What Makes this Financial Crisis Different from Others?

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Theme: This ARI aims to review the underlying causes of the financial crisis that erupted in the US in 2007, using a comparative approach and noting similarities with earlier crises (Mexico in 1994 and South Korea in 1997).

Summary: As the financial crisis turns into an economic one, debate and political responses move away from the international realm and shift to a national focus. However, this crisis shares certain similarities with earlier cases of financial turmoil, which once again highlights the need to address the complicated challenge of international financial governance.

Analysis: The financial crisis that broke out in the US in 2007 and spread to the rest of the world's wealthy and developing economies over the course of 2008 caught analysts, governments and private-sector forces utterly by surprise.

Naturally, myriad analyses have been offered as to the causes of the crisis, as has debate over the best ways to respond to it. In that regard, there have been repeated comparisons with other crises. One of the most frequent ones is the comparison with the Great Depression in 1929, which also started in the US. The consequences for the real economy are compared with those of World War II, and the work that the G-20 countries embarked on in November 2008 is compared with the process that led to the Bretton Woods accords of 1944. In light of these parallels, one might conclude the world is in a situation as unpredictable as it is exceptional, one that last emerged more than 60 or even 80 years ago.[1]

At the same time, there is a growing consensus as to the underlying causes of the current crisis. The financial liberalisation that began in the major economies in the 1970s and spread to other countries over the next few decades generated vacuums in terms of oversight and regulation. These, in turn, paved the way for transactions and financial products that fuelled international liquidity but also systemic risk, to the point of financial implosion.

Given these elements, it would be relatively easily to deduce, first of all, that a crisis of these characteristics is of an exceptional nature. Secondly, if the mess stems from a lack

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1 See, for example, E. Ontiveros (2008), 'Crisis con personalidad', in *La crisis financiera: su impacto y la respuesta de las autoridades*, Biblioteca de Economía y Finanzas nº 16, Analistas Financieros Internacionales, Madrid, November, introduction, p. 9-12.

of regulation, especially at the national level, the answer would be to regain certain levels of financial regulation and supervision.

Indeed, the current financial crisis shares some of the features of the Great Depression of 1929, and the consequences for the real economy that most countries are now suffering could be compared to the shock inflicted by World War II. In other words, it is a global crisis –not one limited to a specific region– and its epicentre is located in a developed economy –in this case the US– with grave consequences for the real economy, also at the global level.

Still, on the one hand it could be argued that in several ways the present crisis is not exceptional. It has several of the features of the recurrent financial crises that emerging and developing countries have suffered over the past 20 years. Thus, on the other hand, from some standpoints it could be said that say the new crisis is another manifestation of the global financial instability we have been enduring for decades. Finally, regardless of whether the current situation is at least partially the result of various national processes of financial deregulation, there is a systemic or overall problem that also requires systemic or overall measures.

Why is it important to frame the analysis of the crisis in the international context of the last 20 years?[2] As the financial crisis has gradually turned into a real crisis –or, in other words, as the financial crisis has been joined by a crisis in the real economy– the efforts made by the authorities and the debate on what to do have become more and more locally focused. This is only natural: when there are consequences for the real economy, responses are confined more to the national level and should differentiate between different systems of production. On the other hand, at the strictly financial level, the attention that has been focused on the internal problems of the US economy –such as excessive household and business debt– and the errors its authorities made in macroeconomic management –such as a prolonged, expansive monetary policy and excessive state-sector spending– have also helped shift the focus away from a global approach to a local one. Therefore, as part of the debate on how to respond to the crisis, in this study we aim to give greater emphasis to measures of a global nature.

