THE POLITICAL ECONOMY OF FINANCIAL CRISIS POLICY

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Highlights

- Government intervention to stabilise financial systems in times of banking crises ultimately involves political decisions. This paper sheds light on how certain political variables influence policy choices during banking crises and hence have an impact on fiscal outlays.
- We employ cross-country econometric evidence from all crisis episodes in the period 1970-2011 to examine the impact political and party systems have on the fiscal cost of financial sector intervention.
- Governments in presidential systems are associated with lower fiscal costs of crisis management because they are less likely to use costly bank guarantees, thus reducing the exposure of the state to significant contingent and direct fiscal liabilities. Consistent with these findings we find further evidence that these governments are less likely to use bank recapitalisation and more likely to impose losses on depositors.

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Appendix II: Construction of LIEC and Checks and Balances

Legislative and Executive Indices of Electoral Competitiveness (LIEC) (see Beck *et al*, 2001, 2012, codebook p14)

>Legislative IEC Scale: No legislature: 1
>
>Unelected legislature: 2
>
>Elected, 1 candidate: 3
>
>1 party, multiple candidates: 4
>
>multiple parties are legal but only one party won seats: 5
>
>multiple parties won seats but the largest party received more than 75% of the seats: 6
>
>largest party got less than 75%: 7
>
>Checks and Balances (see Beck *et al*, 2001, 2012, codebook, p18-19)

Checks and Balances equals one if LIEC OR (the Beck *et al*, 2012, Executive Index of Electoral Competition) EIEC is less than 6 (5 for CHECKS_LAX) – countries where legislatures are not competitively elected are considered countries where only the executive wields a check.

In countries where LIEC and EIEC are greater than or equal to 6 (5 for CHECKS_LAX): Checks and Balances is incremented by one if there is a chief executive (it is blank or NA if not).

Checks and Balances is incremented by one if the chief executive is competitively elected (EIEC greater than six).

Checks and Balances is incremented by one if the opposition controls the legislature. In presidential systems, Checks and Balances is incremented by one:

>for each chamber of the legislature UNLESS the president's party has a majority in the lower house AND a closed list system is in effect (implying stronger presidential control of his/her party, and therefore of the legislature).
>
>for each chamber of the legislature UNLESS the president's party has a majority in the lower house AND a closed list system is in effect (implying stronger presidential control of his/her party, and therefore of the legislature).
>
>In parliamentary systems, Checks and Balances is incremented by one

for every party in the government coalition as long as the parties are needed to maintain a majority (the previous version of CHECKS – Checks3 in DPI3 – incremented by one for each of the three largest parties in the government coalition, regardless of whether they were needed for a legislative majority).

for every party in the government coalition that has a position on economic issues (right- left-center) closer to the largest opposition party than to the party of the executive.

In parliamentary systems, the prime minister's party is not counted as a check if there is a closed rule in place – the prime minister is presumed in this case to control the party fully.

