The Credit-to-GDP Gap and Countercyclical Capital Buffers: Questions and Answers

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Abstract

Basel III uses the gap between the credit-to-GDP ratio and its long-term trend as a guide for setting countercyclical capital buffers. Criticism of this choice centres on three areas: (i) the suitability of the guide given the objective of the buffer; (ii) the early warning indicator properties of the guide for banking crises (especially for emerging market economies); and (iii) practical measurement problems. While many criticisms have merit, some misinterpret the objective of the instrument and the role of the indicator. Historically, for a large cross section of countries and crisis episodes, the credit-to-GDP gap is a robust single indicator for the build-up of financial vulnerabilities. As such, its role is to inform, rather than dictate, supervisors' judgmental decisions regarding the appropriate level of the countercyclical buffer.

JEL Classification: E44, E51, E61, G01, G21

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