A Brief Look at Some of the Most Recent Financial Crises

It is impossible to state the specific number of financial crises there have been in recent history. Naturally, such a number would depend on the variables we use to define the crises –a drop of x% in the value of a currency, a fall of y% in the growth of bank lending with respect to GDP, a decline of z% in the stock market, and so on–. So, different analyses of financial crises offer up varying lists of crises. For instance, in a paper published in 2002, Dymski identified eight debt and exchange-rate crises in the space of eight years, from 1994 to 2002. These were the Mexican crisis and the consequent Tequila effect of 1994-95, the Asian financial crises of 1997-98, the crisis involving the Brazilian real in 1998-99, the fall of the rouble in the same period, the Turkish crisis of 2000, the Argentine crisis of 2001-02, a new attack on the Brazilian real in 2002 –coinciding with the elections that were won by Luiz Inácio 'Lula' da Silva– and, finally, the Uruguayan collapse in 2002.[3] But there are various tallies of financial crises. Wolf cites

2 For other analyses of the causes of the current crises, see, for instance, F. Steinberg (2008), 'The Global Financial Crisis: Causes and Political Response', *Elcano Newsletter*, nr 51, December.

3 G.A. Dymski (2002), 'The International Debt Crisis', September, mimeographed, http://www.economics.ucr.edu/papers/papers02/02-10.pdf.

several:[4] according to a World Bank study in 2001, from the late 1970s to the end of the 20th century there were 112 systemic banking crises in 93 countries. Bordo & Eichengreen identify 95 crises in emerging economies and 44 in high-income countries between 1973 and 1997; of these, 17 of the crises in emerging economies were banking crises, 57 involved currency exchange rates and 21 involved both. In other words, in this context the international financial crisis that erupted in the middle of last year is anything but exceptional.

We will now try to review the main causes of two of these recent crises: the Mexican one that broke out in late 1994 and spread through the rest of Latin America and the South Korean crisis of 1997, which was caused in part by contagion from South-East Asia.

The Mexican Crisis and the Tequila Effect
In the years leading up to the Mexican crisis, many Latin American countries launched economic reforms that attracted the attention of international investors. In Mexico's case, the domestic reform process and terms for access to certain treaties or organisations – such as joining the North American Free Trade Agreement, the OECD (Organisation for Economic Cooperation and Development) and GATT (the General Agreement on Tariffs and Trade)– brought about an economic reform agenda that included domestic economic deregulation, an opening up in terms of trade and finance and the privatisation of state-owned companies in several sectors. International investors, who considered the changes positive, were also prompted by low interest rates in the US in the early 1990s, which caused them to focus once again on Mexico after the 'lost decade' of the 1980s. According to data from the International Monetary Fund (IMF), the entry of foreign capital in Mexico increased in the first half of the 1990s, from 1.29% of GDP in 1989 to 10.30% in 1993, only to drop to -0.82% in 1995.

Foreign financing entered Mexico mainly as bonds, a financial instrument involving great liquidity and one that was therefore quite volatile. Although money also came in as foreign direct investment and shares on the stock market, for the most part this stemmed from the process of privatisation and was negligible compared with the funds that took the form of debt. Debt contracts and titles were also denominated in foreign currencies. This massive entry of capital transformed into a credit boom that financed local consumption and imports, as well as speculative bubbles that emerged in the real estate sector and the stock market. Of course, these transactions were denominated in Mexican pesos. In other words, besides excessive foreign debt and a rise in internal credit directed at high-risk activities, there arose a currency imbalance between assets and liabilities. To put it bluntly, in the years before the crisis of 1994, Mexico was suffering from what the literature on economic crises refers to as a deterioration of its economic fundamentals.

Over the course of 1994, this was compounded by other complications, some of them economic and others of a political nature. In terms of the economy, perhaps the one that stands out most is the fact that interest rates in the US, the moderate levels of which were at least partially responsible for the entry of capital into Mexico in the early 1990s, rose several times as the year progressed. The same rates which in February 1994 were at 3.25% had risen to 5.50% in November of that year. With a lower differential in interest rates, the lure of Mexican debt was also lesser. To make things worse, a series of events left Mexico engulfed in political instability: the rebellion that broke out in the state of Chiapas in 1994, the killing in March of Luis Donaldo Colosio, a presidential candidate in

4 M. Wolf (2008), *Fixing Global Finance*, The Johns Hopkins University Press, Baltimore, chapter 3, p. 28-57.

the elections scheduled for August, and the killing of Jose Francisco Ruiz Massieu, Secretary General of the Institutional Revolutionary Party (PRI) in September of that year.

