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# Overinvestment, collateral lending, and economic crisis

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**Abstract**

This paper presents a model in which a high growth economy becomes susceptible to a sudden financial crisis. In the model firms are motivated to over-invest because of government subsidies, and bear the burden of the tax or other costs caused by the government subsidies. The model provides several predictions that may well be consistent with the recent experience of east Asian countries. First, a higher government subsidy generates higher investment and GDP growth rates, a higher level and growth of real estate price, and a higher level of current account deficits. Second, the rapid growth induced by government subsidies makes the economy very vulnerable to adverse shocks. When adverse shocks hit the economy and the expected loan-to-collateral value ratio rapidly increases, foreign investors become suspicious about the safety of domestic banks and begin to withdraw their loans. Subsequently, financial panic and economic crisis suddenly occur. Third, capital market liberalization, by provoking huge foreign capital inflows and outflows, increases the possibility of crisis and amplifies the scale of crisis. © 2002 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

The financial crises that erupted in the rapidly growing east Asian economies in 1997 brought about unprecedented economic and social distresses on the economies involved. Since the outbreak of the crises, the causes of these crises have been the topic of a hot debate not only because east Asian economies had been growing rapidly, serving as a growth model

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that many developing countries have tried to emulate, but also because their sudden collapse was the least anticipated. Krugman (1998) and Corsetti et al. (1999a) argue that the Asian crisis is a moral hazard crisis as a consequence of poorly regulated and over-guaranteed banks that have recklessly extended credit to risky projects. Radelet and Sachs (1998) regard the crisis in essence as a financial panic triggered by a sudden withdrawal of foreign capital. IMF (1997) and World Bank (1998) attribute the crisis to a combination of factors, including a boom in international lending caused by high growth performance, adverse external shocks, mismanagement of macroeconomic and exchange rate policies, and weak financial sector.

The purpose of this paper is to present a model that explains some salient features of the east Asian crises. The growth process of the east Asian economies is typically characterized by high investment and economic growth, high real estate prices, current account deficits, and then a sudden financial crisis. Until recently, the east Asian economies displayed high saving and investment rates, and rapid GDP growth. Along with these positive signs were a few negative ones such as declines in productivity, increases in current account deficits, and accumulation of corporate and foreign debts. Then, suddenly, financial crises swept through these countries. This paper attempts to show that a fast growing country becomes extremely vulnerable to financial crises.

Because east Asian crises exhibit a complex mixture of currency crisis, banking crisis, and foreign debt crisis, it is hard to single out any one factor as the sole cause of the crises. Recent empirical studies that have examined a large sample of countries for the determinants of the crises could not come up with a clear answer.[1] Theoretical models are still very much sought, although a number of 'third generation' crisis models are competing each other to explain the Asian crises.[2] In this paper, thus, we do not attempt to provide one single answer to the question of why the crises took place in those specific countries in that specific year. Yet, we sketch out another candidate for the third generation crisis models. The basic natures of our model presented here are in line with those of the recent models such as McKinnon and Phil (1997), Krugman (1998), and Corsetti et al. (1999b) that focus on 'overinvestment' of the firms caused by the moral hazard behavior of firms and banks. In our model, government subsidies, which motivate the moral hazard behavior of firms and banks, cause the overinvestment of the firms. But, our model also emphasizes the role of the collateral lending practices of banks, which lead to asset bubbles and bust in the economy, in financial crises. The model also shows the feature of self-fulfilling prophecy of crises which has been emphasized by another line of work in the third generation crisis models such as Chang and Velasco (2001), and Aghion et al. (2000).

The model presented in the paper describes an economy in which firms, because of a government subsidy, are motivated to invest excessively. We assume that firms bear the burden of paying taxes (or cost of briberies to obtain more subsidies), resulting in making losses. Then, these firms compensate for their losses by obtaining bank loans. We also assume that domestic banks borrow from foreign investors up to the amount of the current account deficit, and lend the money to the firms. Through this process, the foreign

[1] See Demirguc-Kunt and Detragiache (1997), Eichengreen and Rose (1998), and Kaminsky and Reinhart (1999).

[2] See, for example Krugman (1999) for the discussion of the 'third-generation' crisis models that can explain the Asian crises.

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