Financial crises

By Charles Goodhart, Financial Market History-Reflections on the past for investors today, The CFA Institute Research Foundation, 2016.

It is as important to understand why financial crises did not occur as why they did. For example, remarkably few banking and financial crises occurred between 1937 and 1973 due to the following reasons:

- Banks were repressed and forced to lend to their governments.
- Competition among banks and other financial intermediaries was consciously restricted.
- Capital controls ensured that competition from abroad was limited.
- Memories of the Great Depression and prior bank failures made bank managers risk averse.
- Unexpected post war inflation kept property and equity values rising, making private sector borrowers safer.

Though bank failures were prevented, because of repression, the services banks provided to private sector clients were limited.

Banks are risky because:

- The assets they hold are riskier than the IOUs they offer to depositors.
- Duration and maturity of the assets are longer than their liabilities.

During a crisis, liquidity becomes the pressing need. Affected banks start selling their assets at depressed values.

The failure of one bank can affect the fortunes of other banks for various reasons.

- The failing bank may owe money to other banks.
- The fire sale of assets can affect the valuation of similar assets held by other banks. When marked to market valuation is applicable, this may reduce the equity /profit.
- The failure of a particular bank is also an extraordinarily bad signal for the creditors of other banks. In most other sectors, the failure of a firm reduces excess capacity and competition and makes the business environment favourable for the other players. But the failure of a bank results in contagion.

Bail in means existing creditors will have to bear part or whole of the burden if the bank fails. Bail in typically involves an auditor who will be under pressure to arrive at a conservative valuation. So bail in can lead to contagion. When a loss of value is confined to a single bank and widely perceived so, contagion is less likely.

Contagion is more likely when there is a common shock to an asset class that is widely held by banks. The crisis will be even greater if banks are involved in lending to that asset class or are lending based on such collateral. If the mood is optimistic and banks have used leverage and cut down on the quantum of liquid assets, the crisis will be deeper. The three worst financial crises of the past 100 years, US in 1929-33, Japan, 1991-1999 and the Global financial crisis of 2007-09 all occurred after a successful decade with strong growth and stable prices.

After a severe financial crisis, efforts are made to prevent the repetition of the crisis. But these efforts can amplify the financial cycle. Regulations keep intermediaries from doing what they find the most efficient and effective. As economies recover and things return to normal, impediments to banking and financial intermediation will slowly but surely get removed perhaps in time for the next financial crisis.

Macroeconomic effects

Financial crises occur when a bank fails resulting in a scramble for liquidity.

Cyclical downturns reinforced by a financial crisis tend to be longer and more severe.

There are two problems with injecting capital. The private sector will not want to take the risk. So, the rescue will have to come from the public sector. Any form of insurance tempts the insured to take more risks.

Conclusion

The quest for a financial crisis free economy is unrealistic. The kind of repression needed to prevent a financial crisis will deny the public the financial services they value.

We should aim for a system that can withstand a crisis. But this cannot be done without public sector intervention and support. The current trend is to shift the burden of failure to the private sector. This may simply not work.