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## Sudden storms

May 1st 2003

From The Economist print edition



### **Financial crises don't come from nowhere. With effort and luck, some can be avoided**

ONE way to improve the capital-flows trade-off—to combine more economic growth with less financial instability—would be to avoid at least some of the financial crises that might otherwise come along. But are they avoidable? They happen so often that it is natural to think that capital mobility and financial distress are inseparable: if a country wants the first, it will have to put up with the second. There is some truth in this. Access to more capital makes bigger crises feasible; every now and then, somewhere in the world, one is going to happen.

Is this because the same mistakes are made again and again, or is each crisis unique? The answer is yes to both: each crisis is unique, and the same mistakes are made again and again. However different the precise circumstances may be in each case, most of the scores of financial crisis seen in the past few decades do have certain central features in common. This is encouraging. Understanding these features and taking steps to deal with them could increase the safety of the global financial system without denying the developing countries the capital they need to grow quickly.

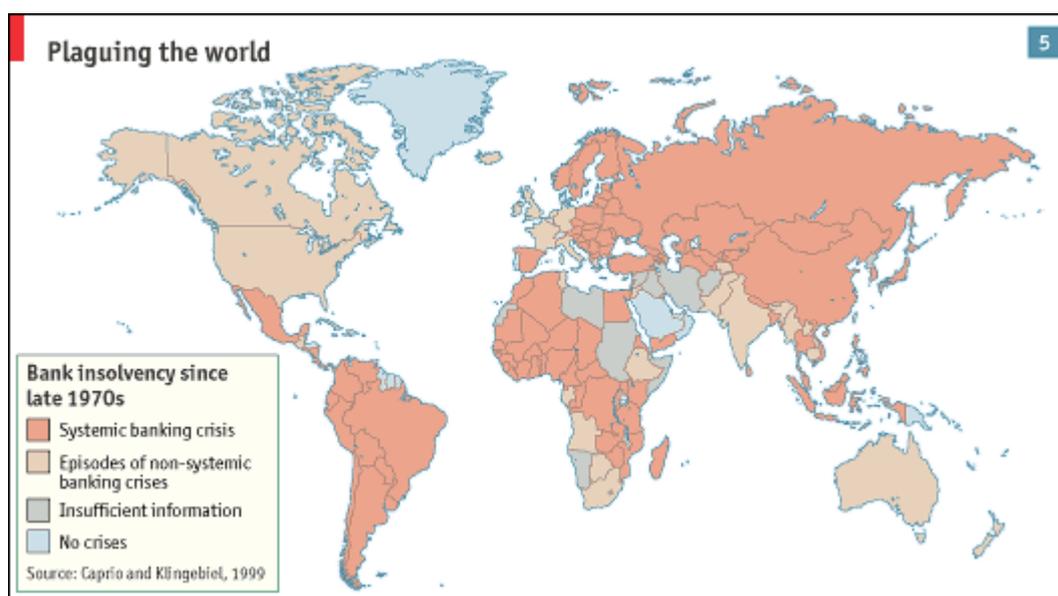
Banks are almost always deeply implicated when a financial crisis occurs—and banking crises are anything but rare (see map below). Given their role at the centre of any market-based financial system, it could hardly be otherwise. International bank flows, which declined so sharply during the 1990s, can still leave a country financially much more vulnerable than the figures suggest, because bank flows are so much more volatile than other kinds. Bank capital can switch quickly from inflow to outflow, so movements that seem small in absolute terms can exercise disproportionate influence.

Two kinds of banking weakness need to be distinguished: dangers specific to the borrowing country where the crisis starts, and risks that are due to capital moving across borders. As the crisis unfolds, these two interact. And the trouble often starts with financial liberalisation, a process that may aggravate both kinds of weakness. Talk about the perils of liberalisation makes some economic liberals uncomfortable, though financial economists, including many with strong pro-market leanings, have been pointing to the dangers of badly handled

liberalisation for decades.

## Falling standards

Every study of the East Asian crisis of the late 1990s has drawn attention to lax lending standards in the crisis countries. A lending boom preceded the breakdowns, and in each country most of the money went into risky assets such as property and equities rather than into productive investment. In Thailand, Indonesia and Malaysia the stock of lending for property accounted for as much as 40% of all lending before the crisis struck. Creditors were therefore unusually exposed to certain kinds of risk. Higher interest rates, for instance, would lower the value of the assets against which they had lent, at the same time as making some of their loans non-performing.



Government involvement in many of the regions' banking systems made matters worse. Ministries urged banks to lend to specific sectors or firms with little regard for creditworthiness. "Connected lending"—that is, lending to the banks' own proprietors or to affiliated businesses—was tolerated or even encouraged. Ordinary standards of prudent loan appraisal were set aside.

