

Financial Crisis I: An Introduction

- Understanding Financial Crises
- Understanding the IMF

Financial Crisis I: An Introduction

- Understanding Financial Crises
 - Motivating examples
 - Causes
 - Consequences
 - Detailed examples

The Latin American Debt Crisis & The Lost Decade



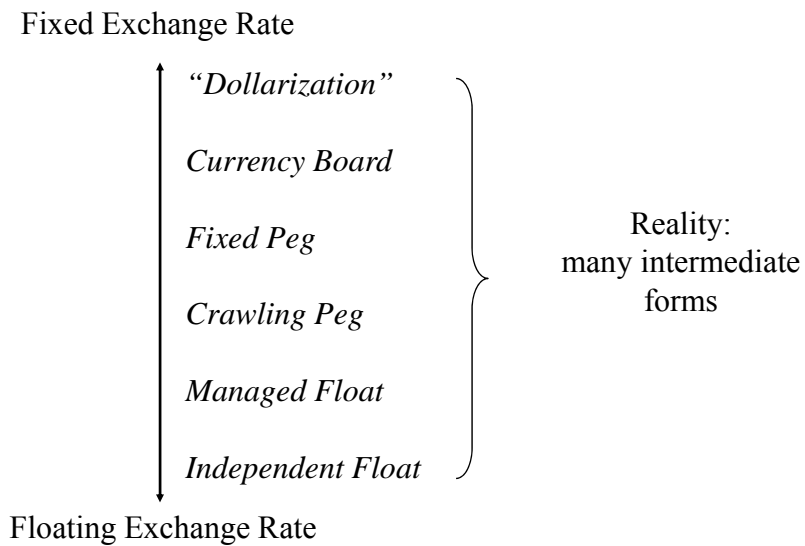
Financial Panic: Ingredients for a Crisis

- A financial crisis is essentially like a bank run, only the “run” is on a nation’s foreign currency rather than a bank
- 3 key elements to consider
 - The exchange rate: A promise to keep
 - Foreign reserves: The muscle behind the promise
 - Mobile capital: A fickle friend
- Ingredient #1: A fragile economy
 - Foreign reserves are low relative to perceived needs
- Ingredient #2: A triggering event

Understanding Exchange Rates

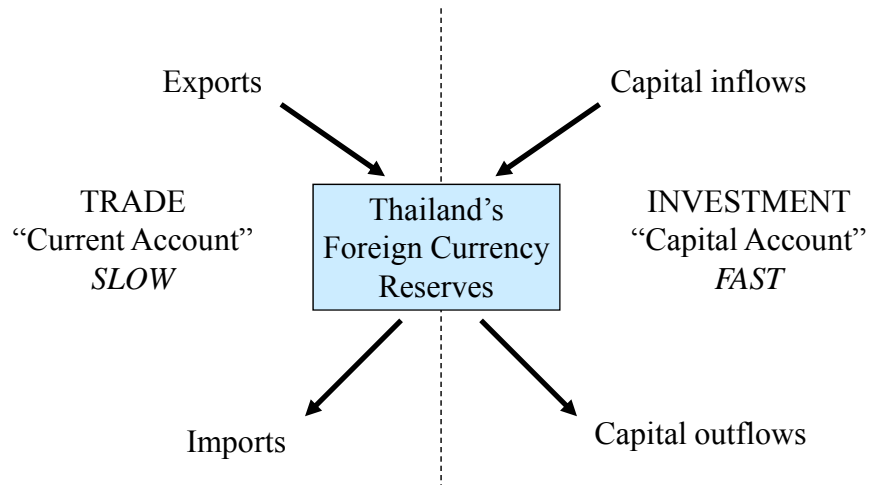
- Cross-country trade and investment requires that currencies can be converted into other currencies
- A *floating* exchange rate is determined by supply and demand for a currency
 - Fluctuations creates “exchange rate risk”, chilling trade and investment
 - Exchange rates often float to uncomfortable places
- A *fixed* exchange rate is determined by the central bank, which promises to convert currency at announced rate
 - In principle eliminates exchange rate risk
 - But can promise be kept?

