Twenty years of international financial crises: what have we learned, what still needs to be done?

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References:


20 Years of Financial Crises

1. Asian Financial Crisis
2. Global Financial Crisis
3. Eurozone Crisis
The Asian Financial Crisis: An overview

• Problems began in Thailand, 1997
• Foreign money flooded into Thailand and fuelled speculative markets, contributing to a huge current account deficit
• Currency plummeted on being allowed to float
• Contagion spread to Indonesia, Korea and more broadly
• But really the problems of the three countries really quite distinct
• The major common factor was the loss of confidence in the region
The Asian Financial Crisis: An overview

• Not a conventional sovereign debt crisis as in 1982:
  – private sector debt
  – a low interest rate environment
  – East Asian debt levels not ruinously high

• More of a currency crisis that developed into a generalised economic crisis
The Asian Financial Crisis: Causes

1. Type & extent of indebtedness – too much in foreign currencies
2. Financial sector weaknesses
3. Fixed local exchange rates
4. Loss of confidence – turn the taps off & any country will struggle
The Asian Financial Crisis

Cause 1: Type and extent of indebtedness

• Type of indebtedness:
  – Short-term debt
    » Increased significantly in 1995-96
    » Risk that adverse economic news will result in net capital outflows and a loss of investor confidence
  – Too much Debt denominated in foreign currency

• Extent of indebtedness:
  – Excess liquidity in the developed world led to indebtedness in East Asia – supply push factors
The Asian Financial Crisis

Cause 2: Financial sector weaknesses

- Premature liberalisation of local financial markets facilitated inflows (offshore banking centre in Thailand for instance)
- Capital inflows drove speculative bubbles in property and shares
- Local financial system failed to effectively intermediate capital – higher local property and share prices cannot generate the forex to repay foreign debt!
- Regulators should have adopted measures to make their nations less attractive for foreign capital
- Inadequate disclosure and regulatory standards
The Asian Financial Crisis

**Cause 3: Fixed local exchange rates**

- Fixed rates encourage excessive borrowing in foreign currency
- Required progressive adjustment to avoid overvaluation
- But choosing to devalue a currency is politically risky – and once the gap between fixed and real values widens … watch out!
- Smaller economies lack the resources to defend the value of the currency against speculative attack
The Asian Financial Crisis

Cause 4: Loss of confidence

- Markets tended to view emerging markets as one entity
- Region-wide loss of confidence led to an exodus from lending and investment
- This led to capital outflows (remember S-T debt levels) and currency depreciation
- Unhedged foreign exchange exposures damaged local corporations
The Asian Financial Crisis

Policy responses to non-performing loans

• Pre-crisis weaknesses that caused an excessive surge in NPLs:
  – High NPL ratios leading into the crisis
  – Poor credit standards
  – Inadequate capital ratios
The Asian Financial Crisis

Policy responses to non-performing loans

- AMCs created in Thailand, Indonesia and Malaysia
- Korea reorganised an existing, state-owned AMC, KAMCO
- Indonesia’s reluctance to implement reforms hindered NPL resolution efforts
  - Many bank closures
  - Immense disruption to banking sector
  - Massive costs to public funds
  - Indonesia’s debt levels were the only ones in the ‘debt crisis’ category so remediation is then tougher
The Asian Financial Crisis

Policy responses to non-performing loans

- Malaysia implemented a pre-emptive approach that maintained confidence throughout the crisis:
  - Focus on problem NPLs
  - Clear guidelines and NPL classifications
  - Preference for restructuring and merging banks rather than closure
  - Malaysia also adroitly used capital controls to buy it a breathing space in which it didn’t have to impose austerity and could react in a considered manner
The Asian Financial Crisis: Lessons learned

1. Fixed exchange rates are high-risk. Floating rates are preferable. Politically, managing fixed rates is very tough.
2. Denominating most of a nation’s foreign debt in foreign currency is risky.
3. Debt needs should be funded with more long-term local currency denominated capital.
4. Financial infrastructure and regulation needs development.
5. Capital flows to emerging markets when there is surplus liquidity in the developed world.
The Global Financial Crisis: An overview

- Started as a domestic mortgage crisis in the United States
- The decision to allow Lehman Brothers to fail and the bailout of AIG triggered a systemic global financial crisis
- Financial institutions lost confidence to deal with one another and funding markets froze
- Regulators/central banks around the world assumed a new role as liquidity providers of last resort for financial markets
- Bail-outs reached unprecedented scope to avoid a complete meltdown of the financial system – extended to all financial institutions not only banks
The Global Financial Crisis: Causes

1. Excessive borrowing and lending
2. Bad securitization practices – no ‘skin in the game’ – fed back into origination practices
3. The regulatory structure depended on adequate disclosure
4. Yet the complexity and opacity of CDOs meant disclosure didn’t work
5. Global transmission of systemic risk again mostly thru CDOs and CDSs
The Global Financial Crisis

Cause 1: Excessive borrowing and lending

- United States subprime mortgage market
  - Low quality lending – e.g. NINJA loans
  - Banks able to accelerate lending regardless of risk - securitization and viewing credit risk on a portfolio basis
  - So called “conforming loans” - Fannie Mae and Freddie Mac guaranteed, purchased and securitized subprime mortgages
The Global Financial Crisis

**Cause 1: Excessive borrowing and lending**

- **Other classes of assets**
  - M&A and private equity
  - **Arrangers and advisors were willing participants to generate excessive fees** – e.g. credit rating agencies
  - **Securitized debt securities** - repackaged and resold to financial institutions and institutional investors
The Global Financial Crisis

