exceeding 25 per cent of capital required prior approval of the Bank of England. That marked the beginning of interference in bank operations. And soon after that, in the 1980s, the rules of Basel took over.

The beginnings of statutory banking regulation in addition to normal company law appeared at different times in different countries. But the first hints of co-ordinated international regulation came in the wake of two 1974 bank failures - those of Bankhaus Herstatt in Germany and of Franklin National Bank in the United States. In large part due to the way in which regulatory authorities handled these failures, these relatively modestly sized banks caused considerable problems for other banks when they failed. This led to the formation of a standing committee of bank supervisors from the G10 countries; it has a permanent secretariat at the Bank for International Settlements in Basel - hence it is also known as the Basel Committee.

The Basel Accord of 1988 (Basel I) established a set of "Capital Adequacy Standards" for banks operating internationally. This accord required banks to hold capital according to Basel risk asset rules. It was recognised that risk assets were not homogeneous, but despite that recognition attention was paid only to credit risk - risk of default. Each asset held by a bank was assigned to one of five risk classes. Each of these classes had a different degree of risk weighting; the higher the risk, the higher the weighting, and the higher the capital required. The weighting was based on the generic nature of the borrower and no attention was paid to individual risks. So, for example, Marks and Spencer would receive the same weighting as a newly started bookshop; and the government of Argentina would get the same risk weighting (zero) as that of the UK. Furthermore, the effect of the focus on credit risk alone meant that no funds had to be set aside to cover, for example, the effects of interest-rate variations on the market value of long-term debt.

Anomalies, such as these and the fact that a lower risk weighting was given to an off-balance-sheet transaction with a business than to

a straightforward loan to the same business, encouraged regulatory arbitrage - the use of some financial instruments to allow a reduction in capital without a corresponding reduction in risk. All that, of course, points to weaknesses in Basel I, and these and other problems led to reconsiderations that resulted in Basel II. Banks had no such incentives to get round the rules when, as described earlier, they themselves chose their appropriate capital ratios.

Even if businesses set their own capital levels and set them prudently, they would at the moment still have to have the amount of capital prescribed by the Basel rules. This 'regulatory capital' may be less than the bank's desired capital (sometimes called its 'economic capital') for some types of loan, for example, some government bonds, and too much for others, for example, mortgages with very low loan-to-value ratios. There was a tendency, therefore, for banks to decide on the prudent amount of capital they needed to hold given their balance sheet, and adjust the form of their lending, the assets they held, or the extent of off-balance-sheet transactions to ensure that they had the right amount of economic capital but still exceeded the required regulatory capital. This encouraged complexity and much of the creation of the financial instruments that were implicated in the financial crisis.

An amendment to Basel I, announced in 1996 and adopted by 1998, tackled one deficiency: market risk - the risk of loss through changes in the market price of assets - was addressed. Banks were, subject to the approval of their regulator, allowed to use their own models to calculate market risk. These models were Value at Risk models, and produced an estimate of the sensitivity of the value of a portfolio to market price movements to show how much a firm would lose for any movement in prices. They would show banks the probability that they could lose a given amount of capital.

In the absence of an approved internal model banks had to use the Basel “standardised approach”. That was a “building blocks” approach. Four market risks were identified - interest rate, exchange rate, equity prices, and commodity prices - ; a capital charge was determined for each of these; and then these charges were added up. Note that because no relationship between the risks was allowed for, risk diversification, a classic principle of prudent banking was ignored and not rewarded in terms of the amount of regulatory capital that was required to be held. The deficiencies of the first Accord were removed in the second.

In 2001 a proposal was made for reform of capital regulation. This proposal was subject to considerable adverse comment, and eventually a ‘three pillar’ approach was introduced. There were measures of credit risk, which allowed for previously neglected ‘subtleties’ such as recognising that some companies can be less risky than some countries, and the recognition of operational risk (risk arising from failure of a part of the bank’s operations - computer failure stopping people getting their money is a good example). In addition to this more complex ‘risk pillar’, there were a supervisory pillar and a market discipline pillar. These three pillars were supposed to support the structure of banking.

The risk pillar has already been described. The supervisory pillar specified the responsibilities of national supervisors. These, in summary, were to ensure that banks measured their risks properly; that they encouraged review and updating of the way risks were measured; that they should encourage banks to hold above-minimum capital; and that they should encourage banks to restore capital to desired levels as soon as possible should banks experience losses. What is surprising about that list is not only that it all seems extremely obvious, but that it comprises functions that look like primary duties of bank management. The market discipline pillar encourages banks to disclose information

on risk exposure, capital adequacy and methods of calculating capital requirements quarterly or semi-annually. This is all information which, if concealed or incorrect, could mislead markets.

