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THE SOURCE OF FINANCIAL CRISIS

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Eight countries including the United States, Britain, Iceland, Ireland, and Spain experienced meltdowns of their banking systems in 2008 during the fourth wave of financial crisis since the early 1980s. The first wave was in 1982 and involved Mexico, Brazil, Argentina, and ten other developing countries. Japan and several of the Nordic countries were involved in the second wave in the early 1990s. Thailand, Indonesia, and Malaysia were caught in the Asian Financial Crisis that began in mid-1997.

The chatter in Washington is that the massive U.S. crisis was caused by the financial shenanigans in New York, including the outrageous compensation in the banks, and the packaging of risky sub-prime mortgages into securities with absurdly high credit ratings. The New York chatter was that this crisis resulted from regulatory ineptitude.

Both U.S. centric views ignore the similarities among the meltdown of the banks in forty countries in the last thirty years. Each of these countries had previously experienced an economic boom. Each of these booms in turn was a response to a surge in cross border investment inflows, which led to an increase in the price of the country's securities and to an increase in the price of its currency. These investment inflows often accelerated for several years even as currencies became increasingly overvalued.

The increase in the indebtedness of a group of borrowers in each country was larger than its interest payments, the borrowers had primary deficits. Moreover the increase in the external indebtedness of each country was larger than its interest payments on foreign debt; each (except Japan) had a primary deficit in its international payments.

The domestic counterpart of the increase in investment inflows to each of these countries was an increase in the supply of credit from domestic lenders to domestic borrowers. These lenders were responding to the expansive conditions in the credit market, and made loans to borrowers who would be less likely to qualify for credit during periods when credit supply was more contractive.

The source of the crisis in each of these countries is that cross border investment flows are highly variable; the increase in the indebtedness of a group of borrowers and the increase in each country's external indebtedness were at rates that were too rapid to be sustained. Both the group of borrowers in each of these countries and the countries themselves were on trajectories for the increase in indebtedness that were non-sustainable. Each crisis was triggered when one or several of the lenders become more cautious in extending loans; then the prices of the securities in each country and the price of its currency declined.

The current international currency arrangement is dysfunctional because booms are accelerate and led to myopia that obscures the eventual adjustment to equilibrium.