APPENDIX 2 TO
CHAPTER 18

Banking Crises Throughout the World

In this appendix, we examine in more detail many of the banking crisis episodes listed in Table 18.8 that took place in other countries. We will see that the same forces that produced a banking crisis in the United States have been at work there too.

Scandinavia

As in the United States, an important factor in the banking crises in Norway, Sweden, and Finland was the financial liberalization that occurred in the 1980s. Before the 1980s, banks in these Scandinavian countries were highly regulated and subject to restrictions on the interest rates they could pay to depositors and on the interest rates they could earn on loans. In this noncompetitive environment, and with artificially low rates on both deposits and loans, these banks lent only to the best credit risks, and both banks and their regulators had little need to develop expertise in screening and monitoring borrowers. With the deregulated environment, a lending boom ensued, particularly in the real estate sector. Given the lack of expertise in both the banking industry and its regulatory authorities in keeping risk taking in check, banks engaged in risky lending. When real estate prices collapsed in the late 1980s, massive loan losses resulted. The outcome of this process was similar to what happened in the savings and loan industry in the United States. The government was forced to bail out almost the entire banking industry in these countries in the late 1980s and early 1990s on a scale that was even larger relative to GDP than in the United States.

Latin America

The Latin American banking crises typically show a pattern similar to those in the United States and in Scandinavia. Before the 1980s, banks in many Latin American countries were owned by the government and were subject to interest-rate restrictions as in Scandinavia. Their lending was restricted to the government and other low-risk borrowers. With the deregulation trend that was occurring worldwide, many of these countries liberalized their credit markets and privatized their banks. These countries then saw the same pattern we saw in the United States and Scandinavia—a lending boom in the face of inadequate expertise on the part of both bankers and regulators. The result was again massive loan losses and the inevitable government bailout.

The Argentine banking crisis of 2001, which is ongoing, differed from those typically seen in Latin America. Argentina's banks were well supervised and in relatively good shape before the government coerced them into purchasing large amounts of Argentine government debt to help solve the government's fiscal problem. However, when market confidence in the government plummeted, spreads between Argentine government debt and U.S. Treasuries soared to more than 2,500 basis points (25 percentage points), leading to a sharp fall in the price of these securities. The losses on their holdings of government debt and rising bad loans because of the ongoing severe recession increased doubts about the solvency of the banking system.

A banking panic erupted in October and November 2001, with the Argentine public rushing to withdraw their deposits. On December 1, after banks had lost more than $8 billion of deposits, the government imposed a $1,000 monthly limit on deposit withdrawals. Then with the collapse of the peso and the requirement that the banks must pay back their dollar deposits at a higher exchange value than they would be paid back on their dollar loans, banks' balance sheets went even further in the hole. The cost of the recent Argentine banking crisis is not yet clear, but it could very well be as large as the previous banking crisis in Argentina in the 1980–1982 period listed in Table 2 and could exceed 50% of GDP.

What is particularly striking about the Latin American experience is that the cost of the bailouts relative to GDP dwarfs that in the United States. The cost to the taxpayer of the government bailouts in Latin America has been anywhere from around 20% to more than 50% of GDP, in contrast to the 3% figure for the United States.

Russia and Eastern Europe

Before the end of the Cold War, in the communist countries of Eastern Europe and the Soviet Union, banks were owned by the state. With the downfall of communism in 1990, banks in these countries had little expertise in screening and monitoring loans. Furthermore, a bank regulatory and supervisory apparatus that could rein in the banks and keep them from taking on excessive risk barely existed. Given the lack of expertise on the part of regulators and banks, not surprisingly substantial loan losses ensued, resulting in the failure or government bailout of many banks. For example, in the second half of 1993, eight banks in Hungary with 25% of the financial system's assets were insolvent, and in Bulgaria, an estimated 75% of all loans in the banking system were estimated to be substandard in 1995.

On August 24, 1995, a bank panic requiring government intervention occurred in Russia when the interbank loan market seized up and stopped functioning because of concern about the solvency of many new banks. This event was not the end of troubles in the Russian banking system. On August 17, 1998, the Russian government announced that Russia would impose a moratorium on the repayment of foreign debt because of insolvencies in the banking system. In November, the Russian central bank announced that nearly half of the country's 1,500 commercial banks might go under; the cost of the bailout was on the order of $15 billion.

Japan

Japan was a latecomer to the banking crisis game. Before 1990, the vaunted Japanese economy looked unstoppable. Unfortunately, it has recently experienced many of the same pathologies that we have seen in other countries. Before the 1980s, Japan's financial markets were among the most heavily regulated in the world, with very strict restrictions on the issuing of securities and interest rates. Financial deregulation and innovation produced a more competitive environment that set off a lending boom, with banks lending aggressively in the real estate sector. As in the other countries we have examined here, financial disclosure and monitoring by regulators did not keep pace with the new financial environment. The result was that banks could and did take on excessive risks. When property values collapsed in the early 1990s, the banks were left holding massive amounts of bad loans. For example, Japanese banks decided to get into the mortgage lending market by setting up *jusen*, home mortgage lending companies that raised funds by borrowing from banks and then lent these funds out to households. Seven of these *jusen* became insolvent, leaving banks with $60 billion or so of bad loans.

