Emerging Market Financial Crises – Lessons for International Banking

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1 Introduction

The series of crises that have rocked emerging market countries during the past ten years had important and lasting effects on many aspects of their economies, not least their financial systems. While there are important differences in the forces driving these crises and in the ways they were resolved, some important common themes can be identified. This paper enumerates some lessons from the crises that are particularly relevant to international banking. The influence of these lessons can be seen in changes in the approach taken to international financial supervision and regulation, in financial system surveillance by the International Monetary Fund (IMF). They are also an important part of the story underlying changing trends in the intermediation of international financial flows, as documented by RYAN, and MURINDE, (this volume).

Section 2 briefly delineates some common features of the crises. Section 3 presents ten lessons that are relevant to international banking. Section 4 concludes the paper.

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[1] This paper was written while the author was an academic visitor at the University of Oxford. Views expressed are those of the author and do not necessarily represent those of the IMF or IMF policy.

2 What Happened in the Crises?

The emerging market crises of the past decade differ considerably in their origins and evolution, but have important common elements.[2] The crises occurred in the context of highly mobile international capital flows. They reflected important imbalances or mismatches in public and private sector balance sheets. Moreover, in all cases, the authorities' ability to mount an effective policy response to the situation was in some way hampered – both by the basic logic of the situation and by political constraints. Given these factors, existing exchange rate pegs proved unsustainable in the face of market pressures.

Once the crises broke out, a cumulative process of financial convulsion ensued. The affected countries' currencies depreciated to a fraction of their pre-crisis levels, well beyond any reasonable estimate of initial overvaluations. Given currency mismatches in balance sheets, the depreciations together with the countries' loss of access to external financing had strong contractionary effects: where the mismatches were in private balance sheets, depreciations generated capital losses leading to widespread insolvency. Where the mismatches were in public sector balance sheets, they exacerbated difficulties in servicing public debt, creating a painful choice between fiscal retrenchment and costly default. The monetary authorities also faced a difficult choice of whether, and how much, to tighten monetary policy to brake the depreciations: tightening could further weaken compromised financial systems, while failing to tighten and allowing depreciation could lead to continued balance-sheet wreckage. In all the crises, to varying degrees, the crises resulted in severe, albeit in some cases quite short-lived economic slumps; at the same time, they led to large corrections in external current accounts that went well beyond any reasonable measure of the initial imbalances.

Beyond these generalities lie some important differences. The Mexican crisis of 1994-95 reflected an overvalued exchange rate and a fragile structure of government debt, notably excessive reliance on short-term dollar-denominated liabilities. The East Asian crisis of 1997-98 primarily reflected balance-sheet weaknesses in private financial institutions and corporations, including poor loan quality and substantial unhedged foreign currency exposures. The Russian crisis of 1998 reflected the currency and maturity structure of the government's financing, against the background of broader structural weaknesses and political uncertainties. The more recent crises in Latin America, notably the Brazil crisis of 1999 and the Argentine crisis of 2001-2002, stemmed from the unsustainable dynamics of the public debt, which put unbearable stress on fixed-exchange-rate regimes.

Given the differing nature of the crises, the role of the financial sectors in propagating the crises also differed. In the East Asian crisis, the financial sector was front and centre stage: pre-existing financial sector weaknesses triggered the initial loss of market confidence and the fragility of private balance sheets gave impetus to the downward spiral of the exchange rate (LANE, and others, 1999, BOORMAN and others, 2000). In contrast, in Argentina, the financial system ap-

[2] This discussion draws on GHOSH, and others, 2002 and KOCHHAR, and others, 2003.