

Abstract

This paper analyzes the causes of financial crises, and on this basis it proposes possible changes in financial regulation. Throughout the paper we work with a hypothesis that the major roots of financial distress are excess credit growth and substantial capital inflows. We test this hypothesis on a dataset comprising entries from Australia, Japan, the UK, and US over the approximate period 1970-2010. The results confirm that there is a consistent relation of credit development to financial crisis incidences and a somewhat less consistent effect of capital inflows. Furthermore, since we find a robust positive effect of past credit growth on the probability of a crisis occurrence, we propose a change in interest rate policy. Our suggestion implies a consideration of credit to GDP ratio during the execution of the monetary policy decisions on interest rates.