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THE GLOBAL ASSOCIATION OF FINANCIAL INSTITUTIONS

The Macroeconomic Implications of Basel III

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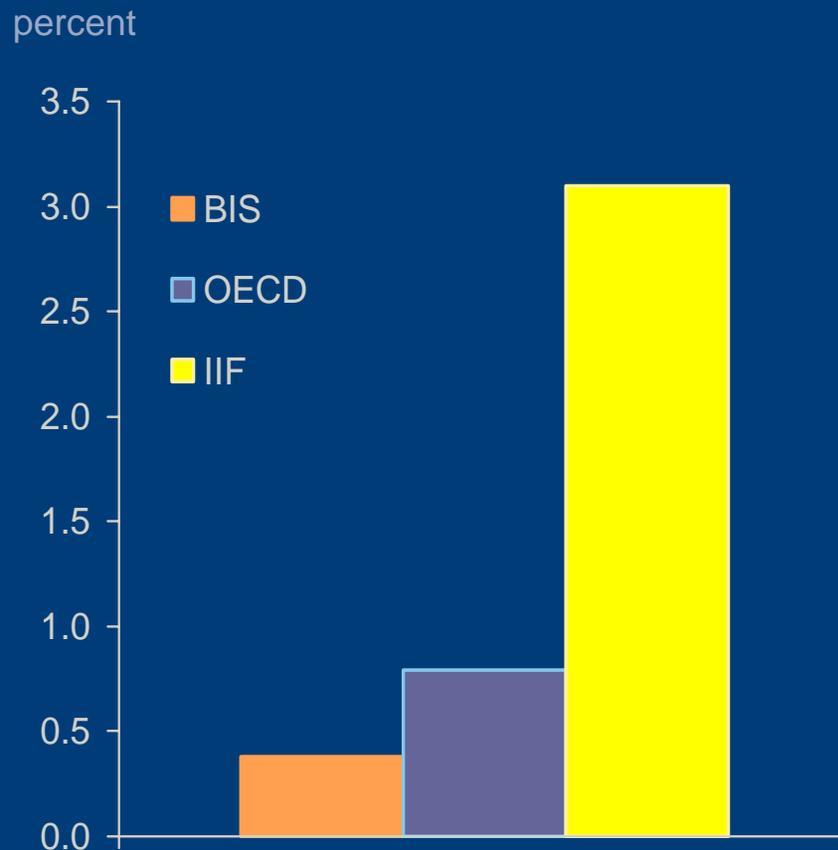
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Summary

- Honest disagreement: time will tell who is right
- This is the hardest (but probably most important) piece of applied economics that I've ever done
- Alan Greenspan in the early 1990s:
 - "I worry that bankers will make any loans"
 - "50 mph headwinds are holding back the recovery"
- Test of the IIF view:
 - Mature market GDP and employment growth will be positive but disappoint for a given monetary policy
 - Banks will be very reluctant to lend, especially to SMEs
 - Euro Area de-leveraging tensions will be significant

Estimated Impact on Economic Growth of Reforms

Cumulative Impact on Level of Real GDP
over 5 years



- Official position: impact very small. Move on.
- IIF position: impact meaningful. May indeed be a price worth paying, but need to be mindful of impact and track its evolution.
- New OECD study (Slovak and Cournede, OECD WP 844). In between, but still low.
- Country impact quite different:
 - Euro Area hit the most;
 - Emerging Economies hit the least

Why such significant differences between “us” and “them”?

- What would you expect?
- Not due to framework used: we all shock bank balance sheets and consider implications for net lending rates. Instead, reflects:
 - Magnitude of regulatory change considered
 - Impact of changes on bank funding markets
 - Differences in view of impact of consequent change in financial conditions on credit sensitivity sectors of economy

How does regulatory reform work to restrain growth?

