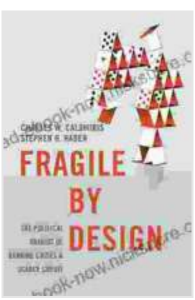
The Political Origins of Banking Crises and Scarce Credit

Abstract

This paper examines the political origins of banking crises and scarce credit. We argue that political instability and weak institutions create incentives for banks to engage in risky lending practices, which can lead to financial instability. We test our theory using a new dataset on banking crises and scarce credit in developing countries. We find that countries with higher levels of political instability and weaker institutions are more likely to experience banking crises and scarce credit. Our findings have important implications for policymakers, as they suggest that political stability and strong institutions are essential for financial stability.



Banking crises are a major source of financial instability. They can lead to a loss of confidence in the financial system, a sharp contraction in credit, and a deep recession. The global financial crisis of 2007-2008 is a prime example of the devastating consequences of a banking crisis.

What causes banking crises? There are a number of factors that can contribute to a banking crisis, including:

- Excessive lending
- Asset bubbles
- Financial deregulation
- Lack of transparency
- Weak supervision

In this paper, we argue that political instability and weak institutions are also important factors that can contribute to banking crises. We argue that political instability creates incentives for banks to engage in risky lending practices, which can lead to financial instability. We also argue that weak institutions make it more difficult to regulate and supervise banks, which can further increase the risk of a banking crisis.

Theoretical Framework

Our theoretical framework builds on the work of Shleifer and Vishny (1998),who argue that political instability creates incentives for banks to engage in risky lending practices. Shleifer and Vishny argue that when political instability is high, banks are more likely to make loans to politically connected borrowers, even if these loans are risky. This is because politically connected borrowers are more likely to be able to repay their loans, even if the economy goes into recession. As a result, banks have an incentive to lend to politically connected borrowers, even if these loans are not profitable.

We extend the Shleifer and Vishny model by arguing that weak institutions can also contribute to banking crises. We argue that weak institutions make it more difficult to regulate and supervise banks, which can increase the risk of a banking crisis. For example, if banks are not subject to strict regulation and supervision, they may be more likely to engage in risky lending practices.

Empirical Evidence

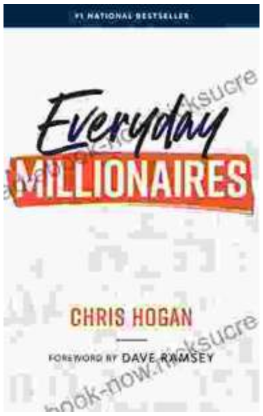
We test our theory using a new dataset on banking crises and scarce credit in developing countries. Our dataset includes data on banking crises, scarce credit, political instability, and institutional quality for 120 developing countries over the period 1975-2015.

We find that countries with higher levels of political instability and weaker institutions are more likely to experience banking crises and scarce credit. Our findings are robust to a variety of different econometric specifications and control variables. For example, we find that the relationship between political instability and banking crises is stronger in countries with weaker institutions. We also find that the relationship between weak institutions and scarce credit is stronger in countries with higher levels of political instability.

Our findings suggest that political instability and weak institutions are important factors that can contribute to banking crises and scarce credit. This has important implications for policymakers, as it suggests that political stability and strong institutions are essential for financial stability. Policymakers should therefore take steps to promote political stability and strengthen institutions in order to reduce the risk of banking crises and scarce credit.

References

- Shleifer, A., & Vishny, R. W. (1998). The Grabbing Hand: Government Pathologies and Their Cures. Harvard University Press.



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