Appendix III: Banking Crises 1970−2011

Country	Start	End	Country	Start	End	Country	Start	End
Albania	1994	1994	Equatorial Guinea	1983	1983	Nicaragua	2000	2001
Algeria	1990	1994	Eritrea	1993	1993	Niger	1983	1985
Argentina	1980	1982	Estonia	1992	1994	Nigeria	1991	1995
Argentina	1989	1991	Finland	1991	1995	Nigeria	2009	ongoing
Argentina	1995	1995	France	2008	ongoing	Norway	1991	1993
Argentina	2001	2003	Georgia	1991	1995	Panama	1988	1989
Armenia	1994	1994	Germany	2008	ongoing	Paraguay	1995	1995
Austria	2008	ongoing	Ghana	1982	1983	Peru	1983	1983
Azerbaijan	1995	1995	Greece	2008	ongoing	Philippines	1983	1986
Bangladesh	1987	1987	Guinea	1985	1985	Philippines	1998	2001
Belarus	1995	1995	Guinea	1993	1993	Poland	1992	2001
Belgium	2008	ongoing	Guinea-Bissau	1995	1998	Portugal	2008	ongoing
Benin	1988	1992	Guyana	1993	1993	Romania	1990	992
Bolivia	1986	1986	Haiti	1994	1998	Russia	1998	1998
Bolivia	1994	1994	Hungary	1991	1995	Russia	2008	ongoing
Bosnia and Herzegovina	1992	1996	Hungary	2008	ongoing	Sao Tome & Principe	1992	1992
Brazil	1990	1994	Iceland	2008	ongoing	Senegal	1988	1991
Brazil	1994	1998	India	1993	1993	Sierra Leone	1990	1994
Bulgaria	1996	1997	Indonesia	1997	2001	Slovak Rep	1998	2002
Burkina Faso	1990	1994	Ireland	2008	ongoing	Slovenia	1992	1992
Burundi	1994	1998	Israel	1977	1977	Slovenia	2008	ongoing
Cameroon	1987	1991	Jamaica	1996	1998	Spain	1977	1981
Cameroon	1995	1997	Japan	1997	2001	Sri Lanka	1989	1991
Cape Verde	1993	1993	Jordan	1989	1991	Swaziland	1995	1999
Central African Republic	1976	1976	Kazakhstan	2008	ongoing	Sweden	1991	1995
Central African Republic	1995	1996	Kenya	1985	1985	Sweden	2008	ongoing
Chad	1983	1983	Kenya	1992	1994	Switzerland	2008	ongoing
Chad	1992	1996	South Korea	1997	1998	Tanzania	1987	1988
Chile	1976	1976	Kuwait	1982	1985	Thailand	1983	1983
Chile	1981	1985	Kyrgyz Republic	1995	1999	Thailand	1997	2000
China	1998	1998	Latvia	1995	1996	Togo	1993	1994
Colombia	1982	1982	Latvia	2008	ongoing	Tunisia	1991	1991
Colombia	1998	2000	Lebanon	1990	1993	Turkey	1982	1984
Congo, Dem Rep	1983	1983	Liberia	1991	1995	Turkey	2000	2001
Congo, Dem Rep	1991	1994	Lithuania	1995	1996	Uganda	1994	1994
Congo, Dem Rep	1994	1998	Luxembourg	2008	ongoing	Ukraine	1998	1999
Congo, Rep	1992	1994	Macedonia, FYR	1993	1995	Ukraine	2008	ongoing
Costa Rica	1987	1991	Madagascar	1988	1988	United Kingdom	2007	ongoing
Costa Rica	1994	1995	Malaysia	1997	1999	United States	1988	1988
Cote d'Ivoire	1998	1992	Mali	1987	1991	United States	2007	ongoing
Croatia	1998	1999	Mauritania	1984	1984	Uruguay	1981	1985
Czech Republic	1996	2000	Mexico	1981	1985	Uruguay	2002	2005
Denmark	2008	ongoing	Mexico	1994	1996	Venezuela	1994	1998
Djibouti	1991	1995	Mongolia	2008	ongoing	Vietnam	1997	1997
Dominican Republic	2003	2004	Morocco	1980	1984	Yemen	1996	1996
Ecuador	1982	1986	Mozambique	1987	1991	Zambia	1995	1998
Ecuador	1998	2002	Nepal	1988	1988	Zimbabwe	1995	1999
Egypt	1980	1980	Netherlands	2008	ongoing			
El Salvador	1989	1990	Nicaragua	1990	1993			

Appendix IV: List of variables used

Variable	Source	Note
Crisis duration	Laeven and Valencia (2012)	Years
Fiscal Costs (% of GDP)	WEO, IFS, IMF Staff reports, Laeven and Valencia (2008), and authors' calculation.	Fiscal costs are defined as the component of gross fiscal outlays related to the restructuring of the financial sector. They include fiscal costs associated with bank recapitalizations but exclude asset purchases and direct liquidity assistance from the treasury.
Liquidity support	WEO, IFS, IMF Staff reports, Laeven and Valencia (2008), and authors' calculation.	Percentage points increase in central bank claims on financial institutions over deposits and foreign liabilities.
Monetary expansion	WEO, IFS, IMF Staff reports, Laeven and Valencia (2008), and authors' calculation.	In percent of GDP. Monetary expansion is computed as the change in the monetary base between its peak during the crisis and its level one year prior to the crisis.
Credit	World Bank	Averaged over the three pre-crisis years, domestic credit provided by the banking sector includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities and deposit taking banks, as well as other banking institutions where data available (including institutions that do not accept transferable deposits but do incur such liabilities as time and savings deposits)
Credit boom	WEO, IFS, IMF Staff reports, Laeven and Valencia (2008), and authors' calculation	As defined in Dell'Ariccia *et al* (2012).
Form of government	World Bank - DPI2012	Parliamentary (2), Assembly-elected President (1), Presidential (0)
Government orientation	World Bank - DPI2012	Right (1); Left (3); Centre (2); No information (0); No executive (NA)
Legislative Index of Electoral Competitiveness (LIEC)	World Bank - DPI2012	No legislature: 1; Unelected legislature: 2; Elected, 1 candidate: 3; 1 party, multiple candidates: 4; multiple parties are legal but only one party won seats: 5; multiple parties did win seats but the largest party received more than 75% of the seats: 6; largest party got less than 75%: 7.

Years to next election	World Bank - DPI2012	Only full years are counted. Thus, a "0" is scored in an election year.
Degree of checks	World Bank - DPI2012	Degree of checks and balances, from 1 to 7.
Snap elections held during the crisis	World Bank - DPI2015, own calculations.	Cumulative number of snap executive elections held during the crisis years // The executive who formally (de jure) holds power is counted.
GDP per capita	IMF, WEO	Gross Domestic Product divided by midyear population. Data are taken in current U.S. dollars taken at t-1
Concurrent currency crisis	Laeven and Valencia (2012)	Definition based on Frankel and Rose (1996)
Concurrent debt crisis	Laeven and Valencia (2012)	Episodes of sovereign debt default and restructuring compiled relying on information from Beim and Calomiris (2001), World Bank (2002), Sturzenegger and Zettelmeyer (2006), IMF Staff reports, and reports from rating agencies.