Understanding Exchange Rates



Understanding Foreign Reserves

- The muscle behind the promise: A country must hold foreign currency to defend a given exchange rate



Causes: Key Early Warning Signs

$$\Delta \text{Reserves} = (\text{exports} - \text{imports}) + (\text{capital in} - \text{capital out})$$

- Trade deficit (overvalued exchange rate)
 - If your exchange rate is too high, then imports are relatively cheap to buy and your exports relatively expensive to sell => Reserves decline
 - *Slowly* pushes a country towards the brink...
- Short-term debt
 - If economic outlook turns worse, then capital will tend to flee when it has the opportunity
 - Relying on short-term debt makes it easy for capital to turn liquid and flee
 - Can *quickly* push a country towards (over) the brink...

Causes: Other Warning Signs

- Dollar-denominated borrowing
 - Firms/banks/governments in risky economies may promise to pay loans back in dollars
 - In principle, eliminates lender's exchange rate risk
 - In fact, will make any devaluation far more painful, and therefore increase fears of devaluation
- Weak bank assets
 - Do banks' assets tend to be "non-performing loans"?
 - Special problem in relationship-based governance systems
- Asset bubbles
 - Are investments real or based on hot air?
 - Massive capital flight possible when bubble collapses

Deeper Problems: Bad Fiscal/Monetary Management

- "Bad" governments spend more than they receive in taxes
 - Cause: Short term political pressures
 - Result: debt buildup
 - Temptation: loose monetary policy = "Print money" to pay for extra spending, or keep interest rates down
 - Problem: Damage trade position
 - Inflation + fixed exchange rate
 - ⇒ currency become overvalued
 - ⇒ exports shrink, imports rise
 - ⇒ *reserves fall*
- } This is important!!

Financial Panic: The Self-Fulfilling Prophecy

- Expectations become reality
 - If investors expect devaluation, then liquid capital flees country while the exchange rate is still high
 - Central bank doesn't have enough foreign currency to meet the sudden exchange demand
 - Currency is devalued in out-of-control fashion
- This *herd behavior* is another type of *coordination game*
 - Equilibrium #1: Everyone stays put
 - Equilibrium #2: Everyone flees
 - Which equilibrium prevails depends on beliefs about what others will do
 - Change in collective beliefs can be sudden and extreme

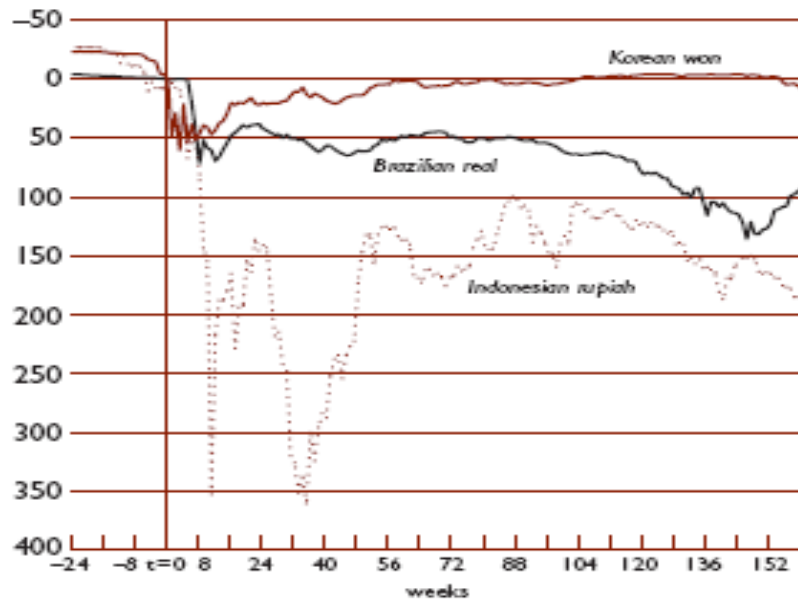
Financial Panic: The Self-Fulfilling Prophecy

