Causes of Financial Crises

- The Traditional "Bad Policy" View
  - <u>Misguided</u> (politically expedient?) <u>macroeconomic policies</u> cause currency crashes:
    - Fiscal laxity/inflation ⇒ overvaluation ⇒ FOREX intervention to defend currency ⇒ drain of int'l reserves ⇒ **currency crisis** ⇒ government forced to devalue or float

- The New "Bad Policy" View
  - Poor <u>financial regulation</u> not macroeconomic policy the problem
    - Government bailout guarantees + lax regulation (or outright corruption) ⇒ <u>moral hazard</u> ⇒ excessive foreign borrowing to finance risky investments ⇒ crisis occurs when bank losses exceed government resources.

Causes of Crises (cont)

- The "Financial Panic" View
  - Policies, macroeconomic and financial, not the problem. Instead, the basic cause of crises is developing country <u>illiquidity</u>.
  - <u>Maturity mismatch:</u> many high-yield projects in developing countries (e.g., building a new factory) are illiquid and a have long-term payoff. But much lending to developing countries is short-term. Things are stable so long as foreign investors keep rolling over short-term loans.
  - But like bank depositors, foreign investors know that a developing country cannot repay all its loans if investors all ask for repayment at once. Hence:

    Random event (e.g, bad news about exports) leads to a loss of confidence ⇒ no new foreign loans ⇒ liquidity crisis (domestic banks must liquidate assets at "fire sale" prices to repay) ⇒ asset prices (stocks, real estate) collapse ⇒ runs on banks ⇒ "self-fulfilling" currency crisis ⇒ devaluation

Reform Proposals

- International lender of last resort
  - Already exists to some degree in current policy: bailouts by the IMF and G-7 bailouts provide liquidity during currency crises .
  - Proposals would make this more institutionalized and predictable (Clinton plan).
  - Problem: moral hazard for both lenders and borrowers