



IMF gets it right on Mexico

Basle III shows its limitations

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The new Basel III mandates for higher capital requirements put a damper on broad money growth rates and throw yet another cloud over prospects for a healthy economic recovery. In short, the imposition of higher capital requirements on banks in the middle of an anaemic rebound from what I call the Panic of 2008-09 is bad medicine, as I stated in 'Why Basel III lowers growth: Higher capital-asset ratios destroy money'. [OMFIF Bulletin, April 2011, p.6]

It's easy to see why higher capital-asset ratios are 'deflationary.' If we hold the level of a bank's capital constant, an increase in its capital-asset ratio requires that the level of its assets must fall. This, in turn, implies that the banking system's liabilities – demand deposits – must contract. Since the money supply consists of demand deposits, among other things, the money supply must, therefore, contract.

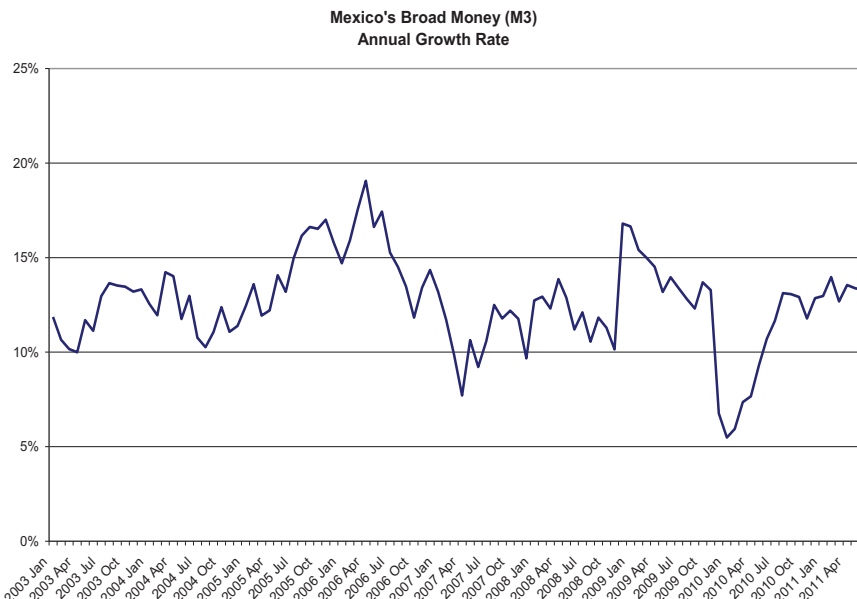
Alternatively, if we hold assets constant, an increase in the capital-asset ratio requires an increase in capital. This destroys money. When an investor purchases newly-issued bank shares, for example, the investor exchanges funds from a bank deposit for the new shares. This reduces deposit liabilities in the banking system and wipes out money.

It's no surprise that Sir John Hicks – a high priest of economic theory and 1972 Nobelist – thought there was nothing more important than a balance sheet.

After those simple analytic reflections, we arrive in Mexico. At present, contrary to the picture in the US, UK and the euro area, Mexico's rate of growth in broad money (M3) is rather robust.

The International Monetary Fund has connected the dots. It is clear from the IMF's July 2011 report on its Article IV consultations with Mexico that the IMF staffers concluded that further increases in the Mexican banks' capital-asset ratios would take some steam out of Mexico's money supply growth and jeopardise Mexico's economic recovery. The IMF hit the nail on the head when it expressed concern that the introduction of new capital surcharges and higher capital-asset ratios in Mexico could negatively affect the economy. It's time to call 'time out' on Basel III. ☒

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Sources: International Monetary Fund, [International Financial Statistics](#) and Author's Calculations.