As a result the Japanese experienced their first bank failures since World War II. In July 1995, Tokyo-based Cosmo Credit Corporation, Japan's fifth-largest credit union, failed. On August 30, 1995, the Osaka authorities announced the imminent closing of Kizu Credit Cooperative, Japan's second-largest credit union. (Kizu's story is remarkably similar to that of many U.S. savings and loans. Kizu, like many American S&Ls, began offering high rates on large time deposits and grew at a blistering pace, with deposits rising from $2.2 billion in 1988 to $12 billion by 1995 and real estate loans growing by a similar amount. When the property market collapsed, so did Kizu.) On the same day, the Ministry of Finance announced that it was liquidating Hyogo Bank, a midsize Kobe bank that was the first commercial bank to fail. Larger banks now began to follow the same path. In late 1996, the Hanwa Bank, a large regional bank, was liquidated, followed in 1997 by a government-assisted restructuring of the Nippon Credit Bank, Japan's seventeenth-largest bank. In November 1997, Hokkaido Takushoku Bank was forced to go out of business, making it the first city bank (a large commercial bank) to be closed during the crisis.

The Japanese went through a cycle of regulatory forbearance similar to the one that occurred in the United States in the 1980s. The Japanese regulators in the Ministry of Finance enabled banks to meet capital standards and to keep operating by allowing them to artificially inflate the value of their assets. For example, they were allowed to value their large holdings of equities at historical value, rather than market value, which was much lower. Inadequate amounts were allocated for recapitalization of the banking system, and the extent of the problem was grossly underestimated by government officials. Furthermore, until the closing of the Hokkaido Takushoku Bank, the bank regulators in the Ministry of Finance were unwilling to close down city banks and impose any losses on stockholders or any uninsured creditors.

By the middle of 1998, the Japanese government began to take some steps to attack these problems. In June, supervisory authority over financial institutions was taken away from the Ministry of Finance and transferred to the Financial Supervisory Agency (FSA), which reports directly to the prime minister. This was the first instance in half a century in which the all-powerful Ministry of Finance was stripped of some of its authority. In October, the parliament passed a bailout package of 60 trillion yen ($500 billion). However, disbursement of the funds depended on the voluntary cooperation of the banks. Immediately after the 1998 banking law was passed, one of the ailing city banks, Long-Term Credit Bank of Japan, was taken over by the government and declared insolvent. In December 1998, the Nippon Credit bank was finally put out of its misery and closed down by the government. After this event, the cleanup process stalled. Disbursement of the funds depended on the voluntary cooperation of the banks: The law did not require insolvent banks to close or to accept the funds. Indeed, acceptance of the funds required the bailed-out bank to open its books and reveal its true losses, and thus many banks remained very undercapitalized. Burdened with bad loans and poor profitability, the banking sector in Japan thus remained in very poor shape. Indeed, many private sector analysts estimate that bad loans peaked at a level of more than $1 trillion. Japan's weak economy, averaging an anemic 1% growth rate over the period 1991 to 2002, contributed to weakness in its banking sector.

Finally, progress began. A new, reform-oriented prime minister, Junichiro Koizumi, who pledged to clean up the banking system, came into office in 2001. Nevertheless, the Japanese government was slow to come to grips with the banking problems; indeed, the amount of nonperforming loans was still estimated to exceed $1 trillion in 2003. That year, the coutnry's fifth-largest bank, Resona, was kept afloat only with a 23 trillion yen ($17 billion) bailout, and a large regional bank, Ashirgara, was declared insolvent and nationalized. With the pickup of the Japanese economy in 2003, however, the number of bad loans in Japanese banks finally began to decline. These are no longer a problem, at least for Japan's largest banks. These banks also have paid back most of the government money lent to keep them afloat. The crisis now seems to be over, and Japan's banks are shifting their focus from mere survival to a return to profitability.

China

Despite its rapid economic growth (nearly 10% per year), China also had a severe banking problem. Estimates of nonperforming loans are currently around $500 billion. In 1998, the Chinese government injected $30 billion into the country's four largest banks (the "Big Four"), all state-owned—Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, and China Reconstruction Bank—with another $170 billion injection in 2000–2001. In 2004, the Chinese government entered into its third bailout, handing out a capital injection of more than $100 billion (which is expected to grow to as much as $200 billion).

The state-owned banks have gotten into trouble because they have lent massively to unprofitable state-owned enterprises and are notoriously inefficient: The Big Four have more than one million employees and more than 100,000 branches. The government hopes that its third try at a bailout will be a charm, and is attempting to handle this one differently. The new bailout is part of a plan to prepare the Big Four to become partially privatized by having them issue shares overseas. These banks are being encouraged to speed up their disposal of nonperforming loans, to close unprofitable branches, and to lay off unproductive employees. The Chinese government is aware that it needs to reform the banking sector so that capital can be allocated to private borrowers with good investment opportunities rather than to inefficient state-owned enterprises, but this is a daunting task. How successful the Chinese government will be in this endeavor remains far from clear.

East Asia

We discussed the banking and financial crisis in the East Asian countries (Thailand, Malaysia, Indonesia, the Philippines, and South Korea) in Chapter 8. Due to inadequate supervision of the banking system, the lending booms that arose in the aftermath of financial liberalization led to substantial loan losses, which became huge after the currency collapses that occurred in the summer of 1997. An estimated 15% to 35% of all bank loans turned sour in Thailand, Indonesia, Malaysia, and South Korea, and the cost of the bailout for the banking system was more than 15% of GDP in these countries and more than 50% of GDP in Indonesia. The Philippines fared somewhat better, with the cost being 13% of GDP.