

## Basel III and Banking Flows to Emerging Markets

### Basel III rules could lead to a decline in banking flows to developing regions—with some being affected more than others

The global financial crisis has led to a range of reform proposals for the regulatory framework governing banks with a view to enhancing their resilience. Agreement has already been reached on some aspects of these new rules—collectively referred to as Basel III. The proposed reforms are expected to reduce the frequency and intensity of banking crises. But there is concern that the costs of moving to a stricter regulatory environment, such as higher capital adequacy ratios, may lead banks to raise interest rates and reduce lending. If Basel III reforms are implemented over a short period, there could be a drag on what is already a weak economic recovery.

To the extent that this short-term impact materializes, emerging markets are likely to be affected through two channels:

- The *trade flows channel*, which acts through lower economic activity in advanced economies and correspondingly lower imports by these countries from emerging markets.

- The *financial flows channel*, which takes place through increases in interest rates in advanced economies and the corresponding decline in banking flows from advanced to emerging markets. Both a direct lending effect (lower lending from banks in advanced economies to nonbanks in emerging markets) and an indirect lending effect (lower lending from banks in advanced economies to banks in emerging markets) are likely through this channel.

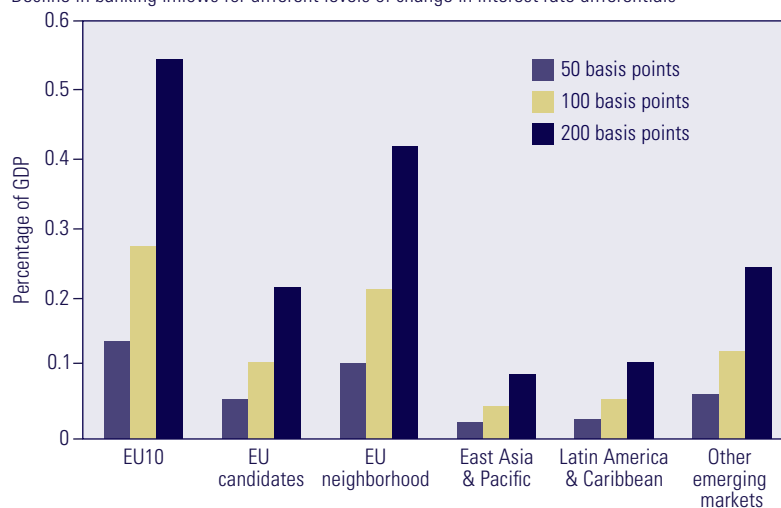
Focusing on the financial flows channel, Ghosh, Sugawara, and Zaldendo simulate the likely effect on banking flows to emerging markets of increases in lending rates in advanced economies. The simulations are based on an analysis of the determinants of bilateral banking flows from 17 advanced economies to 38 emerging markets in the locational banking statistics of the Bank for International Settlements. The analysis includes the push (global) factors and pull (domestic) factors identified in the literature on capital flows as well as indicators of nonfinancial and financial bilateral links. Among these indicators the authors include controls for financial interconnectedness between lending and borrowing countries. They find that emerging markets that are highly dependent on one advanced economy

for funding are less attractive for funding from other countries; at the same time, however, the advanced economy on which an emerging market is highly dependent is less likely to pull out its resources. The empirical methodology also controls for financial contagion, and the authors find that banking flows to emerging European economies are statistically more stable than flows to other developing regions.

The simulations show that implementation of Basel III could lead to a decline of 3 percent in banking inflows to emerging markets for each 100-basis-point decline in interest rate differentials between each lending and each borrowing country. For each region the impact depends on its dependence on banking flows. For example, for the EU10 countries, which depend heavily on such flows, the decline could be as much as ¼ percent of GDP if the change in interest rate differentials is 100 basis points and just over ½ percent of GDP for a change of 200 basis points. Lower levels are likely in other emerging markets (figure 1).

Of course these simulations should be viewed with caution. They assume that the behavioral responses will remain valid even after a structural change of the kind introduced by Basel III requirements. In addition, the calculations do not control for a reassessment of risks in emerging markets following the global financial crisis. Indeed, it can be argued that on this count alone capital flows are likely to be more subdued than in the period before the crisis. In conclusion, developing regions are likely to experience a decline in banking flows—though a manageable one—if Basel III regulations lead to a decline in interest rate differentials, and some regions will be more affected than others.

Figure 1. Expected Effect of Basel III on Banking Flows to Emerging Markets  
Decline in banking inflows for different levels of change in interest rate differentials



Note: EU10 refers to the 10 Central European countries joining the European Union in 2004 and 2007. EU candidates are countries in Southeastern Europe plus Turkey. EU neighborhood includes Belarus, Moldova, Ukraine, and the countries in the Caucasus.

Swati R. Ghosh, Naotaka Sugawara, and Juan Zaldendo. 2011. "Banking Flows and Financial Crisis: Financial Interconnectedness and Basel III Effects." Policy Research Working Paper 5769, World Bank, Washington, DC.