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The Role of Central Banks and the Political Environment in Financial Stability: A Literature Review

Chile, Colombia, Japan, Portugal and the UK

Zoe Venter

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Abstract

Financial instability and the subsequent credit crunches experienced by a number of countries following two decades of global structural reforms highlighted the importance of stabilizing credit supply and assigning a higher importance to financial stability. In this paper, I look at the independence of the Central Bank, the political environment and the impact of these factors on financial stability. I substantiate the literature review discussion with a brief empirical analysis of the effect of Central Bank independence on credit growth using an existing database created by Romelli (2018). The empirical results show that fluctuations in credit growth are larger for higher levels of Central Bank Independence and hence, in periods of financial instability or ultimately financial crises, Central Bank Independence would be reined back in an effort to re-establish financial stability.

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Keywords: Central Banks, Central Bank Independence, Financial Stability, Reform, Political Environment

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[2] ISEG, Lisbon School of Economics and Management, Universidade de Lisboa, R. Miguel Lúpi, 20, P - 1249-078 Lisbon, Portugal. E-mail: zoeventer14@phd.iseg.ulisboa.pt

1. Introduction

On 15 September 2008, the Great Recession entered a critical phase when Lehman Brothers filed for bankruptcy. The financial crisis was preceded by a period known as the Great Moderation, which saw the United States experience a period of major financial deregulation. Financial instability and the subsequent credit crunches experienced by a number of countries following two decades of global structural reforms highlighted the importance of stabilizing credit supply and assigning a higher importance to financial stability. Although many emerging economies such as those in Latin America started to assign a higher importance to financial stability following earlier crises experienced by the region in the early 1990s, the financial stability of advanced economies only became a concern during the financial crisis when advanced economies failed to contain and prevent the damage caused. As global economies become increasingly more interconnected and banking and investment activities become more inclusive, the study of the financial stability of these countries as well as the use of alternative policies becomes paramount. Maxfield (1997) points out that while only three Central Banks became legally independent in the 1980s, the 1990s saw more than thirty Central Banks become legally independent. Cukierman (2008) stresses "the fact that during the forty years ending in 1989 there had hardly been reforms in CB legislation" and Fernández-Albertos (2015) shows that the majority of reforms occurred during the 1990s.

In this paper, I look at the structure and functioning of Central Banks in two Latin American countries namely, Chile and Colombia, two European countries namely, the UK and Portugal and one Asian country namely, Japan. I then consider the political environment in these countries and go on to look at the financial stability of these countries. I substantiate the literature review discussion with a brief empirical analysis of the effect of Central Bank independence on credit growth using an existing database created by Romelli (2018). The empirical results show that fluctuations in credit growth are larger for higher levels of Central Bank Independence and hence, in periods of financial instability or ultimately financial crises, Central Bank Independence would be reined back in an effort to re-establish financial stability.

The rest of the paper is as follows, Section 2 discusses the Central Bank setting and Section 3 discusses the political environment. Section 4 looks at the financial stability in these countries, Section 5 makes use of a simple empirical analysis to substantiate the discussion and lastly, Section 6 concludes.

2. Central Bank Setting

According to Bernhard (2002), Central Bank Independence (CBI) is the ability of the Central Bank to control monetary instruments. Bernhard (1998, 2002) also points out that economic integration may lead to intra-party conflict over monetary policy that could in turn damage the stability of the government while CBI may remove intra-party conflicts over monetary policy and as such may be viewed as a channel by which cabinet stability and durability may increase. Bodea and Hicks (2015), Cukierman (1992), Cukierman et al. (1992), Cukierman et al. (2002), Persson and Tabellini (1990) and Rogoff (1985) all show that CBI has the ability to stabilize the economy by decreasing inflation, reducing inflation volatility, reducing uncertainty in the economy and increasing monetary policy credibility. Independent Central Bank countries are also more likely to maintain or attract capital inflows during interwar periods as investors have confidence in the lack of political motives behind the pegging with gold (Simmons, 1994).

According to Garriga (2016), lower-middle income and low-income countries had more stable levels of Central Bank independence throughout the period between 1970 and 2012. In contrast, Crowe and Meade (2007) show that "Central Banks in emerging market and developing economies have seen an even more impressive shift towards independence over the past two decades than their advanced-economy counterparts". The Central Bank independence of Latin American Economies was restricted seven times during the 2000s however, CBI has increased over the years (albeit more gradually than many other countries) (Garriga, 2016).

2.1. Chile

Banco Central de Chile (BCCH) was established with a degree of operational independence by Decree Law 486 under then President Arturo Alessandri Palma in August 1925. The BCCH adopted a partial inflation-targeting framework for monetary policy in 1990 and in 1999, the Central Bank fully adopted an inflation-targeting framework in combination with a flexible exchange rate regime. Adopting a flexible exchange rate regime removes the BCCH's ability to intervene in the market when atypical circumstances present themselves. In the years leading up to an independent monetary policy for the BCCH, fiscal policy was given preference in decision making which resulted in periods of extreme inflation due to the inability to implement an effective stabilisation policy (Marshall, 2003). Looking at the opposite side of the coin, sustainable monetary policy aimed at maintaining price stability may lead to both lower inflation and lower output volatility.

In 1953, the *Decreto con fuerza de Ley* 106 gave the Central Bank autonomy and defined the bank's fundamental objective to be to "encourage the orderly and progressive development of the national economy through credit and monetary policy, avoiding any inflationary or depressive tendencies, and thus permitting the maximum use of the country's productive resources" (*Banco Central de Chile*). The fourth basic constitutional law, Decree Law 1078 of 1975, resulted in the creation of the Monetary Council, the orderly and progressive development of the national economy and the legal establishment of the autonomy of the Central Bank. The legal establishment of the BCCH's autonomy excludes the bank from the scope of supervision of the General Comptroller of the Republic and the Superintendent of Banks and Financial Institutions (*Banco Central de Chile*). In 2007, the maintenance of annual inflation of the CPI at a level of 3 percent with a 1 percent leeway each way became the main objective of the BCCH. Lastly, the Central Bank acts as a lender of last resort in the same way as many other Central Banks including the Bank of England, the Bank of Japan and the *Banco de la Republica* (Central Bank of Colombia). Since the 1980s, the independence of *Banco Central de Chile* and the autonomy of the supervisors has been at the heart of effective monetary policy and financial supervision however, when the financial system is viewed in isolation, policy externalities may be overlooked and the purpose of the CEF is to balance the trade-off.

2.2. Colombia

The Colombian Central Bank (*Banco Nacional*) was established in 1880 and served as the government's banker and the issuer of the national currency. By 1894, the national bank was liquidated and although *Banco Central de Colombia* was created in 1905, this too was liquidated in 1909. In 1922, following the economic difficulties experienced as a result of the First World War, the lack of stability associated with currency, and credit issuance due to a lack of a Central Bank, Law 30 was passed by congress authorising the Colombian government to create a Central Bank. In 1923, in an effort to improve the understanding of the Colombian economy and the legal reforms, the Kemmerer Commission was created. A number of reforms to the earlier Central Banking system in Colombia were included in the constitution drawn up in 1991 and in December 1992, the Law of the *Banco de la República* (Law 31) was published. The Law of the *Banco de la República* (Law 31) states that "*Banco de la República* is a legal entity of the public law, which will continue functioning as a state-owned body of the constitutional rank, with a legal regimen of its own, with its own and special nature, and with administrative, patrimonial and technical autonomy".

The most important reform was the decision to prioritise inflation control and hence to preserve the currency's buying power although, the consideration and co-ordination with general economic policy remained important. The Central Banks' mandate of maintaining price stability is established at a constitutional level in Colombia with the main monetary instrument used in monetary policy being the Repo interest rate. The Governor of the *Banco de la República* is not accountable for financial stability as it is considered to be beyond the scope of the Central Banks' mandate, as is the case in most other countries, the Central Bank is deemed solvent and the lender of last resort.

2.3. The UK

The end of World War II saw the BoE being nationalized in 1946 by the Attlee government, which resulted in the bank becoming a definitive tool at the government's disposal. The nationalisation of the bank gave the government the power to appoint governors and directors of the bank as well as the power to direct the BoE however, this power has not been employed to date. The BoE is also accountable to both Parliament and the general public although it has independence over how it carries out its responsibilities.

The delegation of interest rate responsibility to the BoE in 1997 meant that the bank became politically independent and now, the BoE is responsible for the setting of monetary policy and hence, the maintenance of monetary stability and the maintenance of financial stability. The BoE works closely with the Treasury who is responsible for economic and financial policy. The Monetary Policy Committee which, is a division of the BoE, is responsible for interest rate decisions with the aim of achieving the inflation target established by the Chancellor of the Exchequer. As a whole, the BoE says that its role is "Promoting the good of the people of the United Kingdom by maintaining monetary and financial stability", the 1988 Bank of England Act confirms that by stating that the Banks' top priority is achieving price stability.[3] The Bank's position as a lender of last resort once again became apparent in 2007 when the BoE acted as a lender of last resort to Northern Rock following a bank failure.