Banks often lacked the resources, human and technological, to apply such standards in the first place. Their lending officers and risk-management systems were stretched beyond the limit of their competence by the sheer volume of business. The same was true of the bank supervisors' resources, such as they were. Not only did the banking authorities lack the skills and the manpower to do an effective job, but they were also usually under the thumb of ministries that were reluctant to see lending curtailed.

"Forbearance" was the rule—meaning permission to keep lending until the problems went away, and to hide the evidence in the meantime. Bad loans were "evergreened": failing borrowers were allowed to service their debt with new loans. Accounting rules allowed such practices to be concealed. Nearly all of the crisis countries turned out to have had vastly greater volumes of non-performing loans on their financial institutions' books than the official figures admitted at the time. The official figure for South Korea's non-performing loans in 1996 was less than 1% of all loans—between one-tenth and one-twentieth of the true position.

In addition to weakly regulated banks, most of the crisis countries had, in effect, virtually unregulated quasi-banks operating alongside. Thailand's finance companies are the most notorious example. South Korea had its "merchant banks": owned by the country's

conglomerates, and more or less unregulated, they were at the forefront of credit expansion and of borrowing abroad. Indeed, the government allowed these ex-finance companies to borrow abroad only if the debt was short-term.

All of this was familiar from earlier financial breakdowns, looking back to the 1960s and before. Paradoxically, one of the least familiar aspects of the East Asian crisis, which helps to explain both its severity and the shock it caused around the world, is that many other aspects of economic policy were being handled well, and that the countries concerned seemed in most respects to be thriving.

In fact, East Asia was an extraordinary success story. Investors had every reason to feel confident. Even fiscal policy was mostly under control, which in developing countries is unusual. In a perverted way, it added to the financial danger. Investors believed that if banks and finance companies should fail, governments would be there to sort things out. The record showed that they were competent, and suggested that they had untapped fiscal resources in reserve.

The countries' success added to the dangers in another way: foreign capital was all the more readily drawn in. The sheer volume of additional inflows compounded the difficulties of monitoring and supervision. It added to the mood of optimism, so standards were relaxed still further. And it introduced the exchange rate as a new and potentially destabilising factor. Foreign inflows, while they lasted, supported the local currencies and added to the feeling that all was well. Governments, moreover, had promised to peg their currencies against the dollar; again, the markets assumed that they meant it, and that they knew what they were doing.

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This sort of activity is strongly self-sustaining. While a bubble is inflating, reckless lending seems merely bold, and appropriately well-rewarded. Deteriorating credit quality is easy to conceal so long as the price of property and other assets offered as collateral is going up. The growth in lending fuels demand, so economic growth stays high as well. That reinforces the government's reputation for competence, so the boom continues.

## Overborrowing syndrome

It is easy to see how this cycle of excess gets out of hand, but what starts it in the first place? Any news that spurs a rush of optimism can get things going. One potential catalyst is financial liberalisation, the very thing that first opens the credit taps. This has been known for decades. A classic text on development finance, by Ronald McKinnon of Stanford University, spelled out the dangers exactly 30 years ago.

A later volume of Mr McKinnon's again drew attention to the risks. Published six years before the crisis of 1997-98, it recounted South Korea's previous experience with overborrowing in the mid-1960s. Starting in 1965, financial and trade liberalisation had stimulated South Korea's growth, prompting a fundamental reappraisal of the country's prospects by foreign investors (not long before, economists had compared South Korea's prospects unfavourably with the North's). Liberalisation allowed capital to rush in, but the surge was too great; it forced inflation up and left the country struggling with the problem until the early 1980s.

Having started, and grown bigger, why does the bubble eventually burst? All it takes is a shift in perceptions, reversing the one that started it all off. After a few years of overborrowing, balance sheets start to look stretched. At some point, borrowers begin to think enough is enough. Here and there, asset sales begin as firms try to restore financial ratios to something closer to normal. Prices stop rising and then start falling. Inflows of capital slow and the currency comes under pressure.

The central bank would like to defend the currency by raising interest rates, but finds it cannot because the weakness of the banks has suddenly become clear. All at once the abyss opens up, and there is a stampede to get away from it. Panic and forced selling accelerate the decline in property and equity prices into a crash. The government's reputation for competence tanks. As capital flees, pressures on the currency force it to give way. Lenders' unwarranted faith in the stability of the currency is important both in inflating the bubble and then in worsening the effects when the bubble bursts.

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In the middle phase, while the bubble is inflating, multiple layers of moral hazard are in play. Domestic lenders are not effectively supervised either by regulators or (thanks to explicit and implicit deposit protection) by the markets. Foreign lenders likewise perform their death-defying feats over a safety net extended by their home governments—with some additional assurance of protection from borrowing-country governments and, should things turn really bad, from the IMF.

