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Central bank reactions to banking crises in fixed exchange rate regimes

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Abstract

Until recently, speculative attacks and banking crises have been largely treated as separate phenomena. However, the recent experiences of several Southern Cone countries indicates that banking difficulties can lead to a currency crises if in combatting them, the central bank adopts policies which are inconsistent with the fixed exchange rate regime. The paper illustrates how this can be the case and discusses what are the policy responses available to central banks that face banking crises in fixed exchange rate regimes.

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Recently, Mexico and Argentina both faced difficulties in their commercial banking sectors.[1] While both countries instituted a menu of non-monetary reforms to divert crisis, only the Mexican central bank played the role of lender-of-last-resort and printed money to prop up its banking sector.[2] This policy was incompati-

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[1] See Rojas-Suarez and Weisbrod (1995) for a thorough account of the banking problems in these two countries.

[2] The Mexican monetary authorities started extending credit to the domestic banking sector at an accelerated rate in 1993. This policy was meant to prevent an increase in interest rates that would threaten its already weak banking sector (see Sachs et al., 1995).

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ble with the pegged exchange rate and contributed to the speculative attack on the Mexican peso in early 1995.[3] As Argentina remained committed to its currency peg and abstained from money creation, the Argentine peso remained unscathed.[4,5] Thus, the different policy responses of the central banks of Mexico and Argentina to their respective banking problems had different implications for the viability of their exchange rate regimes.

The present paper studies the responses available to central banks confronting rational bank runs in fixed exchange rate regimes. While an overhaul of the banking system must be undertaken in the medium- to long-run, in the short-run, a central bank faced with bank runs has two policy options available to it. Assuming that recourse to non-monetary measures are not sufficient for crisis resolution, a central bank can either do nothing and allow banks to close their doors; or print money to prevent an interruption of cash payments. While in the former case economic activity will be interrupted, in the latter, there is a risk of speculative attack and loss of monetary credibility. The optimal policy response to a banking crisis will therefore take into account the costs of the different alternatives, which will depend on economic and political factors.

By studying how central bank reactions to banking crises can give rise to speculative attacks, the paper helps to further our understanding of the potential linkages between these two types of crises. While these two types of crises have received much theoretical[6] and empirical attention, they have been largely treated as independent phenomena.[7] However, the recent experiences of several southern cone countries (i.e., Chile 1981–1982, Venezuela 1994, and Mexico 1994–95) suggest that banking crises, or more appropriately, the government's handling of

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[3] Chile and Argentina suffered similar episodes in the early 1980s when the central banks printed money in response to banking crises. See Rojas-Suarez and Weisbrod (1995).

[4] Indeed, one might say that the Argentine bank runs occurred because depositors knew that given the credible currency board, the central bank would not act as a lender-of-last-resort and so the runs would be self-fulfilling.

[5] While Mexico had a domestic lender-of-last-resort, Argentina had an international one (i.e., the IMF). Indeed, much of the reason that Argentina received international aid and so easily is precisely because it refused to monetise. The Mexican loan package, on the other hand, was obtained less easily and was directed more to defending the currency than for bank reform.

[6] For a review of the literature see Miller (1998a).

[7] Some exceptions are Miller (1996a), which shows how a BOP crisis can cause a banking crisis when deposits are used to speculate on the currency; Velasco (1987), which illustrates reverse causation when the government insures deposits, and Miller (1998a,b), which shows how a banking crisis at home can cause a currency crisis abroad when banks are important creditors abroad. As for empirical efforts, Miller (1996b) shows that a banking crisis postponed a speculative attack on the US dollar in 1893 and Kaminsky and Reinhart (1995) study the potential factors that cause both types of crises.