Montagu Norman served as Governor of the BoE between 1920 and 1944 and was involved in establishing both the Bank for International Settlements and the League of Nations. In 1979, the European Exchange Rate Mechanism (ERM) was established in an effort to decrease

[3] Price stability in the case of the BoE is defined as an inflation rate of 2 percent per annum

exchange rate variability as well as achieving monetary stability throughout Europe. The UK became a member of the ERM in 1990 however, the UK later left the ERM in 1992 following a period of rising interest rates and failed attempts at rescuing the Pound Sterling, the BoE and the PRA published discussion notes on proposals in October and December of 2018 in preparation for the UK's departure from the EU in an effort to ensure that the legal framework is well established at the time of the UK's departure from the EU.

2.4. Portugal

The *Banco de Portugal* was established in 1846 by the Decree of 19 November 1846, which merged the Bank of Lisbon with the *Companhia Confianca Nacional*. BP served as the country's Central Bank until 1999 and although it still acts as its own entity, it is now a member of the European System of Central Banks (ESCB) and as such pursues the objectives of the ESBC. BP operated as a commercial and issuing bank and played an important role in monetary and economic policy in Portugal as well as the economic stability of the country. 1931 saw a new era for banking rules in which the growth of liabilities of BP was limited to a proportion of the amount held in foreign reserves, this resulted in improved monetary control, as the Bank was no longer able to freely finance the government. The Bank became increasingly more dependent on the government for administrative purposes and started to pursue both fixed interest and fixed exchange rates. By 1960, laws had been approved that required banks to hold minimum cash reserve balances and also gave BP the power to intervene in both credit control and interest rate movements.

The Central Credit Register (CCR) contains credit related information and is managed by BP. BP is responsible for the regulation of banking activities in Portugal as well as ensuring the stability, efficiency and robustness of the financial system. The Portuguese banking and financial sectors have proved to be resilient when a number of stress tests are applied and currently meets the requirements of the European Banking Authority. BP was founded as a public limited company and was nationalized in 1974. The Organic Law of 15 November 2015 redefined BP's functions and officially gave the Bank the role of Central Bank, the Bank was also given the power to supervise the banking system. The Organic Law of October 1990 increased the independence of board members and the Organic Law of January 1998 reinforced the independence of BP.

2.5. Japan

The Bank of Japan (BoJ) was established with the Bank of Japan Act of 1882 in an effort to centralize currency production although the *yen* had been established earlier with the New Currency Act of 1871. The Bank of Japan Act of 1942 made changes to the original Bank of Japan Act of 1882 and resulted in a typical wartime approach to Central Banking. In 1949, the Policy Board was established, the Policy Board is the highest decision-making body within the Bank. The Bank of Japan Act of 1942 stated that, "the regulation of the currency, control and facilitation of credit and finance, and the maintenance and fostering of the credit system, pursuant to national policy, in order that the general economic activities of the nation might be adequately enhanced", are the objectives of the BoJ. Revisions to the Bank of Japan Act in 1997 gave the Central Bank independence as it originally acted as a branch of the Japanese government and today, the Bank is not a governmental agency nor a private corporation. Although the BoJ is an autonomous institution, the Bank serves as a bank of banks and a bank of the government. The Bank of Japan Act of 1997 also ensures transparency of the BoJ's operations. In 2004 the BoJ stated that "the Bank conducts on-site examinations and off-site monitoring of financial institutions that hold current accounts with the Bank, so that it can assess their business operations and financial conditions." The BoJ acts as a lender of last resort in times of low liquidity or financial troubles and controls the money supply in Japan as it is the sole issuer of currency. The Bank's main objective is to achieve price stability by controlling monetary supply and interest rates however, the Bank is also responsible for the maintenance of a stable financial system by ensuring the settlement of funds amongst banks and other financial institutions. The BoJ introduced a price stability target in 2013 namely, an inflation rate target of 2 percent. Lastly, the Bank is responsible for upholding confidence in the currency.

3. The Political Environment

Bernhard and Leblang (2002) and Clark et al. (2013) show that CBI may have important political consequences. Eijffinger and de Haan (1996)[4] discuss the three dimensions of CBI namely, financial, personnel and policy independence. Hibbs (1977) and Tufte (1978) find that personal finance influences the public vote and therefore, politicians are harshly punished for

[4] Financial independence refers to the government's ability to use Central Bank loans to fund expenditures, to avoid monetary policy subordination (Garriga, 2016). Personnel independence deals with the ability of the government to influence the board membership of the Central Bank. Policy independence refers to the Central Bank's ability to formulate, specify, execute or set goals for monetary policy (Debelle and Fischer, 1995).

poor economic management and rewarded when the economy is strengthened. King (2003) points out that politicians now have a reduced number of instruments available as they have transferred monetary policy control to unelected Central Bankers. Unfortunately, an independent Central Bank does not necessarily shield the Central Bank from the influence of the government and threats to Central Bank independence still exist (Lohmann, 1998).

McNamara (2002) points out that Central Banks remain resolutely political and partisan institutions due to policy making which has identifiable and important distribution effects. Berman and McNamara (1999) mention that democratic accountability may be of concern when Central Banks are responsible for monetary policy as Central Bankers are not elected by the public and hence, are not accountable to the public. Many politicians choose to artificially stimulate the economy in the lead up to elections, Clark et al. (1998) point out that politicians who hope to maximize their votes will favour the ability to influence monetary policy and hence, will not choose to have an independent Central Bank, which limits their ability to affect monetary policy. In more recent times, due to financial and economic integration, political leaders are held accountable to foreign markets and the independence of Central Banks has once again become attractive (Keohane and Milner, 1996).

In 1925, a new constitution was implemented in Chile, which increased Presidential power and separated church and state however, by 1927, the country entered a dictatorship when General Carlos Ibanez del Campo seized power. Chile received global attention in the early 1970s when Salvador Allende Gossens was elected with the intent of moving the country back to a socialist government and implementing extensive nationalisation programs. The final year of Allende's presidency was plagued by food shortages, hiked inflation, land expropriations and protectionism. On September 11, 1973, eighteen days after Augusto Pinochet Ugarte was instated as General of the Army by President Allende, the government was overthrown and Chile was once again thrown into a dictatorship. This military government saw Chile become one of the most open economies of the developing world[5] and the economic reforms implemented during President Allende's rule set the basis for the major investment and growth that the country experienced in the early 1990s however, this military government was also

[5] "Neoliberalism is generally associated with policies like cutting trade tariffs and barriers. Its influence has liberalized the international movement of capital, and limited the power of trade unions. It's broken up state-owned enterprises, sold off public assets and generally opened up our lives to dominance by market thinking." (Birch, 2017)

responsible for the abolishment of a democratic political tradition and at the heart of multiple human rights violations.

The current constitution was implemented in 1990 and in March 1990, Chile returned to a democracy, following the seventeen-year dictatorship, when Christian Democrat Patricio Aylwin was elected. The remnants of a dictatorship continued to influence the democratic government for almost a decade. The turn of the century saw the democratic process become more resilient and in 2005, the senate approved changes to Pinochet's constitution. August 2006 saw Beijing sign its first South American free-trade deal[6] and by 2017, the binomial voting system[7] was also abandoned resulting in a fully democratic election process. Pinochet's economy was extremely successful due to the lifting of U.S. trade sanctions against the Allende government. The election of President Sebastian Pinera in 2017 has resulted in improved economic circumstances, decreased unemployment and an overall feeling of certainty.

When liberal[8] leader and Colombian Presidential hopeful, Jorge Eliecer Gaitan was assassinated in 1948, a wave of riots spread through the country. The riots in the period between 1948 and 1959, known as *la violencia*, led to the death of roughly 250 000 to 300 000 people and the large-scale destruction of Bogota. Virgilio Barco Vargas (Liberal) became the President in 1986 after winning the Presidential election by a huge majority, in the same year, continuing violence amongst leftist groups and drug cartel death squads resulted in rightist paramilitary murder campaigns against *Unión Patriótica* (UP)[9] politicians. 1989 saw multiple Liberal and UP Presidential candidates murdered upon drug cartel instruction and as a result, Cesar Gaviria was elected on an anti-drug platform. Political peace seemed to be a real possibility. Colombian citizens, in a manner unmatched in Latin America, tend to resort to violence when political differences present themselves. During the 1990 Presidential campaign, three Presidential candidates were assassinated and many others had attempts made on their lives. The assassination of Luis Carlos Galan, in particular, shook the country and resulted in university students organizing a *Marcha del Silencio* as a means of protesting against indiscriminate

[6] Chile and China sign a free-trade deal.
[7] Each district elects one representative from the largest two political parties unless the most popular party is twice as popular as the second most popular party. Critics claim that a binomial election process is undemocratic as it makes it more difficult for smaller political parties to gain parliamentary seats and the views of the general public are not necessarily reflected.
[8] Liberal in Colombia being Conservative in America while, conservative in Colombia means that the Catholic church maintains a special role in both society and the economy.
[9] Leftist party founded by FARC and the Colombian Communist Party in 1985.

violence. Although a new constitution was written in 1991 in an effort to restore peace, several guerrilla groups re-entered the political arena. To make a precarious situation even worse, drug lords had taken over as the main threat to both political and social instability.

