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Can emerging market central banks bail out banks? A cautionary tale from Latin America

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ABSTRACT

This paper investigates whether emerging market countries can implement monetary policies to cope with financial crises as advanced countries did during the recent global crisis—injecting significant amounts of money into the financial system without facing major short-run adverse macroeconomic repercussions. Using panel data techniques, the paper analyzes episodes of financial turmoil in 16 Latin American countries during 1995–2007. The results show that developing and emerging market countries should be cautious because injecting money on a large scale into the financial system may fuel further macroeconomic instability, increasing the chances of simultaneous currency crises.

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1. Introduction

The recent financial crisis in mature markets has put the role of central banks in financial stability in the spotlight. In the large advanced economies, central banks played an active role to prevent the collapse of their financial systems. Central banks initially provided aggregate liquidity in money markets without expanding their balance sheets as they were able to mop up excess of liquidity. Later, they granted large amounts of financial support to individual illiquid – and even insolvent – banks and reserve money eventually increased. Central banks provided assistance not only to banks, but also to nondepositary

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institutions, arguing that the former are no longer the only financial intermediaries that pose a systemic risk.[1] However, despite extensive monetization, these policies did not fuel inflation pressures. Moreover, the U.S. dollar appreciated—whereas the British pound and the euro depreciated gradually with respect to other currencies without causing macroeconomic instability. Thus, expansionary monetary policy seems to have been a "free lunch" from a macroeconomic perspective.[2]

Against this background, a new paradigm is emerging that favors an active monetary policy to cope with financial crises. While generous financial assistance to troubled banks has been mostly circumscribed to the advance economies during the global crisis, emerging markets and developing countries may also adopt this policy in the future to cope with financial distress. But, can all emerging markets and developing countries implement similar policies to tackle banking crises with such little cost in terms of macroeconomic stability?

This paper argues that emerging markets and developing countries should be cautious when using central bank money to cope with financial crises as large scale monetization may cause further macroeconomic unrest.[3] To provide support to this claim, we analyze episodes of financial turmoil in 16 Latin American countries during 1995–2007, review their main macroeconomic repercussions, perform empirical analysis, and distil relevant lessons. The main conclusion is that pouring money into the financial system to confront banking crises tended to fuel macroeconomic and financial instability as it increased the chances of a simultaneous currency crisis.

Despite its importance, the role of central banks in episodes of financial turmoil in emerging markets and developing countries has been marginally addressed in the literature.[4] While the multiplication of banking crises in recent decades motivated a large number of studies, they are rarely focused on the reaction of monetary policy and its macroeconomic effects on the dynamics of the crises.[5] More recently, in the wake of the world financial turmoil, the role of central banks in advanced countries has been extensively examined and, today, there is a lively debate about the scope of central banks' involvement on macroprudential policies.[6] Similar studies in developing and emerging market countries continue to receive scant attention, but it is becoming a topic of increasing interest among policy makers.

[1] Stone et al. (2011) provide a review of unconventional balance sheet measures used by major central banks since 2007. They found that in the large advanced economies central banks leaned heavily on unconventional balance sheet policies. The Federal Reserve, the Bank of England, and the European Central Bank utilized these policies the most, reflecting the complexity of their financial systems and the concomitant degree of stress, and the related lower bound constraint on policy interest rates. The smaller advanced economies generally used unconventional measures less, reflecting their more stable bank-based financial systems. Exceptions here are Israel and Switzerland which undertook large foreign exchange purchases, as well as Sweden. For emerging market economies, the relatively limited provision of liquidity to domestic financial markets was due to the lower degree of systemic stress. However, many emerging market economies did provide large foreign exchange liquidity support. The policy interest rate in only a few emerging market economies fell near to the lower bound, reflecting their higher and more volatile inflation and real interest rates to compensate for the extra risk faced by investor, including of a sudden stop. Thus, they did not face the exceptional circumstance of interest rates constrained by the lower bound and had no need to resort to macroeconomic stability balance sheet policies.

[2] From a microeconomic perspective, large-scale central bank support to financial institutions has created moral hazard because this is likely to relax markets' discipline when measuring risks in the future. From the depositors' viewpoint, they act under the logic that the government implicitly guarantees most or all deposits as a result of extensive financial support or banks' bailout. Thus, depositors will just seek the highest return to their investments, without paying attention to the riskiness of the banks' portfolios and, in general, without gathering information of banks' solvency situation.

[3] Although banking and financial crises may have slightly different meanings – as the latter also includes nonbank financial institutions – we use both terms interchangeably in this paper, given that banks comprise the bulk of the financial system in Latin America.

[4] Only a few studies examine this important issue. See, for example, Dziobeck and Pazarbaşioğlu (1997), who analyze the management of banking crises, including the role of central banks, and more recently Jácome (2008), focused on Latin America.

[5] These studies have primarily stressed the identification of early warning indicators (see, for example, the comprehensive work by Goldstein et al. (2000)), the causes of banking crises (see, for instance, Komulainen and Likkarila (2003) and Noy (2004), using different empirical approaches, and the comprehensive analysis by Kindleberger and Aliber (2005)), the dynamics of banking crises and their aftermath on a country or regional basis (see the work by Collyns and Kincaid (2003)), and the link between banking and currency crises (see the seminal paper by Kaminsky and Reinhart (1999)). From a microeconomic standpoint, studies mostly addressed issues such as the government response to banking crises and their fiscal cost, the role of supervision and regulation in explaining banking crises' eruption and contagion, and the nature of financial restructuring. See for instance the review on how governments managed banking crises by Hoelscher and Quintyn (2003); the analysis by de Juan (1996) on the microeconomic roots of banking crises; and Calomiris et al. (2005) for a taxonomy of resolution mechanisms applied to cope with banking crises.

[6] See the discussion by Borio (2011), the analysis in Nier et al. (2011), and the comprehensive Ingves' report, BIS (2011).

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