

PRINCETON UNIVERSITY  
Economics Department  
Bendheim Center for Finance

**FINANCIAL CRISES**  
**ECO 575 (Part II)**

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Section 1: Introduction

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(All materials available on my website:  
<http://finance.wharton.upenn.edu/~allenf/> )

## 1.1 A brief history of crises

What happened in East Asia in 1997?

After years of growth, the world's most successful postwar economies had severe crises in which stock markets and currencies plummeted.

How can these crises be understood?

Conventional wisdom in media and among many government officials

Crisis are due to basic inadequacies in the financial structure

- Crony capitalism
- Inadequate corporate governance
- Lack of transparency due to inadequate disclosure and accounting systems, etc.
- Poor regulatory supervision
- Government guarantees
- Guarantees by international organizations

BUT

Why didn't it happen before?

- Most of these factors have been present during the period these economies were successful

Crises are not a new phenomenon.

- They have been around for centuries.
- They occur in many countries where institutions are vastly different such as Norway, Sweden and Finland in the early 1990's.

The institutions and other factors present in these previous crises differed significantly from those in Asia

Important not too take too narrow a view

The period 1945-1971 where banking crises were essentially eliminated was very unusual

In the 1930's and before banking crises were common

In the late nineteenth century crises were more common in the US than Europe but before that they were endemic

- Kindleberger (1993) suggests that financial crises occurred on average every 10 years for several centuries

The experience of the 1930's was so bad it led to regulation and direct ownership of banks and other financial institutions in many countries

- This “repression” prevented the financial system from doing its job of allocating resources and led to calls for deregulation
- The resulting financial liberalization led to the reemergence of banking crises after 1971

Section 2 of the course gives a brief history of financial crises

## 1.2 Theories of crises

There is a stark contrast between views of crises in the 1930's and today

- In the 1930's crises were perceived as a market failure and government regulation and intervention was introduced
- Today many regard crises as the result of a government failure

These two approaches have led to a number of theories. These are not necessarily mutually exclusive.

1. Financial panic (multiple equilibria)
2. Business cycle (essential crises)
3. Inconsistent government macroeconomic policies
4. Bubble collapse
5. Amplification theories (fragility and contagion)
6. Government guarantee models

We will discuss these different theories. The analysis of crises then involves trying to understand which theory(ies) are relevant in any particular case.

Section 3 will consider theories of *banking crises*.

- Financial panic (multiple equilibria)
- Business cycle (essential crises)

Section 4 will consider theories of *currency crises*.

- Inconsistent government macroeconomic policies
  - Deterministic equilibria
  - Multiple equilibria
  - Equilibrium selection
- Twin crises
  - Financial panic
  - Business cycle

Section 5 will consider bubble collapse as the cause of crises

- Roaring 1920's and the Great Depression of the 1930's
- Japan in the 1980's and 1990's
- U.S. in the 1990's and 2000's?

Section 6 will consider amplification theories

- Contagion
- Financial fragility

Section 7 will consider government policies as the cause of crises

- Government guarantees and bailouts of the banking sector
- Inadequate regulation and bankruptcy laws
- Sovereign bankruptcy

Section 8 contains conclusions

### 1.3 Policy issues

- To what extent are crises desirable or undesirable?
- Should there be a central bank to provide liquidity to the financial system?
- Should there be an international lender of last resort?
- Should central banks intervene to prevent bubbles in asset prices?
- Do individual institutions pose a systemic risk to the financial system and if so what can be done about it?
- Are government guarantees of the banking system desirable?
- What is the relationship between bankruptcy law and financial crises?
- What is the optimal way to deal with sovereign default?

## 1.4 Concluding remarks

Dictionary definition of a crisis:

1(a) : the turning point for better or worse in an acute disease or fever

(b) : a paroxysmal attack of pain, distress, or disordered function

(c) : an emotionally significant event or radical change of status in a person's life

2 : the decisive moment (as in a literary plot)

3(a) : an unstable or crucial time or state of affairs in which a decisive

change is impending; especially : one with the distinct possibility of a

highly undesirable outcome

(b) : a situation that has reached a critical phase

- Used in a wide range of senses here too

## References

Kindleberger, C. (1993). *A Financial History of Western Europe* (second edition), New York: Oxford University Press.