Capital Flows and Financial Stability: Lessons for Europe from Emerging Economies
By Hyun Song Shin

As Europe continues to reel from its financial crisis, policy-makers would do well to cast an eye on the Asian financial crisis of 1997-1998 and other emerging market crises of that decade to avoid the pursuit of remedies that will only make things worse, argues Hyun Song Shin. If not, the negative repercussions could affect Asia and the rest of the world.

THE GLOBAL FINANCIAL CRISIS that erupted in 2008 has had both intellectual repercussions and large economic costs. It has shaken firmly-held orthodoxies concerning the resilience of financial systems in advanced economies driven by high-powered incentives and “light-touch” financial regulation.

For observers of the emerging-market crises of the 1990s, recent events have a very familiar ring. Policy-makers in emerging economies have learned to be wary of financial booms riding on the back of easy credit conditions, ample liquidity and ballooning current account deficits.

The common thread that ties together the lessons from the Asian crisis of 1997-1998 and the recent global debacle is that the financial system is prone to amplifications of the boom-bust cycle. Rather like a tropical storm over a warm sea, financial crises appear to gather more energy as they develop. They could almost be defined as episodes where the proper role of prices in the allocation of resources breaks down. Policy-makers in Europe would do well to draw lessons from past crises in emerging economies.

NOT WHAT IT SEEMS
Although the euro-zone crisis is sometimes portrayed purely as a sovereign debt crisis caused by prolonged fiscal profligacy, the facts suggest otherwise. Figure 1a shows the government budget balance of Ireland, Spain and Germany, together with the average budget balance for the countries in the euro zone as a whole between 2002 and 2006. The picture painted is of countries witnessing rapidly improving budget balances, with Ireland and Spain moving into surplus, and with Germany and other euro-zone countries seeing a decline in their deficits. By the end of 2006, Ireland had a budget surplus of 3 percent of gross domestic product (GDP), while Spain had a surplus of 2 percent of GDP. This is hardly consistent with recent commentaries emphasizing fiscal profligacy and chronic budget deficits.

Figure 1b shows the debt-to-GDP ratio for Ireland, Spain and Germany over the same period. Both Spain and Ireland had a debt ratio that was lower than Germany and was actually declining over this period. The debt-to-GDP ratio for Spain was below 40 percent at the end of 2006, while the ratio for Ireland was only 25 percent and declining. Before the onset of the crisis, both Ireland and Greece had outwardly sound public finances, with no hint of the trouble that awaited them.

To understand Europe’s current predicament, one needs to grasp the role played by the banking sector in financing the housing bubble. The crisis in Europe is a banking crisis first, and a sovereign debt crisis second. Sovereign risk alone does not explain why Spain, for instance, was one of the first countries to be drawn into the crisis before other countries with much higher debt-to-GDP ratios. The deeper malaise is the silent run gripping the European banking system. Pretending that the problem is purely one of fiscal consolidation or sovereign debt restructuring is to misdiagnose the problem. Worse, the prescriptions that follow will almost certainly worsen the banking distress and accelerate the crisis.

The narrative starts with the introduction of the euro in 1999, which initiated a period of explosive growth in cross-border bank lending in the euro zone. Figure 2 overleaf plots the cross-border assets and liabilities of euro-zone banks in domestic currency, so that after 1999, the series denotes cross-border euro-denominated lending and borrowing by euro-zone banks.

Figure 2 shows that cross-border banking within the euro zone experienced explosive growth, especially after around 2003, setting off property booms in those countries that were recipients of the new cross-border lending. In Spain, the construction industry’s share of GDP rose from less...
This perspective on the cross-border banking sector flows. A country can move from what appears to be a very healthy budget surplus and negligible debt to very large deficits and ballooning debt. The system of loan-to-value (LTV) and debt-to-income (DTI) caps that are used by South Korean banking authorities on residential bank lending in Korea comes to mind as an example of an administrative arrangement that can be applied on top of other prudential requirements on banks.

**Evil Twins**

This perspective on the cross-border banking glut sheds much light on the current European financial crisis, which has the hallmarks of a classic “twin crisis” that combines a banking crisis with an asset market decline that amplifies bank distress. In the emerging market crises of the 1990s — which were also cases of a twin crisis — the banking crisis was intertwined with a currency crisis. In Europe now, a banking crisis is twinned with a sovereign debt crisis, where the mark-to-market amplification of financial distress interacts to worsen the banking crisis.

The analogies between Europe in 2011 and the turmoil in global financial markets in the autumn of 2008 are glaring instances of this vulnerability. As seen from the experiences of Ireland and Spain, the bursting of a housing bubble can have very large negative consequences for public finances. As output slumps and economic activity falls during the crisis, both the fall in net receipts and the increased expenditures to meet the crisis can lead to very rapid deterioration in government finances. A country can move from what appears to be a very healthy budget surplus and negligible debt to very large deficits and ballooning debt.
The economies of China and the United States are highly interconnected and complementary. A trade war would not only hurt both countries, but also the regional and global economies.

from risky positions, leading to spiking spreads on credit default swaps, which leads to further de-leveraging, and so on. This process affects all banks, not just those in the crisis-stricken countries. In this way, spiking sovereign debt spreads are a symptom of the underlying banking crisis.

**BROKEN BALANCE SHEETS**

Forbearance or accounting tricks where the sovereign debt holdings are exempt from marking to market cannot pre-empt the risk management imperative of the banks or assuage them from taking bearish bets to hedge their positions. The only answer is to raise substantial new capital for the banking sector as a whole. All banks, not just those in the crisis-stricken countries, must be rendered sufficiently solvent to quell the banking crisis.

Wholesale creditors run because they have concerns about solvency, but the “run point” where they begin to pull out is at a much higher level of solvency than the bare solvency point where the asset value barely covers the liabilities of the stricken bank. Banks have to be sufficiently solvent in order to prevent runs. The aim must be to recapitalize the banks beyond the point where they are vulnerable to runs by wholesale creditors. This means much higher capital, especially for those banks that have large wholesale liabilities.

Fixing the banking system is the first and essential step in tackling the crisis in Europe. The European stress tests in the summer of 2010 failed to quell the crisis and dispel the impression that the exercise was largely window-dressing that obscured the political inconvenience of raising substantial amounts of new capital for the banking sector. New stress tests were announced in 2011, but were soon watered down, betraying a lack of political will.

The proof of the pudding will be seen in whether substantial new capital is raised for the banking sector as a whole. The increased capital applies to the whole of the European banking sector, since the key is to recapitalize the stricken periphery’s banks, as well as the wholesale creditors to the banks so that they feel less need to engage in self-defeating hedging. If the banks are unable or unwilling to raise new capital, the authorities must stand ready to backstop the capital injection, if necessary by taking a public stake.

The balance sheet capacity of the banking sector must be repaired. This means stating the recapitalization in euro amounts, not capital ratios. Otherwise, given the choice, banks will attempt to meet capital-ratio targets by shrinking assets rather than raising new equity. The credit contraction implied by this will only exacerbate the economic downturn.

The global flow of funds perspective suggests that the European crisis of 2011 and the associated de-leveraging of the European global banks will have far-reaching implications not only for the euro zone, but also for credit supply conditions in the United States and capital flows to the emerging economies. Europe’s policy-makers face a stern test in formulating a credible stress test of the banking sector. There is a huge amount at stake, not only for Europe, but also for Asia and the rest of the world.

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