But the fact is that the three pillars did not support the structure of banking. There was a major banking crisis over a substantial part of the world. All the major studies on the subject (a thorough survey is provided in Lastra and Wood, 2009, and a study of an individual episode can be found in "The Run on the Rock", the report by the Treasury Select Committee of the House of Commons on the failure of Northern Rock) identifies the same principle features: perverse incentives, complacent management and shareholders, inadequate evaluation of risk, and regulatory failure so gross as in some cases deservedly to be described as incompetence. What was the response to these failures? In the U.K. there was the Vickers Commission and in the U.S. the proposals of a team led by Paul Volcker are examples. These proposals had much in common, despite the fact that they are often being contrasted.

It is not surprising that they had much in common because they both were confronted with a similar two-part question: a) how could banks be prevented from failing, and b) how they could be closed in an orderly fashion? The two parts of the question led to the same answer - separate investment banking (dealing in markets, essentially) from the traditional banking activities of borrowing and lending. They led to this answer by different routes. There was an idea that investment banking, described by the naïve as casino banking, was more risky than normal banking. This was quite the opposite of what had been the case in the UK, where the notable failures were of normal commercial banks (RBS and HBOS) which threatened the stability of their investment banking operations.

The Volcker Rule in its purest form prohibits deposit-taking banks from engaging in proprietary trading and investment in private equity or hedge funds. The Dodd Frank Act (which embodied the Volcker rule) enacted a slightly modified form of the rule which permitted limited investment in private equity or hedge funds (up to 3 per cent of Tier 1 Capital) and allowed trading for purposes of hedging, market making and liquidity management.

The main difference between the Volcker rule and the proposal of the Vickers commission relates to the location and height of the fence that divides the different banking activities. The Volcker rule seeks to ban completely what is seen as the most risky sort of trading activity from being carried out in a deposit-taking bank, but allows most investment banking activity to remain. The Vickers ring-fence seeks to insulate the core activities of the deposit-taking bank from a wider range of risky or non-essential activities, but via a split rather than a ban. It saw the advantage of a ring-fence over the Volcker rule is that banning proprietary trading would have only a modest impact in the UK where this is a relatively limited activity. In contrast, ring-fencing should facilitate resolution of both the ring-fenced and non-ring-fenced entities.

Basel III rules will raise banks' capital requirements from 4 per cent to 7 per cent. In June 2011 the Basel committee agreed to impose a surcharge of 2.5 per cent on top of this for banks that were judged to be too big to fail. And many urge even higher ratios. The Swiss National Bank proposed a 19 per cent ratio for Switzerland's two largest banks, UBS and Credit Suisse. The Swiss Parliament approved that rise in June 2011. (Hanke)

Thus what the above has shown is that in spite of much talk about there having been financial deregulation and that that has played a

major role in the crisis, that is not the case. Regulation has steadily changed since the 1980s and has been ratcheted up at various points. And it has frequently moved from one state of regulation to an inferior one.

## Monetary growth

How then have the recent regulatory changes affected monetary growth, and by implication economic growth? Too much money is a bad thing. It leads to inflation. Too little money is a bad thing. It leads to deflation. An unexpected sharp monetary contraction is also a bad thing. In the face of sticky wages and prices in the short run it has damaging effects on the real economy. The importance of the optimum quantity of money has become accepted and that has generally come to mean keeping the trend rate of monetary growth on a path that is consistent with the rate of growth in the real economy. If that can be achieved there should be stable money and prices - in general. When that is understood economic agents can see more clearly what the changes in relative prices are.

For these reasons financial instability is to be feared. A financial crisis (a clear manifestation of financial instability) is generally characterised as a flight to cash. In normal times the non-bank public hold a steady amount of cash in relation to bank deposits. And banks hold a steady amount of cash reserves in relation to their total deposits. These two elements constitute the basis of the money multiplier. The monetary authorities provide high-powered money and the multiplier on this delivers broad money. When, for whatever reason, there is a shock to the system and individuals decide to hold cash rather than deposits, banks try to build cash reserves to satisfy the demand from customers. But the result of these two actions is a shrinkage in the

money multiplier that has disastrous consequences for money growth and hence the real economy.

In these circumstances the monetary authorities need to inject sufficient high-powered money to offset the decline in broad money. The composition of the broad money aggregate does not matter. What matters is keeping M3 on an even keel.

This was a lesson learned over a long period through several financial crises in the nineteenth century. It is the essence of the role of the lender of last resort. The monetary authorities can print money without limit, or otherwise create it. When the financial markets understand this there will be less likelihood of financial panics occurring. It should also be stressed that it must still be possible for poorly behaved banks to fail. The central banks can provide liquidity but not capital.

The biggest demonstration of failure of a central bank to do what was required of it can be found in the behaviour of the Federal Reserve in the years 1929-33. That failure resulted in the great depression, the greatest economic disaster to hit the United States. The Fed, although a young institution at that stage nevertheless did know how to use open market operations and had done so successfully at the beginning of the 1920s. But at various points in the course of 1929-33 it failed to do what was required. The result was that money growth stalled and then fell sharply and produced the catastrophic collapse in output. The lesson was to keep money growth on its trend path.