With the outbreak of the Chiapas insurrection, the stock markets started to fall. International investors' expectations as to profitability and risk inherent in the Mexican economy began to change. Although erratically, stock indices continued to fall for the rest of the year, foreign currency reserves declined and Mexican interest rates began to rise in November. On 22 December, with currency reserves depleted, the Mexican authorities abandoned the system of semi-fixed exchange rates, prompting the collapse of the Mexican peso. At that point, the crisis spread to the rest of Latin America, causing the so-called Tequila effect.

The Crisis in South Korea and Contagion from Thailand
In the first half of the 1990s South Korea undertook a series of reforms that led to greater financial openness. On the one hand, large Korean business conglomerates (*chaebols*) had benefited from what were until then timid reforms and measures aimed at greater openness. Furthermore, as in the case of Mexico, domestic pressure for reform came in tandem with the terms required for admission to certain international fora. For South Korea the entry to the OECD was particularly important, in that sense. Thus, in the years leading up to the Asian crises, South Korea embarked on financial reforms that were somewhat hasty and chaotic. They included deregulation of the financial system and the opening up of the capital account, but the process did not come hand in hand with the proper adaptation of regulatory and oversight mechanisms.

This greater openness facilitated the entry of capital. In 1994 –the same year that capital was starting to flee from Mexico– entry of foreign capital in South Korea more than doubled, rising from just under US$10 billion the previous year to more than US$22 billion. This flow kept growing until 1996, when the figure reached around US$48 billion, only to fall the following year, with a net outflow in 1998.

The entry of capital was mainly through debt –in the form of bonds, but for the most part as short-term loans and credit–. It was a process in which South Korea took on excessive foreign debt, while financing was also of a clearly volatile nature. This over-stretch in foreign debt led to over-indebtedness at the domestic level as well. Unlike what happened in Mexico a few years earlier, and even unlike what happened in other Asian countries hit by the crisis of 1997, there was no real estate or stock bubble in South Korea before the crisis erupted. Nor was this large amount of internal debt associated with consumption of local goods and services or an increase in imports. The bulk of the external lending went either directly or indirectly to financing production in the manufacturing sector, generally for export activities.

This circumstance is very important in terms of its implications for the body of literature on financial crises. In the debate on assigning blame to the factors that cause a crisis, those analysts who stress causes stemming from mistakes in local economic policy in crisis-hit countries tend to point to the emergence of real estate bubbles or other inefficient uses of domestic credit as one of the main explanations of what went wrong.

However, in this regard South Korea's economy performed 'correctly': there were no high-risk, low-production activities or squandering of external resources to finance higher levels of consumption. South Korea used massive inflows of capital from 1993 to 1997 in order

to finance productive manufacturing activity which had generated high levels of exports and growth for the country over the course of decades.

However, as the activities for which credit is earmarked do not explain everything when it comes to the emergence of a financial crisis, the fact that the investments financed with the booming capital inflows were productive does not necessarily mean the money was used properly. With shoddy regulation and financial supervision, as the result of a rapid and disorganised financial openness, the growing financing that was available ended up going to a business network that was increasingly indebted and less and less profitable. And this happened without sufficient requirements of collateral, without sufficient attention being paid to the concentration of risk and without a proper assessment of the debtors' ability to pay the money back.

The manufacturing sector's excess capacity also triggered a problem of excess supply: this led to a fall in prices of a variety of Korean export goods, such as electric and electronic products and semiconductors.

Just as in Mexico's case, a few years before this deterioration in economic fundamentals –with an increase in lending to activities that were not highly profitable, weaknesses in the production system, problems with the current account and a rise in the won because of the massive entry of foreign capital and the depreciation of the Japanese yen– there was also an external factor that prompted a change in the expectations of international investors.

