1 Financial Crises in Emerging Countries

Figure 2 and Figure 3 in Textbook

Figure 2 shows typical financial crises in US. Pay particular attention to the debt-deflation.

Figure 3 shows financial crises in emerging economies: Mexico, 1994-95; East Asia, 1997-98; and Argentina, 2001-02.

1.1 Mexico and East Asia

Financial liberalization and deregulation

$\Longrightarrow$ Lending boom

$\Longrightarrow$ rapid increase in non-performing loans and loan losses

$\Longrightarrow$ Erode bank capital (bank's net worth)

$\Longrightarrow$ contraction in lending, investment and economic activity

1.2 Argentina

Government debt accumulates rapidly

$\Longrightarrow$ Government coerced banks to purchase a large quantity of government bonds

$\Longrightarrow$ As investors lost confidence in the government's ability to repay its debt, bond price collapsed. Banks suffered huge losses.

1.3 Speculative Attacks on Foreign Exchanges

Another main characteristic of financial crises in emerging economies is that an initial shock may be followed by speculative attacks on the foreign exchange markets.

Since many firms and financial institutions had debt denominated in foreign currency, depreciation in their currencies resulted in increases in their indebtedness in terms of domestic currency. Thus, debt markets interact with the currency devaluation to propel the economies into full-scale financial crises.

2 Financial Liberalization, Asset Prices, and Financial Crises

2.1 Three Phases of Boom-Bust Cycles of Asset Prices

Financial crises often follow what appear to be boom-bust cycles of asset prices. The boom and bust of asset price cycles typically have three distinct phases.

Kaminsky and Reinhart (1996a,b) study a wide range of crises in 20 countries including *5 industrial and 15 emerging countries.* A common precursor to most of the crises considered was financial liberalization and significant credit expansion. The resulting expansion in credit is accompanied by a significant increase in the prices for assets such as real estate and stocks.

During the second phase the stock and real estate markets collapse, due to various reasons discussed above. In many cases banks and other intermediaries were over-exposed to the equity and real estate markets.

The third phase is characterized by the default of many firms and households that have borrowed to buy assets, a banking crisis followed by significant loan losses. This is often accompanied by an exchange rate crisis as governments choose between lowering interest rates to ease the banking crisis or raising interest rates to defend the currency. The difficulties associated with the defaults and banking and foreign exchange crises often cause a significant fall in output which can last for a number of years.

Higgins and Osler (1997) consider *18 OECD countries* and document a significant rise in real estate and stock prices during the period 1984-89. These prices subsequently fell during the period 1989-1993.

2.2 Some Examples

Mexico provides a dramatic illustration of an emerging economy affected by this type of problem. In the early 1990's the banks were privatized and a financial liberalization occurred. Perhaps most significantly, reserve requirements were eliminated. Mishkin (1997) documents how bank credit to private nonfinancial enterprises went from a level of around 10 percent of GDP in the late 1980's to 40 percent of GDP in 1994. The stock market rose significantly during the early 1990's. In 1994 the Colosio assassination and the uprising in Chiapas triggered the collapse of stock market. The prices of stocks and other assets fell and banking and foreign exchange crises occurred. These were followed by a severe recession.

The Japanese boom-bust cycle in the real estate and stock markets that occurred in the 1980's and 1990's provides a good example. Financial liberalization throughout the 1980's and the desire to support the U.S. dollar in the latter part of the decade led to an expansion in credit. During most of the 1980's asset prices rose steadily, eventually reaching very high levels. For example, the Nikkei 225 index was around 10,000 in 1985. On December 19, 1989 it reached a peak of 38,916. A new Governor of the Bank of Japan, less concerned with supporting the U.S. dollar and more concerned with fighting inflation, tightened monetary policy and this led to a sharp increase in interest rates in early 1990 (see Frankel, 1993; Tschoegl, 1993). The stock market collapses. The Nikkei 225 fell sharply during the first part of the year and by October 1, 1990 it had sunk to 20,222. The real estate market collapsed by delaying 2-3 years. The next few years were marked by defaults and retrenchment in the financial system. The real economy was adversely affected by the aftermath of the bust and has been in slump for more than a decade.

Q: Given discussions above, what went wrong with financial liberalization and deregulation? Is capital control justified?

Weak supervision

Poor corporate governance

Lack expertise in screening and monitoring

Government safety net and forbearance (Anticipated government guarantee or bailout)