President Andres Pastrana Arango began peace talks with the guerrillas in 1998 however, these talks failed and in 2002, FARC explosions in Bogota killed twenty people moments before President Alvaro Uribe was sworn in. A national emergency was declared a few days later and in 2003, Uribe's proposed austerity measures and political reforms were rejected in a public referendum. Colombia and the US agreed on the terms of a free trade deal in February of 2006 however, this deal was only passed in October of 2011 although concerns about the country's labour relations record still existed. In 2016, President Santos was awarded a Nobel Peace Prize for his efforts in attempting to achieve peace and FARC formally disbanded in June of 2017 after half a century of conflict.

Margaret Thatcher was elected as British Prime Minister in 1979 after a period of Stagflation[10], extreme power of trade unions and incredibly high national debt resulted in the United Kingdom applying for an IMF bailout in 1976. Although BoE independence was proposed by Conservative Chancellor Lawson in 1988 (Lawson, 1992), Hansard (1993) notes that Thatcher's rejection of BoE operational independence was based on political motives as increasing interest rates would have affected homeowners who constituted the majority of the voting population. Thatcher's popularity started to decline after her second re-election in 1987 when a "Community Charge"[11] replaced the earlier local property taxes.

In 1992, then Prime Minister Major also rejected the proposal of BoE independence due to their position as an unaccountable body (Seldon, 1998). Lamont (1999) and Seldon (1998) note that the politics of interest rate movements once again played a role in the decision to reject BoE independence. King (2003) concludes, "while policy makers will continue to focus on the signals they are receiving from this international audience, policies such as institutional reform will continue to be made on the basic of electoral calculations that reflect domestic interests." Theresa May took over as Prime Minister upon Cameron's resignation in 2016 and her term

[10] Economic stagnation combined with high inflation

[11] This 'Community Charge' was a 'flat individual charge on all adult residents, regardless of income, to pay for local services. The poll was introduced in Scotland in 1989 and in England and Wales in 1990.' (Lauderdale, 2015)

has been marred by a "lack of integration and inadequate legitimacy" (Grubb, 2019) as the electorate remains deeply divided and a solution and strategy to Brexit remains unattainable at present. Marsh's Political Risk Map of 2019 stated that 'Rising geopolitical risks and geo-economic tensions represent the "most urgent global risks at present" (World Economic Forum's Global Risks Report 2019)' and the EU and Japan are amongst the most powerful influencers. The uncertainty surrounding Brexit and the global political shift towards the right while liberal beliefs are abandoned, presents an ever-increasing risk to the UK and global political freedom. The UK's political system is likely to revolve around Brexit in the future as attaining political stability may take years in the aftermath of the UK's exit from the EU.

António de Oliveira Salazar became the Minister of Finance in 1928 and in 1932, he became Prime Minister as Portugal was thrown into a military dictatorship following a sixteen-year republic. Salazar's rule saw the formation of the *Policia Internacional e de Defensa do Estado* (PIDE), the censoring of press, the banning of opposing political parties and poverty continued to grip the Portuguese public in the *Estado Novo*[12]. Salazar's repression only worsened and the regime became even more controlled as Portugal was drained of both labour and financial resources as a result of the Guerrilla movements and the mass exodus of Portuguese citizens. The Salazar era left Portugal isolated from the global political scheme as NATO, the UN and EFTA excluded Portugal from the international community and the country's third world status deepened in a European context. Increasing dissatisfaction resulted in the formation of the *Movimento das Forcas Armadas* (MFA) and on 25 April 1974, a coup was staged (and succeeded within hours) and the Carnation Revolution led to the restoration of Democracy in Portugal. Rapid liberalisation and leadership confusion resulted in "democratic chaos" as both political and economic plans failed under a wave of corruption and extremists.

The first President of the Republic, Ramalho Eanes, was elected in 1976, which, marked the end of the revolutionary period, and served until 1986. Portugal joined the EU in 1986 and in 1999, Portugal adopted the Euro. Opello (1985) and Schmitter (1994) note that Portugal could not be integrated as an advanced industrial society as it was not an industrial nation however, EU membership resulted in a wave of grants and investments which led to improved infrastructure.[13] Double-digit growth and low unemployment was achieved in Portugal in the late 1980s and the early 1990s as a large infusion of capital was used in an effort to rescue the

[12] The *Estado Novo* was established through the new constitution of 1933.
[13] Roughly 64 percent of these funds were mismanaged.

economy. Foster and Friedman (2017) note that "in November 2015, more than half of Swedes, Finns, and Dutch said they trusted their respective national governments, while the proportion was less than 17% among Spaniards, Greeks, and Portuguese" and an OECD report in November 2017 shows that migrants have more trust in the Portuguese political system than natives.

Aníbal António Cavaco Silva served as Prime Minister of Portugal between 1985 and 1995 and then as President of country between 2006 and 2016. He is responsible for leading Portugal into the EU and was also the first Prime Minister of Portugal to win a parliamentary majority under the current constitutional situation. President Rebelo de Sousa was elected in 2016 and campaigned to heal the discord caused by the debt crisis of 2011 to 2014. The Socialist Party (PS) headed by Prime Minister Antonio Costa, took office in November 2015 and by the end of 2016, the Portuguese economy was the fastest growing in Europe. Today, both the political and economic situation of Portugal has stabilized as year-on-year growth continues to improve and unemployment reached a ten-year low in the third quarter of 2017 of 8.5 percent.

During the Meiji Restoration, Japan experienced a political system that relied on uncompetitive domestic forces and a less than ideal set of incentives for politicians. The Japanese described their country as having a "first-rate economy and third-rate politics (*keizai irchiryu, seiji sanryu*)" (Rosenbluth and Thies, 2010) however, Japan's new electoral rules established during 1994 have led to global integration and a more open work environment. Morita (2017) finds that MoJ bureaucrats maintain control over the public-comment procedure and that although corporate managers have some form of an influence on reforms their influence over the public-comment procedure is extremely limited. Morita (2017) concludes that legal academics and professionals may exert influence over the public-comment procedure however, the final decision remains that of the MoJ. Ito (1990) finds that there is evidence that Japanese election timings are influenced by growth and inflation circumstances. Voters respond positively to high growth and low inflation and as such, elections tend to be called in periods of high growth and low inflation in an effort to sway voters however, there is no influence of international variables such as exchange rates and foreign reserves on the timing of general elections or local economic performance.

The new electoral system has also resulted in higher electoral volatility as Prime Ministers have rotated on an almost annual basis since 2006 (Kushida and Shimizu, 2013) which ultimately counteracts the enhanced global integration and openness and the political instability spills over to the economy. Shinzo Abe became the Prime Minister of Japan in 2012 when the LDP once again won the national election, he was re-elected in 2014 and 2017. Abe has implemented a 'three-arrow' economic framework known as 'Abenomics'[14] aimed at boosting the Japanese economy. Improving economic growth and a strong stock market resulted in Abe's approval rating increasing to 70 percent. Political disagreements still exist, a prime example being the spiralling Senkaku/Diaoyu islands dispute, which resulted in the exports to China falling by 14.5 percent between June and November 2012. Japan's electoral system weakens the power of trade unions and may result in stubborn income inequality for years to come as the two largest political parties compete against one-another for the median vote. Although political debates now take place, public participation in elections is still low and many Japanese still feel a lack of trust and pride in both the political system and the country.

4. Financial Stability

Empirical studies by Vernon (1983), Shan (1991) and Kim and Hwang (1992) identify a negative relationship between political and economic risks and the level of ownership in the foreign investment. Hennart (1988) and Hill, Hwang and Kim (1990) find that the utilization of lower ownership models in host countries exhibiting higher political risk and uncertainty may reduce the level of host country risk and transaction costs.

The credit boom in Colombia (and other Latin American countries) in the early 1990s led to an increase in the number of households taking out mortgages which, in turn lead to a large increase in house prices. As household leverage and financial burden increased, the support for higher home prices decreased and prices began to plummet. In 1998 and 1999 Colombia experienced a credit crunch and faced extreme vulnerability to financial instability and systematic risk. In the early 2000s, 20 percent of all mortgages in Colombia were not performing and banks had an indirect exposure to exchange rate risk due to unhedged borrowers. Government indebtedness grew and currency mismatches presented themselves leading to the deepest recession that Colombia had experienced in history. As discussed in King (2003), Mosley (2000) points out that policy details were not, in the past, a major concern instead, broad macroeconomic indicators were used to assess the global financial markets.

[14] The 'three arrows' of this economic framework are monetary easing, a flexible fiscal policy and structural reform and to date, the framework has been somewhat successful at stabilizing the *yen* exchange rate, improving consumer confidence and improving the integration of the stock market.

Although this may have been true in the past, the systematic crises experience in Latin America made policy makers aware of the need to focus on policy details and as such, the Colombian government chose to implement macroprudential tools (although not specifically identified as such) in an effort to prevent future crises and limit systematic risk. A number of international issues call for the implementation of macroprudential policy tools in Chile as well or at least the discussion and awareness thereof.