- Regulatory reform raises banks blended cost of capital. This has to be passed on in one of two ways:
- Higher cost of credit to private sector
- Lower availability of credit to private sector
 - Rates may not be an appropriate rationing mechanism
 - Less creditworthy borrowers crowded out – SME sector particularly hard hit
 - Financial repression to bias flow of credit to public sector

Difference #1: Magnitude (and speed) of regulatory change considered

- Capital: BIS MAG (final) 1.3% points; OECD 2% points; IIF 5% percentage points (\$0.7 trillion needed):
 - Higher ratios
 - Changes in risk-weightings
 - Deductions
 - SIFI surcharge and counter-cyclical buffer
- Liquidity: How do you fund higher liquid asset holdings? (IIF \$5 trillion net long-term funding needed). THIS IS A MUCH BIGGER DEAL THAN THE OFFICIAL STUDIES HAVE RECOGNIZED
- Other: taxes, restrictions on activities
- Global synchronization
- Race to the top: lessens impact of extended timetable

Difference #2: Impact of changes on capital markets facing banks

- This is critical to any assessment!
- If requirements leave relative cost of funding unchanged, then more expensive blend of funding leads to higher lending rates
- Models differ radically on how this part of the calculation plays out:
 - Many official sector models assume lower marginal costs
 - IIF framework assumed higher marginal costs
- Jay will talk about debt markets and how regulatory reform is changing S&P's thinking in this area

Will the real Franco Modigliani please stand up?

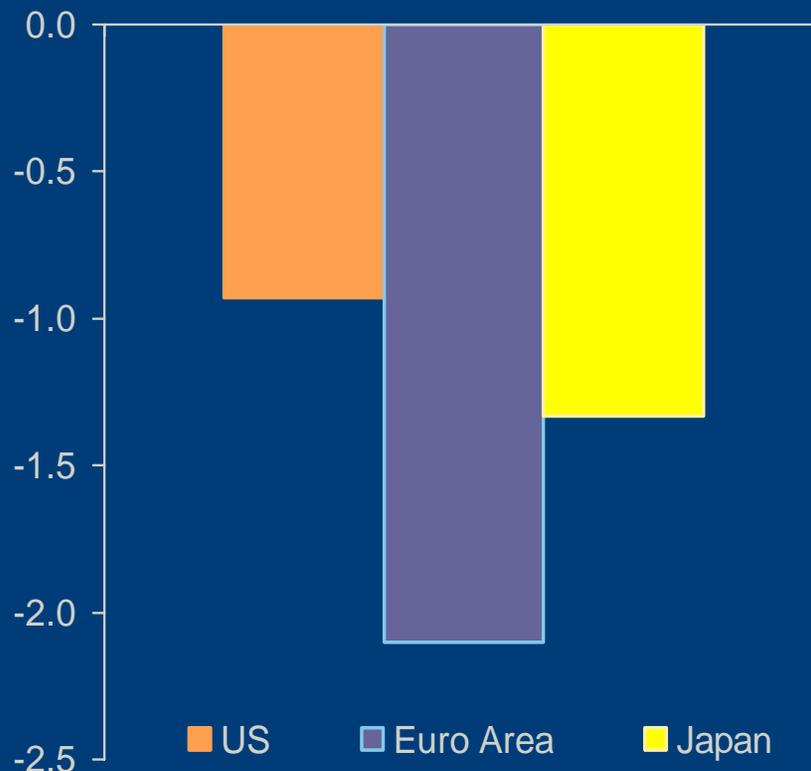
- Modigliani-Miller (1958): A firms' WACC is independent of its leverage ratio
 - Corollary: higher equity implies lower RoE
 - Quantities don't matter
- Modigliani-Sutch (1966): Preferred habitat theory. Investors have to be tempted out of their preferred comfort zones to hold willingly higher outstandings
 - Corollary: the more and the faster the supply, the more concessions issuance requires
 - Quantities and speed matter

Difference #3: Credit sensitivity of economy

Reduction in GDP level after 5 years from 100 basis point increase in bank lending rates

percentage points

Source: OECD



- Less of an issue
- Macro models used: many have stabilizing features
- Scope for monetary policy offset?

What about the benefits of reform?

- Stability benefits from stronger buffers:
 - Banks less likely to cause crises in future
 - Banks less likely to amplify future crises whatever their source
- But be careful of assuming too much in the way of benefits:
 - Historically, higher capital ratios have corresponded to greater economic volatility
 - We haven't exactly been good at reforms post-crisis
- Moral hazard issues: for both policy makers and bankers?
- We believe that public sector estimates of benefits of reform are significantly overstated

The way ahead

- Next steps in IIF research program
- Key to track. We believe the evidence is going our way. Year 2 of global recovery was disappointing to central banks and spurred QE2.
 1. US: ongoing concern about weakness of bank lending
 2. UK: Project Merlin
 3. Euro Area: sovereign debt tensions
 4. Switzerland: the counter example?
 - Risk-asset reduction achieved through massive external deleveraging