What the SARS Panic Can Teach Us about Financial Crises

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For an economic historian, there is nothing unique about the fear that swept through Beijing and other parts of China in April and May. The anxious reactions of a population frightened by SARS were often the same as those that often accompany large-scale bank runs, collapsed investment frauds, and other types of financial panic that rich and poor countries throughout history have experienced. The history of the United States in the 19th and 20th centuries, for example, has many periods of bank runs in which individuals reacted to financial shocks in much the same way that Beijingers reacted to the SARS panic, and to watch the panic in China with these earlier financial examples in mind is very instructive.

China is a rapidly growing country which, like many other countries at its stage of development, has a number of characteristics that make it more vulnerable to financial shocks than many might realize. It has weak capital markets, limited investing and financing alternatives, an undercapitalized banking system, a large number of unsophisticated investors, and a rapidly evolving legal environment. In any country this can be a volatile mix, and in a country that is changing as rapidly as China, even the most effective leadership cannot prevent occasional shocks to the financial system. This is an important point for the financial authorities to remember. There is no case in history of a rapidly developing country – including the United States in the 19th and 20th centuries – that has been immune from banking panics and financial crises, and it would be foolish to assume that China will be an exception.

If these crises are mishandled in a way that leaves Chinese savers uncertain about the risks they face and the ability of the government to control the damage, they can lead to SARS-type panics. For anyone familiar with the history of financial crises, this should be a particularly alarming thought. Financial crises are different from health crises in that panic itself can become a major contributing factor to the perpetuation of the crisis. When

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individual depositors or investors are worried about the health of financial institutions entrusted with their money, their attempts to protect their savings by withdrawing them can force otherwise healthy institutions into liquidation, and so can spread the impact of a shock to other institutions. Even more so than SARS, a financial panic can result in secondary economic impacts of the shock that far exceed the primary impact.

PANIC AND CREDIBILITY

Like most panics, the public reaction to SARS was out of all proportion to its direct impact on public health. Rather than reflect the real health risk, experts argue that the panic reflected the breakdown in government credibility and the rising distrust Beijingers felt towards official sources of information.

Their anxiety did not develop spontaneously. Most observers agree that in Beijing the breakdown in government credibility was a direct consequence of the period in late March and early April during which government officials insistently denied rumors and deliberately played down the risks of infection. But as the disease spread, and began even to hit health workers, the very group charged with protecting the public health, Beijingers began to question the official sources of information and turned instead to rumors and speculation. As each rumor was officially denied, and then subsequently confirmed after intense pressure from worried medical workers, government credibility weakened. When government officials insisted that the danger was over, and then were forced to announce huge increases in confirmed SARS cases, credibility weakened further.

Credibility broke down altogether during a few days in mid-April during which rumors swept through Beijing about hundreds of unreported cases hidden in military hospitals, hotels, and secret wards. The municipal authorities once again insistently denied these rumors, but once again they turned out to be largely true, thus dispelling any residual trust the public might have in official pronouncements. Fortunately, before things degenerated further, the central authorities intervened. By May the new leaders in Beijing had changed their approach and took firm and welcome steps to address public anxiety, but for the first few weeks it proved difficult for them to reverse the damage already done to public trust.

CAN IT HAPPEN AGAIN?

It is not difficult to imagine an alternative scenario in which a financial shock, rather than a health shock, sets off a similar set of reactions. The actual event would probably take place in a provincial city, and it could be a large corporate or private bank default, a major embezzlement scandal, a collapsed or fraudulent investment scheme, or the closing down of one or more large state-owned enterprises. Because most people in China are still unfamiliar with the new rules and institutions that have evolved as part of the new economy, the initial response on the part of both the public and the authorities would be confused and tentative. Like the early reports of SARS, this would trigger a sequence of events in which rumors and popular speculation spread through the affected area as investors or depositors became concerned about the risk to their savings. The first reaction of many of these would be to withdraw their money from any institution associated with the rumors.

Following the ingrained habit of local political leaders, the authorities would at first respond by suppressing information, particularly if local officials were also somehow implicated in the problem. Not only would newspapers and popular internet bulletin boards be censored, but even the central authorities in Beijing would get incorrect or incomplete information on the causes and extent of the shock. This would delay the ability of the Beijing authorities to evaluate the risks to the overall banking system posed by the shock.

