Lecture 13 : Financial crises[1]

A **Financial crises**: major disruptions in financial markets characterised by sharp declines in asset prices and the failures of many financial and non financial firms.

B Factors causing financial crises

1. Increases in interest rates
   - Good credit risks are less likely to borrow
   - Adverse selection makes lending undesirable
   - A decline in lending leads to a decline in investment and aggregate economic activity
2. Increases in uncertainty
   - The failure of a prominent financial or nonfinancial institution, a recession or a stock market crash
   - Difficulty in screening good from bad credit risk reduces lending
3. Asset market effects on balance sheets
   - Deterioration in firms or households' balance sheets (net worth) due to
     i. Falls in share prices or collateral values
     ii. Increases in debt burden consequent of depreciation in the local currency (foreign currency denominated debt contract)
     iii. Increases in interest rates, which decrease liquidity
4. Problems in the banking sector
   - Deterioration in banks' balance sheets due to
     i. Non-performing loans (NPLs)
     ii. Insufficient capital
   - Contagious bank failure (bank panic)
     i. asymmetric information: depositors' fear
5. Government fiscal imbalances
   - Large government fiscal deficit creates fear of default
   - Banks are forced to purchase government bonds
   - Declines in prices of bonds, banks' balance sheets worsen

C Financial crises in emerging-market countries

Mexico 1994-1995 and East Asia 1997-1998

	GDP growth	Inflation	Current Account (%GDP)	Budget Balance (%GDP)
Mexico (1993)	2.0	9.8	-5.8	0.7
Thailand (1996)	6.4	5.9	-7.9	2.2
Korea (1996)	7.1	4.9	-4.1	0.1

Pre-crisis

Similarities

1. healthy economies
   - Mexico joined OECD in 1994
   - East Asia's miracle growth

2. Fixed exchange rate and financial liberalization

[1] Readings: Chpt 8 (Mishkin)
Pongsaparn R (2003), 'East Asian Crisis in the Light of Mexican Experiences: Causes, the IMF and Recovery Path', Thammasat Journal of Economics (September)

- Inconsistent trinity (Obstfeld, 1998)
- Similar patterns of financial liberalization
    1. Free interest rates and no restrictions on credit and lending
    2. freedom in borrowing from abroad
    3. inadequate prudential banking regulations
- (healthy economy + financial liberalisation + fixed exchange rate) led to a surge in unhedged foreign borrowings (mostly short-term)

Differences

1. Usage of capital flows
    - Mexico – consumption boom (83% of GDP in 1994)
    - East Asia – investment boom (40% of GDP in 1997) – doubling of ICORs
      - Thailand: real estates and property
      - Korea: overcrowded industries
2. Financial structure
    - East Asia was more bank-based with high debt to equity ratio

<u>Build-up to the crisis</u>

1. Over-valuation in real effective exchange rate
2. large current account deficit

<u>The crisis</u>

1. disturbance to confidence/speculative and herd-like behaviour under imperfect information
    - Mexico: uprising of Chiapas peasants and assassination of the presidential candidate (1994)
    - Thailand: failure of Bangkok Bank of Commerce (1996) and Finance One (1997), default on interest payments on Euro-convertible bond by Somprasong Land and Development PLC (1997)
    - Korea: bankruptcy of major *chaebols* (business conglomerates), Hanbo and Kia group (1997)
2. Illiquidity turned into insolvency (Diamond and Dybvig, 1983)
    - Bank panic
    - Insolvent debtors
3. Capital inflow reversal and attack on currency caused loss of reserves
4. Currency depreciation (50% within 6 months) led to increases in indebtedness in domestic currency terms
    - Firms' balance sheets worsened leading to refusal to roll over short-term debts and loan losses
    - Banks' balance sheets worsened
5. The IMF austerity program
    - High interest rates to stabilize the currencies and halt capital outflows
    - Restrictive fiscal and monetary policy
    - Financial restructuring