For the South Korean crisis of 1997, the blow from abroad was the Asian crisis that had emerged months earlier in Thailand. In this way, South Korea, besides suffering from its own domestic economic problems, was the victim of a crisis that had erupted in another economy. The balance-of-payments crisis that led to the floating and collapse of the Thai currency, the baht, in July 1997 spread to the Philippines, Malaysia, Indonesia and Singapore. Attacks then started to be aimed at more developed economies, specifically the so-called Asian Dragons. After the summer of that year, financial pressure centred first on Taiwan, then on Hong Kong and South Korea. In November 1997, Korea's monetary authorities abandoned the fixed parity system, the value of the won fell by one half in the space of two weeks and the stock market collapsed.[5]

The Current Crisis: Epicentre in the US

As is to be expected, the current international financial and economic crisis has given rise to many analyses of its causes –from the most immediate ones to the deeper, underlying factors–, its characteristics and the responses that are needed in terms of economic policy.

Although debate is still raging over the relative weight of the factors that ultimately unleashed the crisis in the US, we can identify a list of domestic factors that explain the decline of economic fundamentals in the years before the turmoil exploded, just as we did in the cases of Mexico and South Korea.

First of all, several analyses agree that the Federal Reserve's monetary policy in the first years of this decade might have been wrong. It has even been argued that the crisis that

5 The explanations of the Mexican and South Korean crises have been taken from I. Olivié (2004), *Las crisis de la globalización. Marco teórico y estudio de los casos de México y Corea del Sur*, Colección Estudios, Consejo Económico y Social (CES), Madrid.

erupted in 2007 should have done so in 2001, as a result of persistent macroeconomic problems –such as the collapse of the dot.com boom– and as a result of the 11 September 2001 terror attacks. Under this assumption, the Fed dodged, or at least delayed, a financial crisis in 2001 by keeping interest rates at abnormally low levels. In addition to not resolving the problem once and for all, Fed policy continued to fuel high levels of liquidity in the financial system and this discouraged aversion to risk among US and international investors.

Secondly, in this context of low interest rates, there was a rise in the already high level of private consumption in the US and, added to this, an increase in government spending to finance overseas military operations, among other things. At the same time, in order to finance expenditure, public, private and foreign debt all increased. This process is part of a phenomenon known as global imbalances, in which the excess savings in Asia were used to finance the voracious appetite of the US.

Furthermore, one can point to what Fernández de Lis has defined as a system of financial regulation and oversight that is fragmented among different levels of the US government.[6] The system's weaknesses led to shoddy practices in the granting of loans, inadequate management of risk, the granting of loans to insolvent borrowers and mortgages without sufficient collateral to back up debt.

Just as in Mexico and South Korea 10 years earlier, the decay in the economy's fundamentals was compounded by a change in the expectations of international investors, triggering the outbreak of the crisis. What caused the change in expectations? Although some analysts point to the first bankruptcies stemming from the subprime mortgage market in 2007, it seems instead that the bailouts of mortgage lenders Fannie Mae and Freddie Mac, or even the collapse of Lehman Brothers in August 2008, were the spark that touched off financial panic and the global spread of the crisis.

Common Elements

It is obvious that Mexico, South Korea and the US all had domestic economic problems before their respective crises began. Furthermore, among these problems one common denominator that emerges is the weakness of the system of financial regulation and oversight. In the case of Mexico and South Korea, this might have been the result of financial reforms that were undertaken too fast and/or in a disorderly fashion. Thus, we have the first two lessons: (1) countries must keep their economies healthy, something which obviously not all countries can manage to do all the time for all of their sectors; and (2) systems of financial regulation and supervision are critical and must be sound and efficient. So it comes as no surprise that the first statement to emerge from the G-20 after its meeting in Washington in November 2008 emphasised the importance of financial regulation and supervision at the national level.

What is more, when there is an excess of international liquidity and a massive entry of capital, in the end there also tends to be a massive flight of capital. As Fernández de Lis puts it, the crisis was caused by a series of excesses.[7]

6 S. Fernández de Lis (2008), 'La crisis financiera: origen, diagnóstico y algunas cuestiones', in *La crisis financiera: su impacto y la respuesta de las autoridades*, Biblioteca de Economía y Finanzas nr 16, Analistas Financieros Internacionales, Madrid, November, chapter 1, pp. 13-30.
7 *Ibid*.

But let's go a step further.