In most cases, by cutting off all public discussion the problem would be smothered and the effects of the shock quickly dissipated. If the financial shock were minor, local government credibility might be enough to hide the problem with few ill effects. Such events have reportedly already happened several times in various provincial cities, with bank runs or the sudden collapse of fraudulent investment schemes, but the authorities were able to suppress information while moving quickly to address the problem.

What the SARS panic teaches us, however, is that if the financial shock is large enough, the consequence of denial and dissimulation can be very different. As the impact of the shock exceeds the local government's ability to hide it, rumors and a general sense that the government is mishandling and even lying about the problem will erode credibility. Every time a rumor that has been denied by the government is subsequently confirmed, new rumors will gather strength and spread more quickly.

If the problem persists because the losses were originally underestimated – nearly always the case in financial shocks – the rumors about insolvency will continuously resurface, sometimes days or even weeks after the problem was thought to have been resolved. As the group of actors with inside knowledge widens, they will act individually to protect their own assets and we would begin to see lines of worried investors growing outside the offices of the affected institutions. At some point some critical event – like the revelations that the extent of SARS cases in Beijing was much greater than the government claimed – can set off a collapse of credibility. In that case there would be a scramble among investors and depositors to withdraw their money not only from the institutions at the center of the crisis, but also from any institution caught up in the rumors.

If the shock occurs because of the failure of a poorly monitored bank or a fraudulent investment scheme in which municipal authorities have participated, the temptation may be to use financial resources from other institutions to cover any shortfall. The temptation would be particularly strong if the scope of the problem had been misrepresented to the Beijing authorities. But the effect of using other financial resources could simply cause weakness to migrate from one local bank branch or institution to another, and if the original shortfall is large enough, it can begin to infect other, otherwise healthy, institutions in a spreading and self-reinforcing wave of panic. Banking panics are self-perpetuating, and once public trust disappears, it takes extraordinary and costly measures to defend the financial system.

DEFENDING THE GOVERNMENT'S CREDIBILITY

This may be an alarmist scenario, but it is probably no more alarmist than a warning would have been a year ago that the outbreak of a new disease that caused a couple of hundred deaths in China could cause panic in many parts of the world and lower global economic growth. There have already been small-scale bank runs in China and the banking system is clearly vulnerable to a liquidity crisis. The unexpected virulence of the SARS panic provides one model for how a financial shock could spread through the system. This very real risk makes it clear that there is an urgent need to change entrenched habits in managing shocks.

The current approach in managing many shocks, financial as well as health shocks, has been to cover them up in an attempt to the limit their secondary impacts. There is a perception that greater accountability and a smoother information flow may be good things in the long run, but because of China's relatively undeveloped state they bear too high a cost in the short run. The people are not sufficiently educated, we often hear, to deal with complex problems rationally, and their ill-judged reactions may increase the costs. Furthermore, bad news may scare off foreign investors. By this logic when a problem arises that may adversely affect local or foreign behavior, it is better to cover it up and to prevent information from circulating. Public authorities can then quietly deal with the issue with little negative impact on the rest of society.

It would be foolish to deny that in most cases this strategy has been a successful one, and the cost of the problem was subsequently minimized. But, as the SARS panic shows, although this approach may minimize the secondary impact of small shocks, it may actually increase the secondary impact of large ones. This makes the cover-up strategy dangerous because it is not always easy to judge how persistent or serious a problem is likely to be, particularly when rapid advances in communication technology among ordinary Chinese make cover-ups harder to manage. It was reported, for example, that during one three-day period, over 120 million messages, mostly about SARS, were sent from mobile phones in Guangdong, and although the government may be taking steps to reduce text messaging, it is unlikely that they will eliminate the risk altogether.

In those admittedly rare cases where a shock exceeds the ability of the local authorities to suppress it, the cost to public confidence of a failed cover-up may be extremely high. The perception that the government is unable to manage the process may turn a problem with serious but manageable consequences into a full-blown panic. In this light it is worth reconsidering whether the traditional method of dealing with shocks is the right one. The small benefits of many successful cover-ups may be less than the costs of a few unsuccessful ones.

