

WESTMINSTER ECONOMICS FORUM

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ALERTING POLICY-MAKERS AND BUSINESS LEADERS TO NEW RESEARCH IN AREAS OF TOPICAL INTEREST

Is it worth bolting the stable door before the horse bolts again?
Research on optimal bank regulation and the causes of financial crises.

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Venue: NIESR, 2 Dean Trench Street, Smith Square, London, SW1P 3HE

Speaker: Professor Ray Barrell
Chair: Dr Sushil Wadhvani, CBE.

A summary by Paul Wallace of The Economist

This time is different are fatal words in finance. But can tougher supervision make a difference? Ray Barrell set out a cost-benefit case for tightening the rules. Stricter regulation would deliver a big benefit in making banking crises less likely at an acceptable cost which would not impose an undue penalty on the economy



SUMMARY

Paul Wallace of The Economist

After the gravest international financial crisis since the early 1930s, sterner regulation is on the way: that is a political imperative. Just as predictably, banking lobbies are coming up with scary estimates of the damage that excessive regulatory burdens could inflict on the economy. So what is the economic case for imposing tougher obligations on the financial sector?

Ray Barrell sought to answer this vital question by estimating the costs and benefits of regulation. On the one hand, tougher rules on capital and liquidity act like a tax on banks, which they pass on to the wider economy by charging more for credit. On the other hand, that cost may be worth incurring if it makes harmful crises less likely. This potential benefit will depend on the damage that crises may inflict and how likely it is that tighter regulation can prevent them.

The first-round effect of a one percentage-point increase in

the ratio of banking capital to assets is close to 0.2 points on banks' interest margins. Assuming that bonds and bank finance are close substitutes and that equity (mainly through internally generated funds) makes up half of corporate funding, as is the case in the United States and Britain, this would push up the user cost of capital by 0.1 points. Using a standard production function, in which output is derived from capital inputs together with labour supply and technological progress, this would cut underlying output by 0.1 per cent.

The five-point increase in the capital ratio (from 2007 levels), which regulators have in mind, would thus entail a 0.5 per cent fall in output. The impact would be greater (a 0.8 per cent cut) in European countries which are more reliant on bank finance.

That is a far cry from estimates made by banking lobbies, who claim that a five-point increase in the capital

ratio would cause credit to fall by 15 per cent and output to decline by 5 per cent in the long run. But these estimates are overegged mainly because they do not allow for the fact that borrowers can access alternative sources of funding - bonds or equity - if bank loans become more expensive.

But even if the loss of output from tougher regulation is far less than bankers claim, is it still a price worth paying? That depends in the first place on the costs of financial crises. Not all are followed by recessions; and for that matter not all recessions follow crises. Only one in four crises has a permanent effect in cutting potential output and among these the average cost is 3 per cent of GDP.

That is worth avoiding, but can regulation reduce the chance of such damaging crises? An econometric appraisal of crises in developed economies suggests that it can. Both higher capital (common equity rather than tier 2) and liquidity ratios were found to reduce

Paul Wallace of The Economist

the probability of crises, while house-price bubbles, current-account deficits and a switch from on- to off-balance-sheet activity (rather than the level) made them more likely. On the basis of this research, a five-point increase in banks' capital and liquidity ratios would reduce the probability of a crisis from one every twenty years to once every century.

The findings suggested that regulation should indeed be tightened through the main Basel tool of higher capital ratios, supplemented by a return to the older and wrongly abandoned insistence on adequate liquid assets. There was also a case for supervisors to counter housing market frenzies directly, by lowering loan-to-value ratios, while monitoring current-account deficits and rising off-balance-sheet activities as warning signals.

The warnings of the financial lobbies were also overstated in that they failed to acknowledge the fact that capital ratios had already risen sharply since their 2007

levels, half way towards a possible target of a five-point increase. But the bankers were right in one respect. Any change should be introduced gradually. A sudden increase could be disastrous. By eliminating the headroom that banks like to keep above statutory capital ratios it could lead them to regain their freedom of manoeuvre by slimming their overall balance-sheets through another bout of credit rationing.

It was also important for countries to act together when stiffening regulations. If one country tried to do so alone, borrowing costs would rise there but not elsewhere, and competitiveness might be damaged. Tighter regulation and higher borrowing costs would reduce investment and raise saving. Simulations on the National Institute's world model suggested that the adverse effects on output could be halved through joint action changing the global balance between global savings and investment, which would reduce long-term real interest rates.

In subsequent discussion, Mr Barrell accepted that current-account deficits were not an infallible warning signal, since the banks of surplus countries could run into trouble by lending to the deficit countries. This had happened for example in the Netherlands and Germany whose banks had acquired dodgy American securitised assets. He denied that the extra regulation might hamper growth and argued that a tougher regime was worth having in order to reduce the likelihood of damaging financial crises.



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