Housing valuations and loan-to-value ratios should be an important consideration in Chile when considering the recent surge in house prices in Greater Santiago where home prices were up, 6.7 percent year-on-year growth in 2017 and nationwide home sales increased by 11.3 percent. Laeven and Valencia (2012) show that Chile has not experienced a systematic banking crisis since 1982, which may be an indicator of at least some level of financial stability. The financial crisis at the beginning of the 1980s in Chile can be attributed to an unstable macro policy framework combined with a liberalized and privatized banking system, which lacked both regulation and supervision. The late 1970s saw erratic capital inflows due to the open capital account and the fixed exchange rate. As is the experience of many Latin American countries leading up to and during a crisis, the banks' low-quality credit supply boomed as a result of lax lending standards. An increase in the number of currency mismatches led to the collapse of banks following the abandonment of the fixed exchange rate regime, which, in turn brought the Chilean economy to an abrupt halt. Laeven and Valencia's data set shows that the Chilean financial crisis of 1982 had a fiscal cost of 43 percent of GDP, an output loss of 8.6 percent and an 88 percent (of GDP) increase in public debt.

Colombia is the 55th largest export economy in the world and exported US$11.1 billion of crude petroleum, US$7.63 billion of coal briquettes and US$2.7 billion of coffee in 2017, to name a few. This makes them vulnerable to unexpected swings in the availability of external financing and therefore vulnerable to systematic risk. The Colombian government implemented a series of structural reforms with the aim of promoting economic openness and financial liberalization in the early 1990s and by the late 1990s, the country experienced one of the most severe financial crises in Colombian history as both financial operations as well as interest rates became less restricted. When the total expenditure grew rapidly and the deficits increased, the country began to see the signs of an overheated economy.

Colombia's increased openness facilitated a large amount of capital inflows, which in Colombia are highly and positively correlated with credit supply (Carrasquilla et al., 2000, Tenjo & Lopez, 2002, and Villar et al., 2005). Colombia also has a small, open and banking orientated economy with very low levels of domestic savings which also makes the economy particularly vulnerable to large shifts in the availability of external financing (Uribe, 2012). The terrain of the country makes it costly for intraregional trade and communication, which is costly for the economy. In 2014, JP Morgan announced that it would assign a larger weight to its Colombian portfolio however they were concerned about the risk attached to the exchange rate and the financial stability of the system. Colombia has slowly been integrating into the global economy in recent years following the structural reforms, which have taken place during the past two decades. This has led to an increase in foreign investment both into and out of Colombia.

The Chilean *peso* is known as a "commodity currency" and currency movements in the past have generally followed the movements in copper prices, in 2012 the *peso* briefly appreciated against the US dollar despite a small drop in copper prices. Chile's position as a commodity exporter increases the country's vulnerability to capital inflows and spillovers and therefore, macroprudential policy tools are needed to address these risks, pension funds have already successfully stabilized non-resident capital flows. Corporate leverage, FX-mismatches and the shadow banking system also pose a threat to the Chilean economy. The restrictions imposed on deposit taking and the defined regulatory perimeter, limit the reach of non-bank leveraged financial intermediation with systematic implications in terms of size (challenges still exist for consumer protection). The Chilean policy makers have chosen to adapt a simplistic macroeconomic and macro-finance stance and therefore abstain from actively updating their position.

Rodriguez-Delgado et al. (2013) follow the methodology laid out in Lama (2011) and analyse the recovery experience of different emerging market economies after the Great Recession, they find that the average GDP is about 7 percent lower than the pre-crisis trend for LA6 countries while emerging countries in Europe had an average GDP 22 percent below the pre-crisis trend. The paper focuses on the recovery of Brazil and Chile and finds that while Chile's GDP is 3.5 percent below the pre-crisis trend, Brazil's GDP is significantly lower at 11 percent below the pre-crisis trend level. Lama (2011) finds that between 1990 and 2006, the labour and efficiency wedges played a vital role during periods of low output in Latin American countries while Simonovska and Soderling (2008) focus on Chile specifically and find that a similar conclusion can be made. Rodriguez-Delgado et al. (2013) look at the post-crisis behaviour of Brazil and Chile, both countries experienced an improvement over time in labour wedge distortions, which provided a support basis to the economy's recovery however, only in Chile was this growth sufficient to overcome the poor performance of efficiency unfortunately. The table below shows both the pre-and post-crisis growth rates in Chile. One can see that the post-crisis growth in GDP is actually higher than the pre-crisis GDP growth and the same holds for employment, hours and investment growth.

Figure 1

Chile: Pre and Post Crisis

(average, q-o-q growth)

	GDP	Employment	Hours	Investment
2003Q1-2008Q3	1.3	0.7	-0.3	3.1
2008Q4-2009Q1	-1.2	-0.7	-0.8	-14.1
2009Q2-2012Q4	1.4	1.0	-0.2	3.9

Source: Rodriguez-Delgado et al. (2013).

Fitch Ratings computes a Macro Prudential Index (MPI) that identifies the build-up of any systematic risk[15] due to rapidly growing credit connected with housing and equity markets or real exchange rates. When looking at Chile, one can see that the Chilean *peso* has appreciated roughly 10 percent between 1996 and 2012. The average rate is above the threshold suggested by Borio and Lowe (2002). However, a Staff Report (2013 IMF Article IV Consultation staff report) shows that the *peso* is not overvalued although it is indeed on the strong side. Data collected by the Chilean Central Bank (BCCh) shows that home prices were rising at a faster rate than CPI inflation between 2003 and 2012. Private sector foreign loan and deposit liabilities had not (until 2012) been accelerating in the case of Chile although the current account had shifted from a 1.5 percent (of GDP) surplus in 2010 to a 3.5 percent deficit in 2012. Chilean policy makers felt that although the deficit would need to be monitored, the strong domestic demand had sustained imports (exports were weakened by abnormally high copper prices and lower demand in trade partners). The deficit was not severe enough to cause any immediate or near-term stability risk.

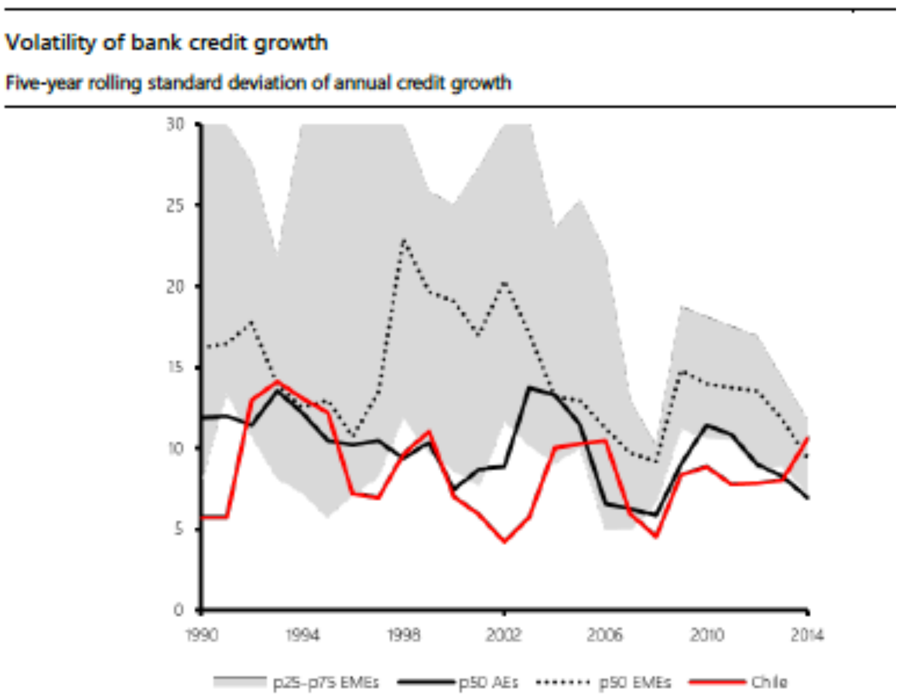
Kamil and Rai (2010) found that multinational banking subsidiaries that relied on domestic deposits were a stable credit source during the global crisis for Latin American countries. The

[15] The factors defining an excessive vulnerability to systematic risk include, i) real private sector credit growth greater than 15 percent a year over two years (on average), ii) real property price growth greater than 5 percent per year in the same period, iii) a REER growth greater than 4 percent per year in the same period or iv) real equity price growth greater than 17 percent per year (in the preceding two years).

availability of credit allows businesses to fund profitable projects and to improve their investment prospects and the availability of credit gives households the opportunity to smooth consumption over their life cycle however, excess credit and lax lending standards could potentially lead to higher credit delinquency ratios, excessive leverage, maturity mismatches and the general erosion of the financial system.

Cifuentes et al. (2017) show that when looking at the Mexican and Asian crises of the 1990s as well as the Great Recession more recently, one can see that the volatility experienced by the emerging market economies was higher than that of the advanced economies in the 1990s, however in the period after the Great Recession, the volatility of EMEs has been in line with that of the AEs (although slightly higher). The graph below shows that not only is the bank credit volatility in Chile lower than the levels in other EMEs and also, the bank credit volatility is lower than in advanced economies in most periods considered but the impact of global shocks is less severe in Chile than in the other emerging markets. Cifuentes et al. (2017) also compute the correlation between macro volatility and financial volatility for each country during a 25-year period and find that the median correlation in Chile is at 0.45, which is 0.3 lower than that of the emerging market, economies.

Figure 2



Source: Cifuentes et al. (2017).

