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Spotting Perfect Storms Financial regulation, rapid credit growth and banking crises

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Abstract: It has been widely observed that many banking crisis episodes were preceded by high credit growth. This has led to the belief that "fast and loose" credit extension by banks and non-bank financial institutions is a primary cause of banking crises worldwide. What is less known, however, is that only a minority of all credit booms are followed by a subsequent banking crisis. Under what circumstances would high credit growth be more likely to result in a banking crisis? This is the primary question which I investigate in this dissertation. One aspect I look at in particular is the role of the supervisory regime in place during the periods of high bank credit growth. Looking at a sample of 77 countries from 1973 to 2009, I find that the likelihood of high credit growth to metastasize into a banking crisis is significantly enhanced in the presence of weak financial sector supervision. I also find that high levels of private credit in relation to GDP and cumulative asset price inflation significantly increases the odds of a credit boom to collapse into a banking crisis. The magnitude of these effects is found to be substantially higher at very high values of credit growth.

Given that stronger supervision could reduce the likelihood of having an unsustainable credit boom -one that ends up in a banking crisis - why don't all countries adopt uniformly stronger, best-of-breed financial regulation and supervision? I address this question by looking at the number of veto players in the political system. Using an ordered logit model and controlling for the size and concentration of the banking sector, as well as government ideology and stability, I find that fragmented political systems with higher degrees political constraints on executive power tend to have significantly weaker financial sector supervision than those in which political power is more concentrated. I also find that leftist ideology of the government in power and government stability raise the odds of having a stronger financial regulation and supervision, while high banking sector concentration lowers these odds.

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