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Financial liberalization and banking crises: The role of capital inflows and lack of transparency

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Abstract

This paper shows that the liberalization of capital inflows may undermine bank stability in emerging markets. After financial liberalization, uninformed international investors rationally provide large amounts of funds at low cost. This enables insolvent banks to accumulate bad loans. In equilibrium, when a substantial amount of losses may have been accumulated, solvent banks do not find it any longer optimal to issue debt at the interest rate that would compensate investors for risk. Investors anticipate this and stop holding bank debt. When the market for bank liabilities breaks down, insolvent banks default. I show that, because of wasteful investment, the liberalization of capital inflows may decrease aggregate welfare.

JEL classification: G21; G28; F34

Keywords: Banking crises; Capital inflows; Transparency; Capital requirements

1. Introduction

Financial liberalizations in emerging markets are often followed by reckless lending and severe banking crises.[1] The identification of the causes of banks' behavior is often difficult because financial liberalizations entail several contemporaneous changes. Competition in the banking sector increases, and, at the same time, the liberalization of the current account allows capital inflows.

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[1] See Kaminsky and Reinhart (1999) for a detailed description of the empirical evidence.

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The existing literature has mainly stressed the first of these changes: Among others, Hellmann et al. (2000) and Allen and Gale (2000) have analyzed how competition affects banks' incentives to risk-taking. The argument goes as follows: Competition in the market for deposits increases banks' cost of funds and gives an incentive to select riskier projects (to shift risk on depositors).

While this argument can provide a good explanation for the Saving and Loan crisis in the US, and, in general, for banking crises in developed markets, it is unlikely to capture the effects of financial liberalizations in emerging economies. In these countries, the liberalization of the capital account, which is an essential part of the financial liberalization, implies that large amounts of funds become available to the banking system, thanks to capital inflows. Since emerging market economies are small with respect to the funds potentially available from international investors, the supply of funds becomes perfectly elastic. Hence, not only is competition unlikely to increase the cost of funds, but the cost of bank liabilities often decreases because banks are no longer constrained by low domestic saving (Henry, 2000). Competition in the loan market is also unlikely to become so fierce as to significantly decrease intermediation margins and increase incentives to risk-taking. In fact, information asymmetries remain strong after financial liberalizations and banks face little competition from financial markets (Demirguc-Kunt et al., 2004). Hence, the very mechanism on which the competition argument relies—lower profit margins—is unlikely to be at work.

Probably for this reason, the vast literature on banking crises in emerging markets considers bailout guarantees as the main cause of excessive lending to unprofitable projects.[2] Bailout guarantees would cause moral hazard because of the lack of punishment for investors and domestic banks in case of default. Knowing that banks will be bailed out, investors would provide funding even though they know that domestic banks are financing negative-net-present-value projects.

However, the empirical evidence on the bailout guarantees explanation is mixed (Eichengreen and Arteta, 2000). Martinez Peria and Schmukler (2001) find that depositors discipline banks by withdrawing deposits and requiring higher interest rates when bank fundamentals deteriorate, if the credibility of deposit insurance is weak. Additionally, Davenport and McDill (2005) find that deposit insurance does *not* diminish the extent of market discipline in the US, where the credibility of bailout guarantees should be far higher. Gorton and Winton (2003) also question the relevance of the bailout guarantees explanation.

This paper proposes a new explanation for boom-bust cycles in emerging markets. It shows that capital inflows may be at the origin of overlending problems. In the model, banks do not observe whether borrowers have access to positive-net-present-value projects when they begin to lend. As a result, banks may become insolvent. In this case, having limited liability, banks refinance negative-net-present-value projects, if they have access to funds. Thus, capital inflows may cause overlending because they increase the amount of funds domestic banks can intermediate.

In equilibrium, overlending arises if investors have incomplete information about the quality of bank assets. Incomplete information may originate from the fact that, within a country, some banks are sound, while others are insolvent. It may also depend on the fact that investors are

[2] There is a large literature relying on bailout guarantees. See, for instance, McKinnon and Pill (1996); Dooley (2000); Krugman (1998); Burnside et al. (2001); Corsetti et al. (1999); Chinn and Kletzer (2000); Dekle and Kletzer (2001); and Schneider and Tornell (2004). Bailout guarantees play an important role also in Akerlof and Romer (1993) where overlending arises because of looting.