As mentioned earlier, the UK applied for an IMF bailout in 1976 in an effort to save the economy from high national debt levels and plaguing stagflation. Although the official bank rate has historically moved between 2 percent and 10 percent, the bailout from the IMF saw this rate increase to 17 percent. The 'Winter of Discontent' in 1979 brought a wave of strikes in public services as workers protested against the Labour government's inability to govern and ultimately its inability to control inflation. The Thatcher government attempted to restore balance to the government budget and also aimed to stabilise inflation however, a failed attempt at influencing money supply resulted in the deepest recession that the UK had experienced since the Great Depression. Globalisation led to renewed international pressure for governments to implement prudent economic policies and the return of the Labour party in 1997 saw economic stability, low inflation, low borrowing levels and the promotion of private enterprises take centre stage.

The mid-1980s saw the first asset backed securities being used in the UK and by the 1990s, financial derivatives were widely traded. A systematic crisis is defined as "a disturbance that severely impairs the working of the financial system and, at the extreme, causes a complete breakdown in it" (Promisel report, BIS, ECSC, 1992). Lindgren, Garcia and Saal (1996) focus on the soundness of banks and they show that financial liberalisation has, in many cases, preceded a financial crisis (Kaminsky and Reinhart, 1996). The UK economy expanded during World War II in contrast to the majority of European countries and at the time, the UK GDP per capita was roughly 90 percent larger than the EU 6. The Golden Age of European growth occurred after the war and between 1950 and 1973, European economies experienced strong economic growth which Temin (2002) attributes to structural changes namely, labour shifts out of agriculture. Between 1945 and 1972, the UK's per capita GDP in relation to the EU founding members' per capita GDP declined steadily however, between 1973 and 2010, this ratio was stable (Campos and Coricelli, 2015).

Jackson (1996) finds that the UK has experienced two periods of bank closures firstly, following the implementation of the Banking Act of 1979, some banks were unable to meet the required standards. Secondly, King (1994) describes a second debt-led deflation period between 1991 and 1994 in the aftermath of the bubble bursting. In the 40 years prior to 2014, the UK banking system's total assets increased from 100 percent of GDP to 400 percent of GDP and the size of the system could double by 2050 (Bush et. al. (2014). Dissanayake (2000) quotes

Lord Liverpool (1826), “the solid and more extensive banks could not fail in time to expel the smaller and weaker”.

Davis and Salo (1997) attribute the increased awareness, improved innovation and the reduced excess capacity to the banking shocks experienced by the European banking system in the early 1990s. In the aftermath of the global crisis, the UK offered both political and economic stability in a turbulent global environment however, in 2014 the UK had the largest current account and budget deficits in Europe relative to GDP and political and economic uncertainty emerged as the UK prepared for a referendum on UK independence from the EU. Campos et al. (2014) notes that neither the Commonwealth nor bilateral free trade treaties have worked for the UK in the past however, the advocates of Brexit argued these two economic alternatives. Although the UK experienced declining GDP per capita in the years leading up to EC membership, the GDP per capita levels remained stable since 1973 and it is therefore clear that EC membership played an important role in strengthening the UK economy and halting the economic decline relative to the EU6 that the UK was experiencing at the time.

Walter (2012) and Satyanath (2006) show that agency ineffectiveness can result either from systematic under-resourcing of the regulatory agency or discretionary non-enforcement (O’Keeffe, 2014) however, the UK spent €10 per €million of assets in 2005 on credit institution regulation which, although lower than Ireland and France, was higher Germany (O’Keeffe, 2014). After slow economic growth relative to other EU countries plagued the UK for a number of years in the post-war era, UK GDP growth started to improve in the 1980s and had overtaken that of France and Germany when the crisis hit in 2007. Real productivity growth was roughly 2.8 percent per annum between 1980 and 2007, restrictions on foreign investment were eased in the 1980s and immigration restrictions were relaxed in the late 1990s (LSE Growth Commission Report). Aiyar (2011) shows that British banks’ experienced a decline in local lending after the Lehman Brothers default due to lower levels of foreign funding and Rose and Wieladek (2011) find that the major reduction in lending in the UK during the global crisis was by nationalized foreign banks. Kamil and Rai (2010) discuss the fact that public rescue programs may have led to banks decreasing the amount of foreign lending. The UK spent roughly €123 billion on recapitalisation and asset relief measures in the aftermath of the crisis and as a number of banks, including Royal Bank of Scotland, and financial institutions needed financial intervention. Aggregate external liabilities decreased 24 percent between March 2008 and October 2009 before they once again stabilised.

Rawdanowicz et al. (2014) show that quantitative easing in the UK may have provided a temporary boost to real GDP of about 2 percent. Real GDP grew 2.2 percent per annum on average between 1980 and 2014 despite the three downturns discussed and in 2014, the UK GDP per capita was 87 percent higher than in 1980 (Office for National Statistics). The UK has not had a trade surplus since 1997 and although the UK experienced slight deflation in April 2015, the UK had only experienced deflation once before, in March 1960. Although housing supply has not risen to meet demand since the end of the global crisis, home prices have continued to increase and the threat of a bursting housing bubble remains imminent. In 2019, wages are on the rise and factory production is strong while foreign investment maintains a high level however, the country continues to face immense political uncertainty as the outcome of Brexit is still unknown and a no deal Brexit becomes ever more likely. In 2018, although economic growth was strong and the economy approached full employment, increasing public services pay demands injected risk into the economy after years of declining living standards for public sector staff and an eroding tax base.

In 1926, Portugal once again entered a dictatorship, António de Oliveira Salazar became the Minister of Finance in 1928 and a new economic era began. Salazar agreed to head the MoF on the condition that he would have "veto power over all fiscal expenditures" (Solsten, 1993) and by 1932, he ultimately became Prime Minister. The Portuguese economy experienced strong growth between the 1930s and the early 1960s as the credit worthiness improved and the fiscal budget recovered. In 1960, Portugal joined the EFTA, the following year Portugal joined the IMF and the World Bank and in 1962, Portugal joined the GATT. The Six-Year Plan for National Development was announced in 1958 with the aim of accelerating economic growth. Economic growth became even more important when guerrilla warfare threatened the stability of the Portuguese economy as well as the government's budget.

In April 1974, a military coup ended the dictatorship and in May 1974, the regime published its Economic and Social Program however, this program was not well defined and simply called for the reformation of the tax system and the implementation of a new framework. The Portuguese government was forced to implement IMF-monitored stabilization programs in both 1977 and 1983 as both the political and economic environment remained unstable in the period after the revolution. Public enterprises became an important part of the public sector in Portugal following the nationalisation of many enterprises in the mid-1970s, this resulted in the monopolisation of domestic markets. These public enterprises suffered financially and relied heavily on debt financing from commercial banks as price freezes due to political influence, a redundant labour force and a lack of competition in a time of rising operating costs eroded the capital base. Prime Minister Cavaco Silva denationalised the state-owned banks and other public enterprises in 1989 as privatization, economic deregulation and tax reform became the primary focus of public policy in the lead up to EC membership. Between 1973 and 1990, general government expenditures as a percentage of GDP increased from 23 percent to 46 percent, the budget surplus of 1973 had turned into a budget deficit equal to 12 percent of GDP by 1984 and the Portuguese economy battled against the current.

In under two decades, the Portuguese economy has experienced major tests to its financial stability. Eurozone convergence of GDP growth in the period prior to the adoption of the euro benefitted the Portuguese economy between 1995 and 2001 as the economy shifted from a manufacturing focus to a service focus. The Portuguese economy experienced a period of extreme expansion as economic prospects bloomed and the investment risk decreased which led to higher levels of private debt, improved labour productivity growth (Corrado et al., 2016) and a boom due to higher domestic demand however, this boom gave way to a severe bust and a decade of economic woes. De Haas and Van Lelyveld (2006) show that during local crises, foreign bank lending is typically more stable than domestic bank lending in emerging European countries and De Haas et al. (2011) shows that multinational bank subsidiaries reduce lending more drastically than domestic banks.

On the other hand, Barba Navaretti et al. (2010) find that multinational banks maintained stable loan-to-deposit ratios and hence, acted as a stabilizing agent in Europe. In 2002, Portugal started to experience stagnated GDP growth and declining investment as the country became less competitive and ever more indebted. By 2004, general government debt reached a level of 60 percent of GDP and by 2010, Portuguese sovereign bond interest rates followed the upward trend of Greek sovereign bond interest rates. In April 2011, the Portuguese economy received a rescue package from the *troika* made up of the IMF, EC and ECB. Portuguese banks tightened lending standards and the government increased taxes in an effort to decrease public expenditure.

The already struggling Portuguese economy only became worse in the aftermath of the global crisis and the European sovereign debt crisis as unemployment rose to 17.5 percent in 2013, youth unemployment rose to 40 percent, fiscal deficits reached 10 percent of GDP and sovereign bonds were downgraded to 'junk' status. Portugal experienced mass emigration at levels that had not been experienced since the Salazar era. '"There is evidence that the increase in lending restrictiveness hit the non-tradable sector, including construction, real estate and trade (retail and wholesale) disproportionately hard" (Bank of Portugal, 2012)' (Dias and Marques, 2018). Dias and Marques (2018) finds that there is a weaker relationship between productivity and capital growth after the sovereign debt crisis for the non-tradable services sector and concludes that this is most likely due to the non-tradable sector being most affecting by the lower domestic demand at the time and the tighter lending conditions.

