

Lecture 15 : Financial crises¹

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
 - o Good credit risks are less likely to borrow
 - o Adverse selection makes lending undesirable
 - o A decline in lending leads to a decline in investment and aggregate economic activity
2. Increases in uncertainty
 - o The failure of a prominent financial or nonfinancial institution, a recession or a stock market crash
 - o Difficulty in screening good from bad credit risk reduces lending
3. Asset market effects on balance sheets
 - o 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
 - o Deterioration in banks' balance sheets due to
 - i. Non-performing loans (NPLs)
 - ii. Insufficient capital
 - o Contagious bank failure (bank panic)
 - i. asymmetric information: depositors' fear
5. Government fiscal imbalances
 - o Large government fiscal deficit creates fear of default
 - o Banks are forced to purchase government bonds
 - o Declines in prices of bonds, banks' balance sheets worsen

C Financial crises in emerging-market countries

Mexico 1994-1995 and East Asia 1997-1998

Pre-crisis

Similarities

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

	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

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)

- o Inconsistent trinity (Obstfeld, 1998)
- o 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
- o (healthy economy + financial liberalisation + fixed exchange rate) led to a surge in unhedged foreign borrowings (mostly short-term)

Differences

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

Build-up to the crisis

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

The crisis

1. disturbance to confidence/speculative and herd-like behaviour under imperfect information
 - o Mexico: uprising of Chiapas peasants and assassination of the presidential candidate (1994)
 - o 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)
 - o Korea: bankruptcy of major *chaebols* (business conglomerates), Hanbo and Kia group (1997)
2. Illiquidity turned into insolvency (Diamond and Dybvig, 1983)
 - o Bank panic
 - o 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
 - o Firms' balance sheets worsened leading to refusal to roll over short-term debts and loan losses
 - o Banks' balance sheets worsened
5. The IMF austerity program
 - o High interest rates to stabilize the currencies and halt capital outflows
 - o Restrictive fiscal and monetary policy
 - o Financial restructuring