

## IMPLICIT RISKS OF THE IMPLEMENTATION OF BASEL II AGREEMENT

Interview with *L. Randal Wray*

by *Marcos Antonio Macedo Cintra*<sup>1</sup>

### **MAMC: In your view what is the major goal and the core issue of Basel II?**

**WRAY:** From what I understand, it represents a synthesis of market discipline, rules and regulations, while rewarding banks that adopt well-designed risk management procedures.

While the original Basle Accord, effective from 1992, adopted minimum capital standards (8%) for all banking organizations, Basle II allows well-managed banks to *optimize* capital--they may be able to reduce capital.

The goal of Basle II is to more closely align capital requirements to the bank's internal risk-rating system, while also allowing the option of greater use of external credit rating agencies.

**MAMC: How do you evaluate capital requirements in view of risks faced by assets as the main indicator of banking safety and soundness on an individual basis and on a banking system basis?**

**WRAY:** It is difficult not to applaud the energy of the framers of Basel II, even while doubting its effectiveness in promoting financial stability. In a static national and international financial environment, Basel II probably will do a good job at promoting safety and soundness on an individual bank level. The problem is that the environment changes through time.

The question is this: Can Basel II substantially reduce the creation of a fragile financial structure and tendency to financial crisis? Almost certainly not. Basel II cannot do much to counter the effects of success and euphoria that will change perceptions of risk among borrowers, lenders, regulators, and private credit rating agencies.

The force of the market induces participants to reduce assessed risk at the most dangerous time—those that try to buck the speculative trend not only face lower returns but also questions of their management skill and profit drive.

Even external credit rating agencies get caught up in current fad and fancy and whirlwinds of optimism and pessimism. They missed the Asian Tigers crash.

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**MAMC: Does the fact that risk evaluation is backward looking weaken Basel II? If so, what would be an alternative for higher stability (considering the boundaries of banking regulation)?**

**WRAY:** Rules, regulations, and risk calculations are necessarily backward-looking, dealing with past innovations. Many of the risk assessment practices in Basle II require calculation of default risk and cost of default based on the previous five (or 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)--that can take just about five to ten years to run their course.

As we know from the US experience with the thrift crisis, the thrifts that won accolades for the best performance and best management in any particular year invariably wound up in trouble the next year.

The notion that the market can supervise banks requires rather heroic assumptions about availability of information, capacity to process that information, and ability to act on knowledge.

One of the advantages of discretionary supervision over rules is that supervisors can try to deal with innovations that were not foreseen. 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. 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. Basle 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.

This is why the great economist, Hyman Minsky 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 fiscal budget constrain swings of income--especially profits--and spending. Big Bank supervision in the boom, and lender of last resort intervention in the bust, help stabilize financial institutions.

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

**MAMC: In your opinion which would be the major instance regulating instability in the global economy: BIS and Basel II or US institutions (Federal Reserve and Department of Treasury)?**

**WRAY:** The national and international environment is probably the most important factor determining financial stability. When this environment is favorable, banking is pretty easy. However, global stability was threatened after the early 1970s for a number of reasons, and we saw quite a few financial crises, including banking crises, for the next quarter century.

The explosion of third world dollar debt after the run-up of oil prices in 1979 led to the creation of huge interest and principal payment flows denominated in dollars. Indebted nations had to earn dollars to service debt. Hence, a “chronic” US trade deficit has been required to supply the dollars needed.

While there is much talk about the “unsustainability” of US budget and current account deficits, that is where the global supply of dollars comes from.

I do think that the current US situation is “unsustainable”--but not for the usual reasons. It has nothing to do with solvency of the nation or federal government--but rather with the growth of household debt. Eventually US consumers will cut back spending, the US will slow, the current account will be reduced somewhat, and the fiscal deficit will grow.

I fear that the implication for much of the rest of the world will be slower growth and more debt problems. Banking problems will soon follow.

**MAMC: Would there be any other measures or policies--which (or do not) complement Basel II--that could lead to greater stability and prosperity in the global economy?**

**WRAY:** Greater transparency, better risk assessment, and improved supervision of banking are desirable but alone will not do much to enhance financial stability. The improved financial positions of banks around the world in recent years is due more to favorable national and international environments in which they operate than to improved risk assessment after Basle.

Continued improvement of Latin American and other developing economies, generally, will be much easier in the context of robust global economic growth. The typical orthodox policies such as lower costs, improved productivity and freer trade mostly redistribute shares of the global pie (“beggar thy neighbor”).

To increase the growth of the pie requires 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), most nations cannot succeed at that game. In the absence of sufficient reserves, an exchange rate peg holds domestic fiscal and policy hostage to the exchange rate.

Unfortunately, conventional wisdom holds that nations with “weak currencies” ought to abandon independence and adopt the dollar (or some other key currency) to eliminate the possibility of discretionary policy. If economies are naturally stable, such a policy--combined with the risk management provided in Basle II--might work.

However, if economies naturally trend toward fragility in the absence of government intervention, then 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 provide.

**MAMC: In an environment of increasing presence of institutional investors in the financial system and their risk portfolio positions, what is the reason to improve banking regulation without including these institutions?**

**WRAY:** We do give banks a special status, and thus, should pay closer attention to their safety and soundness. Banks do most of the clearing in the private sector, and almost all the clearing between the private sector and the government. It is essential that their liabilities trade at par against the currency. In other words, we cannot allow them to default on their checkable deposits—and given the implicit and explicit “social insurance” involved, it is appropriate to subject them to greater supervision. That said, it is probable that greater supervision of other types of financial institutions is also warranted.

**MAMC: In your point of view could domestic and international financial regulation institutions propose other initiatives other than those supposedly focused on stability/safety of banking system? Is so, pls specify.**

**WRAY:** A stable economic environment is probably the most important thing. Full employment with price stability is probably the best policy goal. Minsky advocated an employer of last resort program to fight unemployment and poverty in a noninflationary manner. Such a program would also have strong countercyclical influences, with spending on the program rising when the private sector sheds workers.