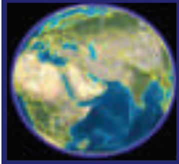
October 2008 | Number 7



Economic Viewpoint

Notes by Danny Leipziger*

Lessons from Developing Countries on Financial Crises

The current financial meltdown has produced some economic ironies. The G7 Communiqué is remarkable for the degree of government intervention proposed and in that sense the actions cannot help but raise some hackles in the developing world. There is a strong irony insofar as these are measures long castigated by the OECD countries, particularly the U.S. To recap, they are (i) increasing the scope of deposit insurance; (ii) recapitalizing private banks with public monies; (iii) buying bad assets from banks at unclear prices; and (iv) discounting receivables or guaranteeing term credit with public monies. Don't get me wrong; these are all necessary and hopefully, if coordinated and large enough, sufficient to stem the hemorrhaging in the system. However, just imagine if a small, lower middle income country attempted this policy course.

Let's see whether there are some lessons to be drawn from the experiences of developing countries facing financial distress, or put differently, let's examine how far away from best solutions the current set of interventions lie. Of course, one needs to take into account that the current crisis is a global crisis, that it started and needs to be arrested in the largest financial center, the U.S., and that the fall-out effects of the meltdown are felt in almost every country in the world that is integrated into the international financial system.

Deposit insurance has often been an academically interesting debate, but almost all countries have adopted some form of insurance. The issue, however, that international advisors always stress is who pays for the insurance. In normal times, banks can pay a very small fee that covers the expected outlays, and even when crises hit, the standard prescription is for government to only step in once the banks' own deposit guarantee is exhausted. Many advisors have also urged rather tight limits on the guarantee, on the assumption that it is the small saver whose information is weakest. Of course, in a systemic meltdown, governments are forced to decide whether to cover all deposits or only transactional ones, and also where to draw the line in terms of time deposits and deposits of foreigners. Blanket coverage is usually not an affordable option. The main lesson is that governments often need to do whatever necessary to stem a crisis of confidence in the banking system.

Recapitalization of banks sounds a lot better than nationalization. Since almost 50 percent of banking in many developing parts of the world is public, the rhetoric of international advisors and financiers is fiercely anti public sector banking. But what does recapitalization of banks really entail? In the best of circumstances, the government takes non-voting preferred shares in banks, using taxpayers' monies, to make an investment that may at some point in the future yield a return. This equity stake is made independent of the condition of the bank, namely its share of non-performing loans or reserves, and the investment is based on being too big to fail—not the best criteria for investing public funds necessarily—and certainly at odds with the advice normally proffered to divest public banks.

Purchasing distressed assets is always tricky business because no one knows the proper price. At a moment of distress, Bear Stearns may be worth one dollar or ten; Merrill Lynch may be worth half its book value; and AIG may be worth nothing. This problem has been faced by governments all over the world. The Koreans faced this when the high interest rate regime that was imposed (and which Joe Stieglitz rightly criticized) rendered most chaebols insolvent due to their "excessive" leverage. Yet assets had to be removed from balance sheets and a guess made as to their equilibrium value. The U.S Treasury is now having to make the same guess, and if they guess too low, the bailout might fail. So, as with developing countries, they will err on the side of generosity—something for which Korea and Thailand, and others faced with financial collapse, were criticized.

Creating liquidity when extreme risk aversion coagulates financial markets is perhaps the greatest challenge. How can one restore confidence, a clear public good, and who bears the risk of being wrong. Again we have to turn to government, and despite voices to the contrary, this is a legitimate role for government. But whose paper should be guaranteed and discounted and at what price? Should quality matter or should central authorities be willing to provide new liquidity to all at a single price? What about moral hazard in times of severe distress? Central banks over the past few months have provided massive amounts of liquidity with little concern for the quality of the underlying asset. Just imagine if Peru or Niger or Laos were to follow these prescriptions. Boy, would there be a ruckus!

Perhaps this crisis has taught us something and hopefully as the second effects inevitably play themselves out, the advice that is given to developing countries will take the current realities into account. Pure solutions are only textbook friendly; in the real world things get more complicated, as we unfortunately have seen in recent weeks.

*The views expressed here are personal and do not represent necessarily the position of either the World Bank Group or its Board of Executive Directors. Comments can be sent to *Dannyleipziger@gmail.com.*