COLLEGE OF EUROPE
BRUGES CAMPUS
ECONOMICS DEPARTMENT

The Consequences of Basel III and the Monetary Policy of the European Central Bank

Supervisor: **Prof. Christian de BOISSIEU**

Thesis presented by
Philip Maria Albert Hoffmann
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Abstract

Basel III was the reaction to recent financial crisis and has been translated into European law. The European legislator intervened with Basel III to make banks safer, but an intervention in the financial ecosystem brings negative externalities. These externalities can also be influenced by the monetary policy. This paper analyses the influence of Basel III combined with the monetary policy since 2007.

The literature of this paper includes academic work, working papers, reports of the European Central Bank and the Bank for International Settlements.

Reports and working papers of the Bank of International Settlements and the European Central Bank are used to explain Basel I-III and the monetary policy since 2007. Based on working papers from institutions as for instance the OECD, we analysed the impact of Basel III. Financial data from sources like Bloomberg or the European Central Bank is used to analyse the impact of Basel III and the ECB´s monetary policy.

The main paper is divided into 5 parts. The first and the second part explain Basel I to Basel III, and the monetary policy of the European Central Bank from 2007 to March 2015. The third part explains firstly the consequences of Basel III and the monetary policy individually and then the consequences of both of them combined. The fourth part includes an econometric model that explains the influences of higher capital requirements on sovereigns in the Euro-zone. The part 6 gives an outlook analysis of whether the new regulation combined with an expansive monetary policy could create a bubble.

The research came to the result that Basel III and the monetary are individual and together responsible for negative externalities. Basel III decreases the credit supply, while the monetary policy pushes liquidity in the banks. This leads to a decrease of loans for consumption and non-financial firms and an increase of loans for house purchase and sovereigns in the banks balance sheets. The result is that the banks asset will be more concentrated and interconnected. The econometric model proved that higher capital requirements and lower key interest rates also lowered the interest rates of German and French government bonds. The analysis of the German stock index DAX and the German housing prices reveals increasing P/E ratios, which are used as an indicator of bubbles. This leads to the final conclusion that banking regulation and monetary policy have to be better coordinated.