Although the views on Portugal's recovery differ, Gouveia and Coelho (2018) and Centeno and Coelho (2018) favour the view that the recovery is grounded in lasting structural changes over the two decades prior to recover combined with policy initiatives aimed at fostering an environment of business and consumer confidence. On the other hand, Chen et al. (2012), ESM (2017), IMF (2017) and the European Commission (2016) attribute the recovery to the implemented adjustment program, which set in motion a domestic deflationary process and in turn, helped to restore external competiveness. Portuguese home prices started to recover in the second quarter of 2013 and by the second quarter of 2018, real home prices had increased 33 percent (Banco de Portugal, 2018). Although I favour the first view due to the skyrocketing home prices and rental costs as well as the ever-increasing fuel price which counteracts the deflationary argument, one can be certain that the Portuguese economy has indeed reached a turning point as unemployment dropped to 7.4 percent in 2018 and fiscal deficits decreased to 0.9 percent of GDP in 2017 which is the lowest level since Portugal became a democracy. A report issued in 2017 by the OECD points out that the share of non-performing loans in the banking sector at the time represented more than 12 percent of total loans which is one of the highest levels among European countries. The OECD, at the time, suggested that a reform package be implemented to strengthen the regulatory framework in an effort to reduce the proportion of non-performing loans. The Action Phase of a project undertaken by the OECD and the Portuguese authorities was announced by the OECD Secretary-General with the aim of identifying skills challenges in Portugal.

In 2017, Portugal exited the European Commission's excessive deficit procedure following improved growth, controlled budgets and falling interest costs, which gathered momentum toward the end of 2016. Government debt, in 2017, was still amongst the highest in Europe at 126 percent of GDP however, the country's sovereign debt became eligible for inclusion in several international bond markets, which improves investment prospects and creates an opportunity to cover debt payments at a faster rate. A 2018 BP Financial Stability Report notes that "The Shanghai Composite Index dropped by 19% from January to mid-November", a slowing Chinese economy due to unstable US-China trade relations poses a threat to the Portuguese economy due to the number of Chinese investors in Portugal, particularly through the Golden Visa Investment Scheme[16]. Low household savings rates also pose a threat to Portuguese financial stability as Portugal has an aging population and a far-reaching social security system yet simultaneously, households are highly indebted. The Portuguese banking sector is the most profitable it has been since the crisis as a series of recapitalisations which improved capital positions and cleaned up balance sheets has reduced the susceptibility of the banking sector to external shocks and hence, stabilised the banking sector (Sušec, 2019).

In 1971, the currency was allowed to float which resulted in increased value, a position as a major reserve currency and ultimately an improved set of potential policy choices for the government as floating exchange rates are seen as effective policy tools. The stronger currency ultimately worsened the bubble in Japan as demand for Japanese products plummeted. Asset deflation at the time and economic stagnation combined with the low demand for Japanese products led to a systematic crisis in 1997. The Stagflation, between 1991 and 2000, experienced by the Japanese economy could be attributed to a fall in total factor productivity growth according to Hayashi and Prescott (2002) however, Dekle and Kletzer (2003) and Brewer et al. (2003) attributes the poor economic growth to financial sector or banking sector problems. Following the burst of the stock and land price bubbles in the early 1990s, the government was forced to inject capital into fifty-seven financial institutions in the amount of ¥12.4 trillion and in 2009, four thirds of the value had been returned (Ueda, 2009).

Peek and Rosengren (1997) and Peek and Rosengren (2000) show that in 1990, the drop in Japanese stock prices resulted in decreased lending by Japanese banks in the US. The early 1990s also saw a scheme by which failing banks were absorbed into healthier institutions however, when the crisis was amplified, the number of healthy institutions available and able to absorb the failing institutions had diminished and the scheme ultimately failed. By 1997, Sanyo Securities (a medium sized securities company) went bust and a number of other

[16] Banco de Portugal's Financial Stability Report of December 2018 notes that 8% of real estate properties amounting to 12% of sales value in Portugal were purchased by non-residents in 2017 although the majority of these investors were either from France or the UK.

financial institutions followed as panic flooded the Japanese financial system. In 1998, two banks were nationalized temporarily in an effort to rescue these institutions and 1999 saw 15 large banks receive capital injections from the government. In the early 2000s, the post office was also privatized in an effort to boost the economy. Japan ultimately emerged from the crisis in the mid-2000s.

Japan relies heavily on the export of cars and technology and when worldwide demand for Japanese exports decreased during the global crisis, Japan entered its first recession since 2002. Ito (1990) mentions that in the 1960s, it was thought that if the US sneezed it resulted in Japan catching a cold however, by the 1980s this had been reversed. In the 1980s, the Japanese economy consistently grew at roughly 3.8 percent in a low inflation environment but real GDP growth in Japan hit a low of -5.2 percent in 2009 as the economy entered a dire state. Japan also relies on the import of oil, gas and raw materials for industrial production due to the lack of natural resources in the country. Although Japan recorded a trade surplus each year between 1980 and 2010, the 2011 Tsunami, increased the reliance on imports as all nuclear reactors in Japan were closed down and energy supply was reduced. Japan is still dependent on exports however not to the extent that the world may think, in 2010 export dependence in China was at 27 percent, Korea was at roughly 50 percent and Japan came in at a modest 15 percent. The Basic Energy Plan in Japan has said that Japan will attempt to reduce their reliance on nuclear power. The reliance on imports and exports to keep the Japanese economy afloat makes the economy particularly vulnerable to both internal and external risks as well as innovation in foreign countries as demand for cars and technology may plummet if the world no longer feels the need to import Japanese products.

Hoshi and Okazaki (2002) note that the MoF was more concerned about rising real estate prices and the relationship with income distribution than the relationship between credit supply growth and financial instability. Real estate prices and credit supply continued to grow as the MoF did not decisively implement measures or regulation to curb this. “Shadow Banking” also emerged in Japan in a similar way to the “Shadow Banking” system in the US whereby Japanese banks provided credit to non-banking financial institutions who in turn provided real estate projects with credit. The use of the “Shadow Banking” system continued to increase as the MoF’s recommendations on credit supply in the regulated banking sector became stricter. An earlier inspection by the BoJ found that lending was dangerously concentrated in certain industries (Kumakura, 2008) however, the fact that credit supply and housing prices continued to rise points toward a lack of supervision on the part of both the BoJ and the MoF. Japanese policy makers tend to implement the necessary policies after the fact instead of as a preventative measure which raises questions about the policy makers forecasting methods or policy choice implementation strategy. Kanaya and Woo (2000) point out that the hesitation of authorities in implementing measures was caused by the fear that the banking sector would be plunged into a state of panic. In 1995, the balance sheets of *Jusen*[17] raised the alarm and after immense lobbying, tax payer money was used to address the issues in the financial system. The decision was made in the interest of catering to a sector of the financial industry instead of with the intention of rescuing the Japanese economy, this brought to light the issue of having a financial regulator within a fiscal authority and the conflict of interest that may occur (Ueda, 2009).

The Japanese financial system is sensitive to heightened financial risks from abroad and in October 2016, many factories across the globe, including Japan, decreased production as demand started to slow down following the US-China trade war, slower global growth and political uncertainty in the presence of Brexit. The lower demand and slower production resulted in reduced exports and exports experienced their largest decline in roughly two years in January 2016 as the value of exports to China plummeted. A large portion of Japanese national debt is held by domestic lenders, which are large financial institutions that are dependent on the Japanese government for continued protection (Kushida and Shimizu, 2013), this protects the economy from swings in the exchange rate and global financing conditions which would see the value of debt payments increase drastically. Economists such as Joseph Stiglitz and politicians such as Angela Merkel have questioned Abenomics in the past and the scandal regarding inaccurate economic statistics does not bode well for the stability an already fragile Japanese economy and political system nor does it improve consumer confidence.

5. An Empirical Analysis

As a means of substantiating the discussion of the role of Central Banks and the political environment in financial stability, a simple panel regression is run using the credit growth in an economy. Romelli (2018) constructs a comprehensive index of Central Bank independence using the Grilli et al. (1991) and Cukierman et al. (1992) GMT and CWN indices as a starting point. The Romelli (2018) Extended Central Bank Independence (ECBI) index includes information on the 1.) Governor and Central Bank board, 2.) Monetary policy and conflicts

[17] Special Housing Loan Corporations.

resolution, 3.) Objectives, 4.) Limitations on lending to the government, 5.) Financial independence and lastly, 6.) Reporting and accountability. The ECBI index included in the Romelli (2018) paper covers 154 countries for the period of 1972 to 2017 however, the dataset provided to me by Davide Romelli covers an earlier period for Chile, Colombia, Japan, Portugal and the UK and hence, my empirical analysis looks at the period between 1962 and 2017. The CBI index, as coded by Romelli (2018), ranges from zero to one with one representing the highest level of Central Bank independence.