Cause 2: Suboptimal securitization

- Securitization was financialized, over-complex, and lacked transparency obscuring the underlying risks
- Derivatives
  - Heightened counterparty risks
  - Limited supervision - major bank participants
  - Regulatory failure to identify credit risks
- Credit rating agencies
  - Ratings agencies conflicted – ‘building a product to achieve a rating’
The Global Financial Crisis

Cause 3: Disconnect between the regulatory structure and the financial system

- **Macroprudential supervisory failure** - focused on individual firms and monetary stability not risks across the connected financial system nor how risks aggregate over time.
- **Blurred financial demarcations** – supervision of firms did not account for diversified business models nor broader risk profiles.
- **Procylical regulations**
  - **Basel II** – quantitative risk modelling, reliance on credit ratings, and credit risk mitigation techniques (e.g. derivatives).
  - **Accounting standards** – “marked to the market”.
The Global Financial Crisis

**Cause 4: Global transmission of systemic risk**

- **Too big to fail**
  - *Lehman Brothers* – position in debt, equity, and derivatives.
  - *AIG* – world’s largest issuer of credit default swaps.

- **Domestic regulation in a global financial system**
  - *Information gaps* - pertaining to cross-border institutions.
  - *Resolution of SIFIs* - no legal and regulatory structures.

- **Financial funding market failures**
The Global Financial Crisis: Lessons learned

1. Securitization regulation that mitigates market risks
2. Comprehensive regulation of the financial system
3. Design regulations that are not procyclical in crises
4. Effective systemic risk regulatory structures
   – Regulation and infrastructure (e.g. CCP)
   – Macroprudential supervision
5. A framework to resolve SIFIs
   – Domestic arrangements and powers
   – Reinforcing international cooperation
The Eurozone Crisis: An overview

- Predominantly a banking crisis which led to public bailouts (e.g. Ireland, Spain, Cyprus)
- Competitiveness crisis (e.g. Greece, Portugal, Spain)
- Led to massive payment imbalances within the Eurozone (e.g. Germany, Finland, the Netherlands vs Southern Europe) - surpluses that were invested in real estate bubbles in Ireland and Spain and financed budget deficits which is never sustainable!
- Sovereign debt crisis – public debt accumulated to the point of unsustainability
The Eurozone Crisis: Causes

1. The connection between the banking crisis and the sovereign debt crisis
2. Lack of crisis management institutions
3. The failure of Greece – which was entirely predictable without full fiscal union
The Eurozone Crisis

Cause 1: The connection between the banking crisis and the sovereign debt crisis

- Bank bailouts have contributed to sovereign debt (e.g. Ireland, Spain)
- Banks solvency is at risk due to their sovereign bond holdings (e.g. Greece, Cyprus, France)
- Weak growth contributes to the potential insolvency of sovereigns - shrinking GDP leading to ballooning debt to GDP ratios (e.g. Portugal, Italy, Greece, Spain)
The Eurozone Crisis

Cause 1: The connection between the banking crisis and the sovereign debt crisis

- **Feedback loop** - a weakened banking sector holds growth back and a weak economy undermines banks
The Eurozone Crisis:

Cause 2: Lack of crisis management institutions

- Growth and stability pact loosely enforced
- No supervisory structures for cross-border banking
- No crisis management mechanisms
- No cross-border bank resolution structures
- No debt mutualization
The Eurozone Crisis

**Cause 2: Lack of crisis management institutions**

- Crises will happen and institutions should be in place to absorb the shocks
- No central debt issuance facility
- No fiscal transfers
- ECB had no Treaty mandate to act as a shock absorber in Euro area sovereign debt markets
- No unified bank supervision
- No fiscal burden sharing for bank rescues
- No European scheme guaranteeing deposits
The Eurozone Crisis:

Cause 2: Why were institutions absent?

- Policy Assumptions
  - Financial markets are efficient and can absorb shocks through market discipline and interest rates
  - Current account imbalances do not count because they do not trigger a run on the currency (as is the case where both foreign and domestic capital is withdrawn from the economy)
The Eurozone Crisis

Cause 2: Why were institutions absent?

- A string of disastrous intellectual fallacies
  - Financial markets are prone to crisis and market discipline can break down as a result of herding and panics or due to the existence of too-big-to-fail banks
  - Are there any optimal currency areas?
  - Floating exchange rates provide a wonderful automatic stabiliser – which disappeared with the Euro
  - Current account imbalances count because a confidence run on a suffering member state is inevitable (and so is its amplification to the monetary union)
The Eurozone Crisis:

Cause 3: The failure of Greece – why did Greece fail?

- Failure of democratic institutions: client state fostering lawlessness
- The Greek state cannot collect its taxes
- Systematic corruption
- Cartelized economy
- The power of vested interests
The Eurozone Crisis: Lessons learned

1. Financial stability risks are magnified within integrated cross-border markets
2. ECB intervention is not enough
3. Centralization of bank supervision and resolution within a single currency zone is essential for a functional monetary union
20 Years of Crises: Commonalities among causes

1. Originated in banking systems and real estate markets
2. Excessive lending and borrowing - high levels of subprime loans
3. Regulatory responses tended to be reactive and not proactive
4. Inadequate or absence of crisis management tools/mechanisms
5. Supervisory disconnect between microprudential regulation and credit risk and macroprudential reg and systemic risk
6. In all three crises – no one before the crisis struck understood the systemic linkages – countries were viewed as separate entities – as was the case before the GFC and in Europe.
20 Years of Crises: Commonality among lessons learnt

1. Domestic mortgage crises can today rapidly evolve into regional/global systemic crises
2. Macroprudential/systemic regulation and supervision of domestic credit risks is imperative
3. Resolution mechanisms/tools required for SIFIs
4. Co-ordinated regional/global supervision of integrated cross-border institutions and markets is necessary
Thank you.

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