

# **“Currency and Banking crisis in Emerging Markets: Is it fundamentals or self fulfilling prophecies?”**

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## **Abstract**

Financial systems are periodically prone to financial crises. In Emerging Markets Economies these events frequently develop as “twin crises”. Different theoretical explanations for this phenomenon have been offered in the literature: (i) they are the realization of bad equilibriums not related to the real economy (ii) they are the consequence of a deterioration on the macro fundamentals (iii) they are the natural response of economic agents to excessive risk taking by financial institutions.

We develop a methodology to empirically test the relevance of these hypotheses and apply it to the study the Argentine financial crisis of 2001-2002. Using panel data techniques we study the determinants of daily changes on individual banks’ deposits to determine the nature of the crisis.

Our results strongly favor (ii), since the macro fundamentals do play a key role in explaining deposits’ dynamics.

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## **1. Introduction**

Financial systems are periodically subject to financial crises. The modern theoretical literature on banking crises, mainly built on the grounds of the seminal papers of Diamond and Dybvig (1983), offers three basic explanations for bank panics: (i) They are a realization of a bad equilibrium, i.e. random events caused by agents’ misperceptions about other agents liquidity needs, (ii) They are an equilibrium phenomenon, i.e. the response of economic agents to a deterioration of macro fundamentals, (iii) They are an exercise of market discipline through which depositors punish excessive risk taking by financial institutions.

In Emerging Markets Economies (EME), however, these events frequently develop as “twin crises”, i.e. a combination of currency and banking crises and are, in general, very costly in terms of economic growth.<sup>1</sup> In the second half of nineties a sequence of financial crises hit EME: the Mexican crisis of 1995, the Asian crises of 1997, the Russian default of 1998, and more recently, the Argentine crisis of 2001-2002. This brought a renewed interest on this issue and many argued that a new kind of phenomenon was appearing. Chang and Velasco (1998), however, stress common features of these episodes with previous crises: market-oriented economic reforms, trade and financial liberalization, deregulation and privatization of public enterprises. They also emphasize that financial fragility, due to inadequate bank regulation and supervision was a main common weakness shared by almost all these experiences<sup>2</sup>.

More recently, Allen and Gale (2001) argue that previous creation of asset

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<sup>1</sup> See Kaminsky and Reinhart (1999).

<sup>2</sup> See Diaz Alejandro (1985), for an illuminating and detailed description of the Chilean case.