The regression equations are as follows:

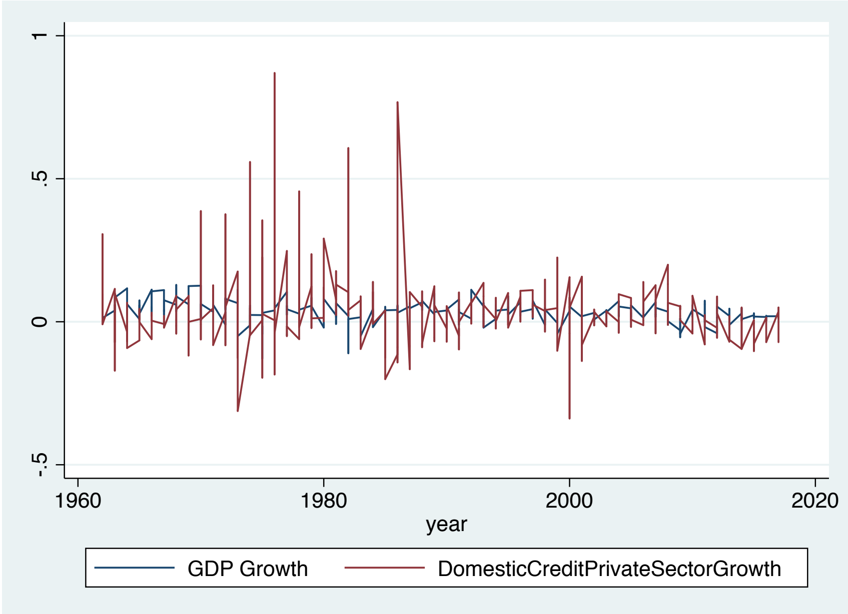
$$Credit\_Growth_{it} = \varphi_i + \beta_1 Credit\_Growth_{it-1} + \beta_3 ECBI_{it-1} + y_{it-1} + \varepsilon_{it} \quad (1)$$

$$Credit\_Growth_{it} = \varphi_i + \beta_2 Credit\_Growth_{it-1} * ECBI_{it-1} + y_{it-1} + \varepsilon_{it} \quad (2)$$

$$Credit\_Growth_{it} = \varphi_i + \beta_1 Credit\_Growth_{it-1} + \beta_2 Credit\_Growth_{it-1} * ECBI_{it-1} + \beta_3 ECBI_{it-1} + y_{it-1} + \varepsilon_{it}, \quad (3)$$

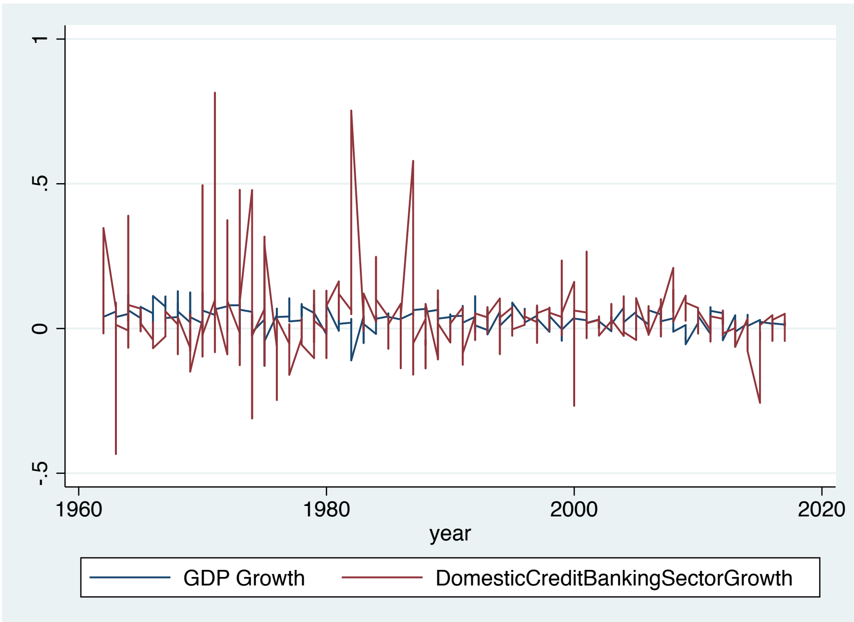
where, Credit_Growth is the annual growth in the level of credit and ECBI is the level of the Extended Central Bank Independence index, y_{it} is the annual GDP growth rate, φ_i are country fixed effects to account for unobserved cross-country heterogeneity and ε_{it} is a disturbance term satisfying standard conditions of zero mean and constant variance. Both figure 3 and figure 4 show the relationship between the credit growth rate and the GDP growth rate between 1962 and 2017. The credit growth measure in figure 3 is domestic credit to the private sector, while the credit growth measure in figure 4 is domestic credit by deposit banks and other financial institutions. The correlation between domestic credit to the private sector and GDP growth is -0.0089 and the correlation between domestic credit by deposit banks and other financial institutions and GDP growth is -0.1978 when considering the entire period. The graphs show that credit and GDP have similar growth paths in recent years, and GDP growth is included in the analysis due to the relationship between the two fundamentals.

Figure 3



Data Source: World Bank

Figure 4



Data Source: World Bank

The analysis is repeated for two measures of credit growth namely, domestic credit to the private sector and domestic credit by deposit banks and other financial institutions. By measuring the impact of Central Bank independence on credit growth, the impact of Central Bank independence on financial stability is identified. Credit growth acts as a proxy for financial stability as financial crises are often preceded by credit and asset growth (Borio, 2018).

Table 2 shows the results of regressing domestic credit to the private sector growth on its lagged value, the ECBI index and lagged GDP growth (with country fixed effects). When domestic credit to the private sector is regressed on the ECBI index in the full sample, the coefficient is negative however, this coefficient is not statistically significant. The coefficient is positive for the case of Japan and Colombia however, this coefficient is still not statistically significant. The coefficient on lagged GDP growth is positive and statistically significant for all cases except Colombia for the second regression and for all cases except Colombia and the UK for the first and the third regression. The coefficient on the interaction term between credit growth and the ECBI index is positive and statistically significant in the second regression for all cases except that of Colombia and the UK. In the cases where the interaction term is statistically significant, the impact on credit growth is larger for higher levels of Central Bank independence.

Table 3 shows the results of regressing domestic credit by deposit banks and other financial institutions on its lagged value, the ECBI index and lagged GDP growth (with fixed effects). The results are somewhat different to those of Table 2. Similarly to Table 2, the coefficient on the interaction term between credit growth and the ECBI index is positive and statistically significant for the cases of the UK and Portugal for the second regression. The positive and statistically significant coefficient on the interaction term between the ECBI index and credit growth in some cases implies that the impact on domestic credit by deposit banks and other financial institutions is larger for higher levels of Central Bank independence. The coefficient on the ECBI index is statistically significant for Portugal in the third regression whereas for the first credit growth variable (Table 2), the coefficient on the ECBI index is not statistically significant for any of the cases although. The coefficient on lagged GDP growth in Table 3 is positive and statistically significant for the case of Japan and the full sample for the second regression and for the full sample for the third regression.

For instance, Romelli (2018) finds that the political environment and institutional setting do not play an important role in the likelihood of reforms of Central Bank independence and that financial crises tend to result in reforms aimed at reducing Central Bank independence. This result is substantiated in the above analysis as the positive and statistically significant coefficient on the interaction term implies that the swings in credit growth are larger for higher levels of Central Bank independence which means that in times of financial instability or ultimately financial crises, Central Bank independence would be reined back in an effort to restore financial stability. Based on the empirical results this would be the situation in all cases except Colombia for regression two and Portugal for regression three when focusing on domestic credit to the private sector and the cases of Portugal and the UK for regression two and Portugal for regression three when focusing on domestic credit by deposit banks and other financial institutions.

