



The threat from – and to – banks' balance sheets

- **US banks balance sheets are expanding and money growth is accelerating**
- **But regulatory policies could shrink balance sheets and stifle output growth**
- **In the euro area this is already happening**

Banks' balance sheets are back in the news. The 22nd July main story on the front page of the *Financial Times* is that Deutsche Bank intends to shrink its balance sheet by one-fifth. The bank will also issue more hybrid equity capital. Meanwhile, on the front page of that day's Companies & Markets section, there was an article about a Royal Bank of Scotland report, which says that EA banks need to shrink their assets by at least €2.7 trillion (from currently €25 trillion) by 2016 in order to get down to a balance sheet size of three times EA GDP. This would be on top of the €2.4 trillion reduction in balance sheets already seen since early 2012. To put it in different terms, EA bank balance sheets have already shrunk by 6.8% and would, according to RBS, need to shrink by another slightly more than 10%. The rest of the *FT* week was dominated by comments on the Bank of England's 'Taliban' attitude towards enforcing bank balance sheet deleveraging.

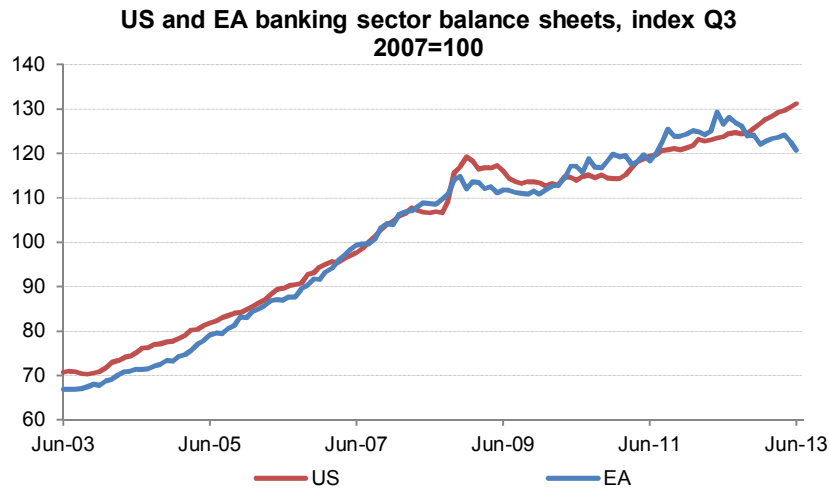
Part of the reason behind these developments and views is the laudable intention of averting future financial crises through imposing stricter and higher capital/asset rules on banks (the Basel III rules). A number of countries – including the US, the UK, Sweden and Switzerland – have made it clear that they will impose even stricter rules on their banking systems. That banking system balance sheets need to shrink is clear. But, much depends on which assets and liabilities are diminished. Shrinking inter-bank exposures and derivatives positions – essentially, reducing banks' prop trading – is one thing. Calling in loans is different and potentially harmful. This is of course partly because calling in loans contracts the outstanding stock of credit; but, much more importantly, because it also leads to a contraction in the stock of broad money. (Paying down loans reduces bank deposits; bank deposits held by the non-bank private sector make up more than 90% of broad money in most advanced economies.) Similarly, raising capital by issuing equity or bonds that are bought by the non-bank private sector also reduces broad money.

It is one of the peculiar developments of Great Recession that politicians, central bankers and regulators are on the one hand clamouring for banks to lend more; and on the other hand imposing regulations that make it difficult for banks to do so and even encourage them to shrink the outstanding stock of credit.

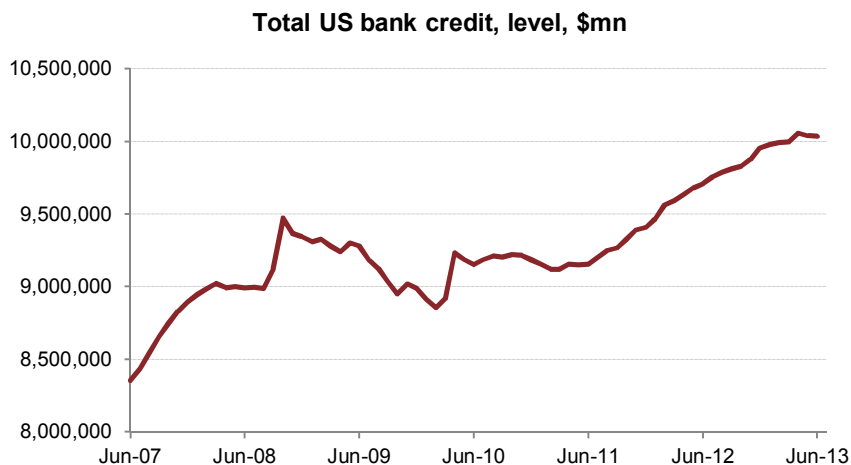
In the euro area, banks' balance sheets actually continued to expand, if erratically, after the crisis erupted in Q3 2007. But, from May 2012 (when they peaked) to June 2013, they shrunk by 6.8%. By contrast, the assets of US commercial banks have generally trended up since Q3 2007, with the exception of the period from May to October 2009 (although this came after a QE-induced surge in the second half of 2008). The recent divergence in bank balance sheet trends is as good an illustration as any of the different outlook for the two economies, with EA GDP likely to contract in 2013; while that of the US not only will expand, but should end the year with quarterly growth at or possibly even above trend.

