ERSA Research Brief

May 2018

Can bank capital adequacy changes amplify the business cycle in South Africa?

By Foluso Akinsola[1] & Sylvanus Ikhide[2]

The phenomenon of bank regulation procyclicality requires very careful examination for both regulatory bodies and supervisory authorities given the salient role of the financial sector as an engine of growth to the real sector. Consequently, policies and regulations should be formulated in a way that will not hinder the financial deepening of the markets. Regulatory measures that promote excessive risk-taking during a crisis could have severe implications for the procyclical behavior by most banks. We suggest that the South African economy needs forward-looking policies that will mitigate the flow of credit to the real sector and at the same time ensure financial stability.

The aim of this study was to examine the extent of linkages between business cycle and capital adequacy requirements in South Africa employing the VECM framework. We want to understand the extent to which the imposition of capital adequacy can accentuate and deepen the business cycle in the financial system. The Johansen Cointegration approach was used to ascertain whether there is indeed a long-run co-movement between capital adequacy and business cycle, but first we tested the stationarity of our series under the NG–Perron and KPSS framework, where we established that all the series were I(1), a property essential for cointegration analysis. Results from the tests and VECM model show that there are significant linkages among the variables, especially between capital adequacy and business cycle. In other words, the imposition of a capital adequacy requirement can amplify the business cycle in South Africa

[1] Doctoral graduate in Development Finance, University of Stellenbosch Business School, South Africa. All correspondence should be directed to akinfolu@yahoo.com. University of Stellenbosch Business School, P.O. Box 610, Bellville, Cape Town, South Africa, Tel: +27745090423

[2] Professor of Development Finance. Sylvanus.Ikhide@usb.ac.za, University of Stellenbosch Business School, P.O. Box 610, Bellville, Cape Town, South Africa.