What little discipline markets might supply under these circumstances is undone by lack of information. Lenders' unwarranted faith in the stability of the currency is important both in inflating the bubble and then in worsening the effects when the bubble bursts. The promise to defend the currency creates a kind of moral hazard too: an exaggerated sense of safety, leading people to do things which they would otherwise regard as too risky or too costly.

Looking back at the beginning of the 1990s, with the East Asian debacle yet to come, Mr McKinnon put it like this:

[We] know that in any purely private capital market each individual borrower faces an upward-sloping supply curve for finance. That is not really a distortion. The more that is borrowed, the riskier the loan gets at the margin. The upward-sloping supply curve imposed by private lenders accurately reflects the increasing riskiness of the private borrower as he increases his exposure.

Consider instead the world of the 1970s and 1980s, where governments guarantee all credit flows. The host government in the borrowing country guarantees private foreign credits, either officially or unofficially. In the lending countries we have official export-import banks and deposit insurance for the commercial banks. Consequently, the normal upward-sloping supply curve for finance did not face individual private borrowers in the third world during these two decades of huge accumulation of external debts. Because of the government guarantees that were involved, they could borrow at a virtually flat rate of interest.

Exactly the same thing happened all over again in the 1990s, and not just in East Asia but in many other countries too. Nobody should suppose for a moment that, after East Asia, it cannot happen again. Turkey and Argentina, to name but two, already confirm otherwise.

## **Is it infectious?**

This account of the forces that drive the cycle of optimism, overborrowing (especially from abroad), excessive risk-taking and crisis may seem plausible for any given individual economy—but one of the hallmarks of recent financial stress has been its multinational character. One country gets into financial difficulties, then another and another. This co-called contagion need not be confined to particular regions. The Russian financial crisis of 1998, itself a kind of aftershock from the East Asian crisis, put Brazil and other Latin American economies under pressure almost immediately.

Some economists insist that this apparent contagion is not real. They argue that countries

make their own way into a position of financial weakness and vulnerability, essentially in the way just described. They object to the term contagion because it implies that the countries and governments concerned are not to blame. Bad news about a neighbouring or similar economy, they say, merely alerts investors to problems elsewhere the markets had been unaware of, or willing to ignore.

On this view, it is not so much the disease that spreads as awareness of the disease. Financial crises may tend to appear in clusters, but the sources of the problem are fundamentally national in character: that is, they spring from the mistakes of borrowers in, and lenders to, a particular country, not from some global propensity to system-wide breakdown.

It is true that contagion will not bring down a financial system which is strong, and that a crisis needs strictly domestic material to work with. Also, some of the economic shocks that trigger crises in more than one country are global or regional in their effects to begin with, such as a change in world interest rates, or a big movement in the dollar or yen, or a big change in the price of oil. If events of that kind start a cluster of crises, contagion is not to blame (any more than one would call it contagion when an earthquake causes neighbouring buildings to collapse).

The fact remains that even an economy which has been rendered vulnerable by weak supervision, excessive optimism and prolonged overborrowing is not necessarily doomed. If it is lucky, it might pass quietly through that period of danger and emerge on the other side with its vulnerabilities lessened, either by acts of policy or merely as a by-product of advancing economic development. If it is unlucky, it will be affected by bad news just when it is most susceptible. When this happens, it seems reasonable to call it contagion.

A crisis in a neighbouring or similar country might suffice to bring on financial difficulties in just the same way as a purely domestic reappraisal of economic prospects could do: bad news that forces a rethink. Often, cross-border financial flows also come into play, exerting their own direct and powerful influence on events. The evidence points clearly to a "common banker" effect: if two countries have borrowed from the same lender, when one gets into trouble the other can expect to face a squeeze as well, regardless of differences in underlying economic conditions.

There are other channels of contagion too. Equity markets have spells of moving in step, especially in downturns. Rich-country portfolio managers have a tendency to herd together when it comes to investing in emerging markets. When a bank or portfolio manager faces losses in one developing country, it may choose (or be forced by regulators) to sell assets in other markets to shore up its position. If one country devalues its currency, competing exporters come under pressure to do the same, regardless of the effect devaluation might have on corporate and financial balance sheets. All of these factors link economies together.

Because of technology, financial markets move faster than ever before. Partly for the same reason, financial institutions are bigger than ever. When a big rich-country bank changes its mind about the prospects of a particular emerging economy, the effect on asset prices in that economy can be dramatic; all the more so if other rich-country banks decide to join in.

In short, the possibility of contagion certainly adds to the risks of relying on foreign capital, shifting the balance of pros and cons away from openness to capital. For countries that nonetheless still seek access to foreign capital, it underlines the relative attractions of forms that will move only slowly when circumstances change, notably FDI. And it emphasises the dangers of the most mobile and volatile form of capital, short-term bank debt.