That lesson was learned and the Fed demonstrated on more than one occasion that it had learned the lesson. Perhaps it over-learned the lesson and at any sign of trouble it eased monetary conditions. Certainly after 2004 U.S. monetary growth was surging at rates that reached 15 per cent per annum until the crash of 2008. It then collapsed precipitately and kept falling for more than two years by

which time it was in negative territory. It was not growing again until 2011. This was in spite of the programme of quantitative easing.

The U.S. inevitably suffered a deep recession. That was also true of the euro area where a similar pattern of broad money growth could be found and with the same consequences. Most dramatically this was the case in Greece. The U.K. too had a similar path to the U.S. Countries that did relatively well were countries where the money stock held up, countries as diverse as Switzerland and China.

## Conflict

The institutions that eventually became central banks frequently began their lives as government banks. They were formed primarily to carry out government business. But they gradually began to do commercial lending. When other commercial banks appeared they competed alongside them. In their evolution towards central bank it was necessary for the formerly government banks to withdraw from commercial rivalry since there could arise a clear conflict of interest. For example, for macro-economic reasons it might be desirable to raise interest rates while for commercial reasons it might be desirable to lower rates. That kind of conflict could become worse if the new central banks assumed some sort of supervision of the other banks. It would be intolerable for a central bank to be in competition with a bank whose activities it was in some ways directing.

Even although central banks have withdrawn from commercial rivalry is there still a possible conflict between macro-economic policy (or monetary policy) and microeconomic policy (or macro-prudential policy as that is sometimes puzzlingly called)? The Deputy governor of the Bank of England Charlie Bean argues 'No': ' Tightening monetary policy reduces both aggregate demand and credit supply, while tighter

regulatory policy does the same.' (Bean 2011) But what if one needs to be tight and the other loose? What if the monetary policy called for is a loosening - an easing of credit conditions, while regulatory policy is deemed to need tightening, say that banks need to better capitalised. Then there is surely a conflict.

That particular scenario seems to capture quite accurately present circumstances in the United Kingdom and further afield in the years following the global Financial Crisis. Monetary policy has been loose: low interest rates and quantitative easing. (And that is now said to be going to continue for a long period ahead in the new policy of forward guidance.) But at the same time the banks have been accused of being over-leveraged, that is insufficiently well capitalised, and that has to be corrected. So regulatory policy and monetary policy are in conflict.

And yet it is clear that the official view does not accept that. Robert Jenkins, who was a member of the Bank of England's Financial Policy Committee made the point strongly in a speech in September 2012: 'Bank A has a trillion euro balance sheet supported by 50 billion of equity. Now, let's double the equity required to 100 billion and retire 50 billion of bank debt. Has the balance sheet shrunk? No. Has the bank had to cut credit? No. Does more capital necessarily lead to less lending? No. So does society have to choose between safety and growth? No. ··· But if you fall for this fallacy you will agonise between doing what is right for the economy short term and what is right for stability and your country long term. Bankers have exploited this fear.'

Notice the sleight of hand. The bank actually had a 100 billion of capital to start with - 50 billion of equity capital and 50 billion of debt capital. So when it was required to raise its equity capital it swapped debt for equity. Of course it follows that its balance sheet will not need to change in any other respect. But that is not what is

being demanded from either domestic or international regulators.

The opposite and correct case has been strongly put by Tim Congdon. 'The regulatory blight on banking systems in all the world's so-called advanced economies, which means for these purposes all nations that belong to the Bank for International Settlements (BIS). The growth of commercial banks' risk assets is constrained by official demands for more capital relative to assets, for more liquid and low-risk assets in asset totals, and for less reliance on supposedly unstable funding (i.e. wholesale/inter-bank funding). If nothing else were happening, the contraction of asset totals and the rise in the proportion of capital to total liabilities would result in falls in the quantity of money, broadly defined, which would in turn imply falls in the equilibrium levels of national income and wealth. In some of the Eurozone's Club Med countries, and even to some degree in France and Italy, these processes of money contraction are still very much at work.' (Congdon a, June 2013, p.1)

Indeed Congdon goes much further. He argues that the collapse in bank lending that took place in 2008 (in all leading economies) was a direct consequence of the rushed response to the crisis that saw capital requirements raised immediately. It was that that was responsible for the 2009 policy of quantitative easing. While that has not entirely offset the drop in bank lending it went a long way. Had there been no quantitative easing the broad money aggregate would have been of the order of 25 per cent lower than it is today.

But, of course, it continues to be stressed by the authorities that ever- higher capital requirements, as outlined above, are being called for in the next few years. But with the economy beginning to grow slowly there is also the suggestion that quantitative easing has come to an end and indeed that it will have to be gradually withdrawn. What

then happens to money growth and the growth of nominal income?

In summary, 'The regulatory blight in banking systems has therefore been the dominant cause of the sluggish growth rates of nominal gross domestic products, across the advanced-country world, that have characterised the Great Recession and the immediately subsequent years. Indeed, the five years to the end of 2012 saw the lowest increases - and in the Japanese and Italian cases actual decreases - in nominal GDP in the G-7 leading industrialised countries for any half decade since the 1930s'. (Congdon, 2013b, p.1))

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