INFORMATION AND ACCOUNTABILITY

The recent events in Argentina show how dangerous it can be when a banking panic gets out of hand. In 2001, the Argentine government tried to minimize public concern by denying persistent rumors that it was facing a payments crisis. It insisted that fears of a government default were groundless, and forced banks to provide the government with “temporary” liquidity. Argentines trusted the government, and during 2001 there was remarkably little nervousness among ordinary depositors, who, to the surprise of the experts, kept their deposits in the banking system.

But the public had been misled. In December when Argentines discovered that the crisis was much worse than they thought and their bank deposits had to be frozen or partially confiscated, the country exploded in rage and fear. The subsequent social unrest during December and January resulted in riots and even deaths in most major cities. Politicians could not go out in public without being assaulted or spat on by the enraged public. Desperate Argentines lined up in front of banks begging or demanding their savings. At one point a retired worker took a rifle into the bank and effectively "robbed" an amount equal to his deposit, claiming that this was not a robbery because the money was his. Although he was quickly apprehended by the police, he became a national hero.

During a financial crisis the government's credibility is probably the single most important resource in combating the effects of panic, and once the Argentine government lost its credibility, the banking system collapsed, to be followed by economic and political collapse. China, of course, is in a very different position. It is fortunate in having a government that is more trusted by the public than in many other countries, but Chinese authorities should not take this trust for granted. As the SARS crisis shows, trust can evaporate quickly. Once government credibility is gone, there is little that can stop panic from spreading. This suggests that at all times preserving government credibility must be a major objective.

The best way to ensure credibility is for the government not to be seen misrepresenting risks. The public must have full confidence that any risks it is facing are clearly identified and explained by the appropriate authorities. This requires that two conditions be met. First, the government must have in place a series of possible crisis scenarios that cover all possible events, even unlikely ones, with well-designed responses for each type of shock. In this way shocks can be met with planned responses rather than with confusion and improvisation. Second, when a shock does occur, instead of suppressing information, the causes of the shock must be addressed publicly with an announcement of the full government measures to be employed to limit the adverse consequences.

In fact, even though it is relatively easy to cover up minor shocks, like small scale bank runs and collapsed investment schemes, the financial authorities may still derive two benefits from allowing them to become public knowledge and by being seen to move quickly to minimize systemic risk. First, they can reinforce public trust in the authorities by being seen to deal openly with financial problems. This will increase their ability to act during major crises. Second, minor shocks that cause small losses are very useful for educating the public and making it more sophisticated about financial risks. The more aware the ordinary citizens are of the risks, the less the likelihood of behavior on their part that leaves them vulnerable to shocks. It is far better for China that small investors learn about risk through a series of low level and localized shocks than through a generalized crisis.

For all the criticism in the international press, the Chinese government has made a great deal of progress in the way it handled the crisis. The SARS panic was surprisingly sudden and much sharper than anyone could have imagined. It is hard to know how much worse things might have gotten, but it is almost certain that they could have deteriorated rapidly and the crisis might have been devastating for social order. But once the central authorities understood the scope of the problem they moved quickly and forcefully to limit public risk. President Hu Jintao, Premier Wen Jiabao, and Wang Qishan, the new acting mayor of Beijing, appeared often in public and have shown themselves to be concerned, determined, and in control. Most importantly, they have repaired some of the damage to the government's credibility. In Beijing there has been a significant return of confidence.

However there should be no doubt that this approach should have been used right from the beginning when rumors first started surfacing about SARS. Better information flow and greater accountability at provincial and municipal levels would have sharply reduced the secondary impact of SARS. This is an extremely important lesson for those responsible for the health of China's financial system. The question is not so much whether China will experience financial shocks, but rather how severe they will be and how quickly they will dissipate. The strategy of protecting the public by suppressing information may often succeed in limiting the costs of a shock, but when it fails it can cause profound damage to public credibility, and in the world of finance, a collapse in credibility can quickly lead to a liquidity crisis. A rapidly growing country is always prone to a wide variety of external and internal shocks. It is extremely important that China learn how better to manage the process.