Table 1

Regression Results: Domestic Credit to Private Sector								
Type I	Coefficient	Variable	Full	Chile	Colombia	The UK	Japan	Portugal
	β_1	$PrivateCredit\_Growth_{t-1}$	0.30 (0.06)***	0.40 (0.13)***	0.02 (0.14)	0.17 (0.14)	0.23 (0.11)*	0.37 (0.12)***
	β_3	$ECBI_{t-1}$	-0.01 (0.05)	-0.04 (0.15)	0.10 (0.10)	-0.11 (0.20)	-0.46 (0.71)	0.05 (0.06)
	β_4	GDP_Growth_{t-1}	0.37 (0.21)*	-0.17 (0.53)	1.63 (0.76)**	1.49 (0.85)*	0.35 (0.27)	0.84 (0.33)**
		Constant	0.01 (0.03)	0.06 (0.09)	-0.11 (0.07)	0.03 (0.06)	0.14 (0.22)	-0.05 (0.04)
	R^2		0.10	0.17	0.09	0.11	0.17	0.23
	Observations		275	55	55	55	55	55
	P-Value		0.00	0.02	0.16	0.10	0.02	0.0040
Type II	Coefficient	Variable	Full	Chile	Colombia	The UK	Japan	Portugal
	β_2	$PrivateCredit\_Growth*ECBI_{t-1}$	0.62 (0.12)***	0.74 (0.27)***	0.09 (0.24)	1.03 (0.67)	0.84 (0.36)**	0.62 (0.18)***
	β_4	GDP_Growth_{t-1}	0.40 (0.21)*	-0.16 (0.53)	1.42 (0.75)*	1.55 (0.82)*	0.46 (0.22)**	0.67 (0.28)**
		Constant	0.01 (0.01)	0.04 (0.03)	-0.04 (0.03)	0.00 0.03	0.00 (0.01)	-0.01 (0.01)
	R^2		0.09	0.14	0.08	0.12	0.17	0.25
	Observations		275	55	55	55	55	55
	P-Value		0.00	0.02	0.13	0.04	0.01	0.0005
Type III	Coefficient	Variable	Full	Chile	Colombia	The UK	Japan	Portugal
	β_1	$PrivateCredit\_Growth_{t-1}$	0.20 (0.15)	1.07 (0.62)*	0.02 (0.47)	-0.56 (0.56)	-1.17 (3.32)	-0.27 (0.41)
	β_2	$PrivateCredit\_Growth*ECBI_{t-1}$	0.22 (0.32)	-1.40 (1.28)	0.00 (0.86)	3.73 (2.80)	-0.47 (0.72)	0.99 (0.62)
	β_3	$ECBI_{t-1}$	-0.01 (0.05)	0.00 (0.16)	0.10 (0.10)	-0.19 (0.20)	4.66 (11.08)	0.02 (0.06)
	β_4	GDP_Growth_{t-1}	0.37 (0.22)*	-0.30 (0.54)	1.63 (0.80)**	1.56 (0.84)*	0.36 (0.27)	0.71 (0.34)**
		Constant	0.01 (0.03)	0.05 (0.09)	-0.11 (0.07)	0.04 (0.06)	0.14 (0.23)	-0.02 (0.04)
	R^2		0.10	0.19	0.09	0.14	0.17	0.27
	Observations		275	55	55	55	55	55
	P-Value		0.00	0.03	0.28	0.09	0.04	0.0034

Table 2

Regression Results: Domestic Credit by Deposit Banks and Other Financial Institutions								
Type I	Coefficient	Variable	Full	Chile	Colombia	The UK	Japan	Portugal
	β_1	$PrivateCredit\_Growth_{t-1}$	0.07 (0.06)	-0.01 (0.15)	-0.04 (0.14)	0.31 (0.13)**	0.15 (0.13)	0.24 (0.14)*
	β_3	$ECBI_{t-1}$	0.01 (0.05)	-0.19 (0.19)	0.10 (0.10)	0.06 (0.15)	0.21 (0.84)	0.04 (0.06)
	β_4	GDP_Growth_{t-1}	0.50 (0.23)	0.57 (0.69)	0.73 (0.75)	0.65 (0.66)	0.51 (0.32)	0.38 (0.34)
		Constant	0.00 (0.03)	0.14 (0.12)	-0.07 (0.07)	-0.01 (0.04)	-0.06 (0.27)	-0.02 (0.04)
	R^2		0.02	0.03	0.03	0.13	0.08	0.07
	Observations		274	55	55	55	54	55
	P-Value		0.16	0.65	0.64	0.07	0.24	0.27
Type II	Coefficient	Variable	Full	Chile	Colombia	The UK	Japan	Portugal
	β_2	$PrivateCredit\_Growth*ECBI_{t-1}$	0.17 (0.13)	0.11 (0.33)	-0.07 (0.24)	1.88 (0.65)***	0.46 (0.41)	0.51 (0.20)**
	β_4	GDP_Growth_{t-1}	0.51 (0.23)**	0.59 (0.70)	0.59 (0.74)	0.75 (0.63)	0.47 (0.26)*	0.27 (0.29)
		Constant	0.01 (0.01)	0.02 (0.04)	-0.01 0.03	-0.01 (0.02)	0.01 (0.01)	0.01 (0.01)
	R^2		0.02	0.01	0.01	0.16	0.08	0.12
	Observations		274	55	55	55	54	55
	P-Value		0.07	0.71	0.69	0.01	0.12	0.04
Type III	Coefficient	Variable	Full	Chile	Colombia	The UK	Japan	Portugal
	β_1	$PrivateCredit\_Growth_{t-1}$	0.00 (0.16)	-0.68 (0.52)	0.27 (0.48)	-0.35 (0.42)	0.97 (4.67)	0.72 (0.43)
	β_2	$PrivateCredit\_Growth*ECBI_{t-1}$	0.16 (0.34)	1.57 (1.16)	-0.57 (0.83)	3.67 (2.24)	-2.77 (15.73)	-0.02 (0.06)
	β_3	$ECBI_{t-1}$	0.00 (0.05)	-0.26 (0.19)	0.11 (0.10)	-0.05 (0.17)	0.21 (0.85)	1.55 (0.67)**
	β_4	GDP_Growth_{t-1}	0.51 (0.23)**	0.91 (0.72)	0.79 (0.76)	0.88 (0.66)	0.50 (0.34)	0.16 (0.34)
		Constant	0.01 (0.03)	0.16 (0.12)	-0.08 (0.07)	0.00 (0.04)	-0.06 (0.27)	0.02 (0.05)
	R^2		0.02	0.07	0.04	0.17	0.08	0.17
	Observations		274	55	55	55	54	55
	P-Value		0.25	0.49	0.71	0.05	0.37	0.05

6. Conclusion

The views on the Central Bank Independence of emerging markets vary with Garriga (2016) stating that the move towards independence has been more stable while, Crow and Meade (2007) believe that an impressive shift in Central Bank Independence has taken place over the past two decades. There is however, a consensus view that Central Bank Independence has the ability to stabilize the economy. The countries discussed all have Central Banks that are somewhat autonomous with *Banco Central de Chile's* autonomy being legalised in 1975, *Banco de la República*'s level of autonomy being increased in 1992 and *Banco de Portugal* becoming autonomous in 1998 after being nationalised in 1974. Both the Bank of England and the Bank of Japan became autonomous in 1997 although the Bank of Japan still acts as a government's bank.

Although Romelli (2018) concludes that the political and institutional setting does not influence the introduction of Central Bank Reforms, I tend to disagree. As Clark et al. (1998) points out, politicians may favour control over monetary policy when they are seeking additional voter support. In the Latin American countries considered, improved political freedom and stability has resulted in more trade and hence, improved economic growth and financial stability. In the UK and Portugal, the political history has indeed influenced the relevant Central Banks and financial stability. Central Bank autonomy was rejected for a number of years in the UK due to the potential negative consequences on the political powers, Portugal saw its Central Bank being nationalized after the fall of the *Estado Novo* and autonomy was only granted when political stability was re-established.

In this paper, the structure and functioning of Central Banks in Chile, Colombia, Japan, Portugal and the UK is considered. The political environment and the financial stability is then discussed and the literature review discussion is substantiated with a brief empirical analysis of the effect of Central Bank independence on credit growth using an existing database created by Romelli (2018). In the empirical assessment, we find that the coefficient on the interaction term between credit growth and the ECBI index is positive and statistically significant for all cases except that of Colombia and the UK for the second regression for domestic credit to the private sector and for the cases of the UK and Portugal for domestic credit by deposit banks and other financial institutions. Fluctuations in credit growth are larger for higher levels of Central Bank Independence and hence, in periods of financial instability or ultimately financial crises, Central Bank Independence would be reined back in an effort to re-establish financial stability.

Appendix

1. Summary Statistics

Table 3

Summary Statistics					
Variable	Obs	Mean	Std. Dev	Min	Max
Year	280	1989.5	16.19217	1962	2017
CountryCode	280	3	1.416746	1	5
GMTPol	280	0.2977679	0.2422766	0	1
GMTEcon	280	0.4526786	0.2519938	0	0.875
GMT	280	0.3752232	0.2267713	0'.0625	0.875
LVAU	280	0.4274179	0.3034966	0.098	0.9555
LVAW	280	0.4280357	0.2734289	0.1355	0.9415
ECBI	280	0.46815	0.2187273	0.1465	0.8955
ECBIBoard	280	0.462775	0.1894191	0.1785	0.94
ECBIPolicy	280	0.4298357	0.2010331	0	0.8
ECBIObj	280	0.2785714	0.3266613	0	1
ECBILending	280	0.4112821	0.379557	0	1
ECBIFinances	280	0.6018286	0.2007459	0.2775	0.9035
ECBIReport	280	0.6245536	0.3068254	0	1
PrivateCreditDepositandOther	275	73.725	53.98647	2.62792	196.125
PrivateCreditDepositandOtherGrowth	275	0.0323635	0.1225012	-0.4042293	0.9175656
PrivateCreditDeposit	275	68.16017	49.389	2.62792	196.125
PrivateCreditDepositGrowth	275	0.0299291	0.1254591	-0.4042293	0.9175656
DomesticCreditPrivateSector	280	80.64572	55.56723	6.061692	221.2885
DomesticCreditPrivateSectorGrowth	280	0.0315707	0.1240398	-0.3382399	0.8696678
DomesticCreditBankingSector	279	106.3056	81.21718	14.35644	347.0154
DomesticCreditBankingSectorGrowth	279	0.0318098	0.1271709	-0.4335481	0.81455
GDPGrowth	280	0.0347765	0.0340156	-0.129121	0.1288247

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