A capital idea that will hurt poorer countries

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The Basel committee of banking regulators has proposed a new capital accord with the aim of more accurately aligning regulatory capital with the risks that international banks face. But the agreement could have precisely the opposite effect when it comes to developing countries.

The current Basel II proposal would significantly over-estimate the risk of international bank lending to developing economics. This would excessively increase capital requirements on such lending, sharply raising the cost of bank borrowing by developing countries and reducing the supply of loans to them.

Bank lending to the developing world has already fallen sharply in the past five years, stifling growth – most recently and spectacularly in Latin America. To reinforce that trend would plainly contradict one of the aims of the Group of 10 richest countries, which wants to encourage private financial flows to developing countries and use them as an engine for stimulating and funding growth.

One of the main benefits of lending to – an investing in – developing countries is their relatively low correlation with mature markets. Spreads on syndicated loans – which reflect probability of default – tend to rise and fall together within developed regions more than between developed and developing countries; similar results are obtained for the correlation of bank profitability. Furthermore, broader macroeconomic variables – such as growth of gross domestic product, interest rates, evolution of bond prices and stock market indices – show far more correlation within developed economics than between developed and developing ones.

A bank's loan portfolio that is diversified between developed and developing countries has a lower level of risk than one focused exclusively on lending to developed economics. Since the new Basel II rules are intended precisely to help banks cope with un-expected losses, it is surprising and unfortunate that the current proposals do not explicitly incorporate the benefits of international diversification. Unless the proposal is amended, capital requirements will not clearly reflect the risk and will unfairly penalise lending to developing countries.

It is therefore imperative that the Basel committee, in its next (and almost final) revision of the proposed accord, incorporates the benefits of international diversification, for example explicitly reducing capital requirements.

There is a clear precedent. The Basel committee has already made such a change with respect to lending to small and medium sized enterprises. Following the publication of its consultative document in January 2001, there was widespread concern – especially in Germany – that the increase in capital requirements would sharply reduce bank lending to smaller companies, with potentially devastating effects on growth and employment. Critics argued that the probability of a large number of SMEs defaulting simultaneously was lower than for a smaller group of large borrowers. After intensive lobbying by the German authorities, the Basel committee agreed to lower average capital requirements by about 10 per cent for smaller firms.

Our recent research implies that at least as large a modification is justified with respect to international diversification, in regard to lending to developing countries.* There are no practical, empirical or theoretical obstacles to a change that could greatly benefit the developing world and ensure more precise measurement of risk and capital adequacy requirements.

The Basel committee has always emphasised the technical nature of its proposals and technical case for including the benefits of diversification is extremely strong. Furthermore, G10 governments are committed to encouraging private financial flows and therefore should avoid measures that might have the opposite effect.

Developing economies and transition countries are not represented at all in the Basel committee and so have limited leverage to make their case. However, given the committee's technical expertise and fair-mindedness, there is still a chance that it will amend the current proposal to take account of the benefits of international diversification. It would be technically wrong, economically unwise and politically insensitive not to do so.

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