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However, a closer analysis reveals that there are problems in the US banking sector as well, in spite of record profits just being reported for Q2. Specifically, although deposits (and hence broad money growth) are expanding, as are business loans, total credit has been contracting since April. The fall is so far not huge – down 0.2% over the past two months, or slightly in excess of 1.2% at an annualised rate. But what is worrying is that this is a clear break with the trend of the past three years. Moreover, the stock in securities in bank credit – risk assets – is down 0.9% over two months.



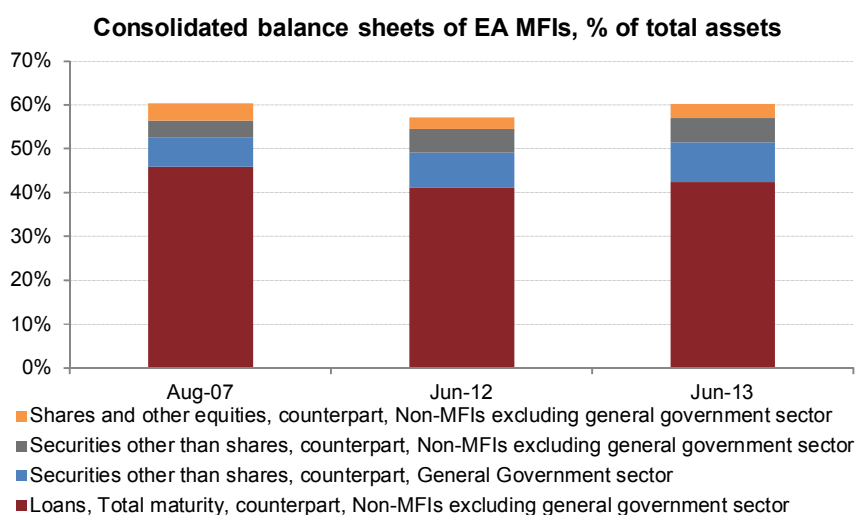
Part of what is going on is that US banks are moving out of Treasuries and other fixed income. Over the past two months, US banks' holdings of total securities have fallen by \$24bn. But the bulk of that is a fall in holdings of non-MBS Treasury and agency securities, which are down \$23.4bn, or 4.6% from April to

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June. Meanwhile, holdings of interbank loans and of cash assets are up by \$2.9bn (21.2%) and \$178bn (9.1%) respectively. If you assume – as you have to – that bonds are likely to face a bear market, you should move out of fixed income. The rise in cash, meanwhile, is primarily due to the Fed’s quantitative easing. These developments are also a consequence of what *The Economist* refers to as “regulators and politicians ... trying to suppress banks’ risk appetite, not whet it.”¹ The problem here – a point made by Tim Congdon of [International Monetary Research](#) – is that if banks are not supposed to buy risk assets, then the growth of their balance sheets – and hence of broad money – will depend on the growth of non-risk assets like cash. Yet, the Fed intends (rightly, given the economic outlook) to start tapering its quantitative easing, probably beginning within the next two or three months. What then? The Fed, of course, does not understand money and ascribes no importance to it (with honourable exceptions, mainly in the St Louis Fed). But how to square the circle if you a) want banks to lend more; b) don’t want them to buy risk assets; and c) the supply of non-risk assets dries up or at least diminishes?

The balance sheet of US commercial banks is at least expanding. Not so in the euro area. As noted above, consolidated balance sheet of euro area MFIs contracted by 6.8% from May 2012 to June 2013. But there are other differences. In the United States, banks are moving out of fixed income but increasing their loans to the non-bank private sector, if slowly (2.4% in the year to June) and with some loan categories, notably real estate-related, not growing. In the euro area, the stock of loans to the non-bank private sector is contracting while banks are piling up securities, notably but not exclusively fixed income. Whereas total assets of EA MFIs have fallen by €1,899bn since peaking in May 2012, holdings of securities other than shares issued by general government (ie, bonds and bills) have increased by €260bn. Meanwhile, the capital and reserves of EA banks is also now contracting, down by almost 3½% over the past four months.



¹ *The Economist*, The triumph of low expectations, 20th July, 2013

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The US monetary data point to a potential risk, namely that the on-going recovery could be aborted through excessive regulations and a desire to impose higher standards on US banks. However, in the case of the EA, the risk is more than potential – it is already there, with both balance sheets and credit contracting and money supply growth slowing from a three-month moving average of twelve-month growth (the ECB's preferred measure) of 3.7% in November 2012, to 2.8% in May. Moreover, even in the euro area, there will one day be a recovery of some sort; at which stage interest rates will normalise and bond prices will fall. But one pre-condition for a healthy recovery is faster broad money and credit growth. This will be difficult to achieve if, at the same time, regulators insist on pursuing policies that encourage further shrinking of banks' balance sheets.

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