Following the European Monetary System crisis of the 1990s, Obstfeld developed the basic model of second-generation balance-of-payments crises.[8] Under this model, two elements are needed for a financial crisis to take place. On one the hand, the main macroeconomic parameters, or fundamentals, must be in a 'grey area': they cannot be excellent, in which case the economy in question would avoid a crisis, nor awful, in which case the domestic economic situation would lead inexorably to crisis, with no need for any other factor. On the other hand, there has to be a change in the expectations of international investors. Otherwise, the economy can remain in a state of shaky equilibrium indefinitely –actually, as long as someone is willing to keep financing the situation–.[9]

Aside from the fact that Obstfeld's proposal seeks to explain the underlying causes of currency crises, and that the financial crisis that broke out in the US does not feature a collapse in the value of the US dollar, could we apply this overall reasoning to the three crises analysed in this study? This would mean that in each case, a decline in economic fundamentals did not in and of itself trigger the outbreak of the crisis. There are basically two ways of knowing whether this is true. The first is to examine whether at other times the same economies were subjected to similar weaknesses in their fundamentals without necessarily suffering a financial crisis. The other way would be to see if there is another economy which, in a similar period, had a similarly precarious macroeconomic situation without sliding into a financial crisis.

In the Mexican crisis, several studies spanning the entire spectrum point to the rise in interest rates in the US and domestic political instability as the factors that touched it off.[10] In South Korea it is even more noteworthy that in earlier periods the economy deteriorated even more in some of its macroeconomic variables without slipping into a financial crisis. For example, while foreign debt was 12% of GDP in 1996, it had reached 50% between 1980 and 1986. Finally, and with regard to the US, it is no secret that the country has been posting twin deficits for decades. The overall imbalances may have deepened in recent years. But since the 1990s the US has registered a chronic current account deficit which it has financed through a debt which the rest of the world economy has been willing to supply, in part because the US dollar is an international reserve currency. In fact, the crisis did not even break out at the point when the current account deficit was at its worst: it now stands at 4.6% of GDP but had been as high as 6%, in the past.

Why is all of this important? Because it means that external factors, whether global or international, are key elements. And they will be increasingly so, as the process of financial globalisation advances, in the outbreak of financial crises with possible repercussions around the world. It also means, therefore, that implementing measures to avoid as much as possible the emergence of crises like the ones we are now suffering requires us to go beyond the realm of national financial regulation and firmly address the issue of global financial governance.

8 M. Obstfeld (1994), 'The Logic of Currency Crises', *NBER Working Papers*, nr 4640, September.
9 Second-generation crises differ from first-generation ones in that in the latter, deteriorated economic fundamentals lead inexorably to a crisis, regardless of whether there is a change in the expectations of international investors. Cases commonly cited as major examples of first-generation crises are the ones in Latin America in the 1980s and, although there is less of a consensus on it, the Argentine crisis of 2001.
10 See Olivié (2004), *op. cit.*

Conclusion: What makes this crisis different from others? Based on the analysis in this paper, it could be said that in terms of its characteristics or underlying causes, it would seem that not much makes it stand out. Certainly, the economic policy responses and the magnitude of its impact are not comparable with those of previous crises, and in any case not with those of the crises in Mexico or South Korea. But that is mainly because this time the epicentre is in a developed economy –specifically, in one of the most powerful and one most closely connected to the rest of the world economy–.

Thus, the fact that the battery of measures taken to combat the crisis is more ambitious than in earlier episodes has more to do with its political implications than with its economic causes. In that respect, a window of opportunity is in fact now opening to progress in international financial reforms. The window opened after the Asian crises as well, but it closed immediately. For instance, recall that it was after the crisis in the late 1990s that the IMF tried to launch a mechanism for a more equitable sharing out of the cost of non-payment of international debt among creditors and debtors.

However, the emphasis on the domestic problems of the US and several European economies –among them those of Spain, the UK and Iceland– has shifted the debate on what measures to take against the crisis to the national sphere. The process is gathering steam as the financial crisis turns into an economic recession, which requires different kinds of responses depending on the characteristics and weaknesses inherent in each national economy.

This study has aimed to stress the importance of adopting measures of a global nature as regards international financial governance, especially as the world looks ahead to the G-20 summit meeting in London in early April.

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