Cost of Banking Crises: Does the Policy Framework Matter?

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Abstract

This paper empirically investigates the impact of fiscal and monetary policy frameworks, and the impact of the exchange rate regime on the unconditional cost of banking crises. Due to their discipline and credibility-enhancing effects, stringent policy frameworks are expected to decrease the probability of banking crises. However, having the hands tied by such frameworks prevents policymakers from properly responding to crises if such an event occurs. Our analysis, based on a sample of 67 countries over the 1970-2012 period, reveals that extremely restrictive policy features such as corner exchange rate regimes, budget balance rules without "friendly" clauses and a high degree of both monetary policy conservatism and independence are conducive to a higher real cost of crises. In contrast, by combining discipline and flexibility, fiscal rules with easing clauses, intermediate exchange rate regimes and an inflation targeting framework can significantly contain the costs of banking crises. As such, we provide evidence of the benefits of "constrained discretion" regarding the real impact of banking crises.

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