Everyone Else

	Stay	Run
You	Stay 0	Run -10
You	Run -1	Run -5

Equilibrium #1 Equilibrium #2
Everyone stays Everyone runs

Devaluation: The Crisis Strikes

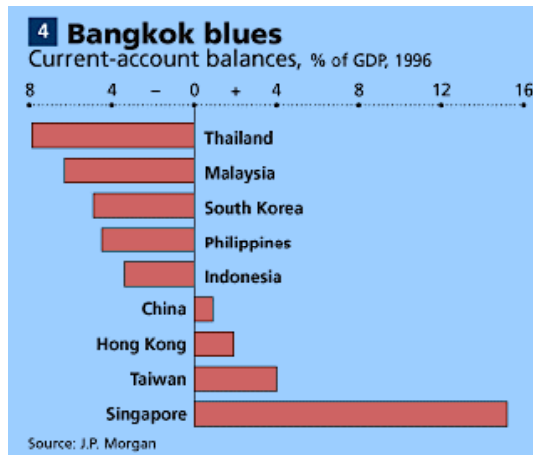


Financial Panic: Consequences

- Banks likely to collapse
 - Local depositors withdraw liquid funds and flee
 - Real bank runs!
- Firms likely to collapse
 - Especially if rely on imports or indebted
- Inflation likely
 - Central bank may print money to pay debts, help banks
 - Firms pass increased import costs into higher prices
 - Hyperinflation possible
- Unemployment, social unrest, chaos...
- More detailed consequences to come in Session #16

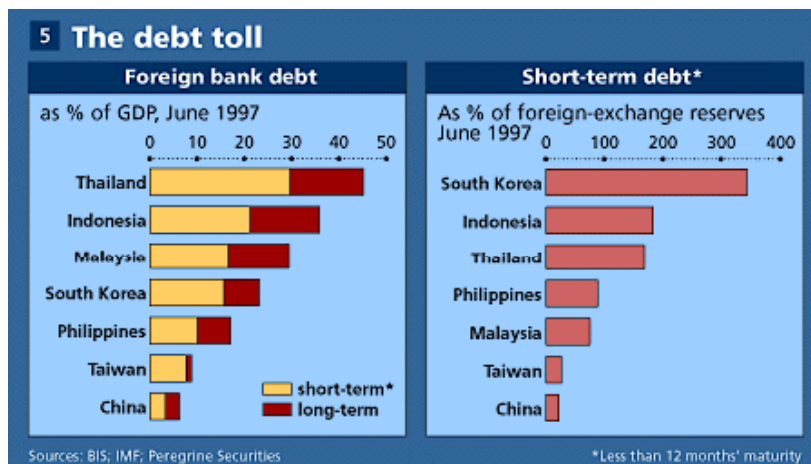
Example: Asian Financial Crisis

- Overvalued exchange rates prior to crisis
 - Current account deficit (imports exceed exports)
 - Must be offset by net capital inflows or declining reserves



Example: Asian Financial Crisis

- Excessive short-term financing prior to crisis
 - Can they keep rolling it over?
 - Also, borrowing in dollars => devaluation will be devastating



Example: Asian Financial Crisis

- Thailand devalues Baht in July 1997
 - Overvalued exchange rate (pegged to strong dollar)
 - Short-term financing
 - Borrowing in \$
 - Real estate asset bubble
 - Contagion: economic fundamentals or general panic?
 - Indonesia, November 1997
 - South Korea, December 1997
 - Malaysia, Philippines hang on } • Export competition
• Investor panic
 - Russia, August 1998
 - Brazil, December 1998
- } • Investor panic
-
- Other events

Example: Indonesia



Summary: Understanding Financial Crises

- Mechanics
 - The exchange rate: A promise to keep
 - Foreign reserves: The muscle behind the promise
 - Mobile capital: A fickle friend
- Underlying factors
 - Overvalued exchange rates
 - Short-term debt
 - \$-denominated liabilities
 - Asset bubbles
- Deeper causes
 - Poor fiscal, monetary management; weak banking system
 - Bad luck

Financial Crisis I: An Introduction

- Understanding Financial Crises
- **Understanding the IMF**

Financial Crisis I: An Introduction

- Understanding the IMF
 - The Purpose of the IMF
 - The Role of the IMF Today
 - Criticism of the IMF

The Purpose of the IMF

- “Three-legged stool” envisioned in Bretton Woods in 1944
 - IMF
 - World Bank
 - ITO
- Primary goal of IMF: *promote international monetary stability*
- Initially, oversaw system of fixed exchange rates
 - All members currencies pegged to US dollar
- Later, international monetary system becomes more flexible
 - Currencies of wealthiest nations tend to float
 - Developing country currencies tend toward being fixed (i.e. carefully managed by government)

The Role of the IMF Today

- The IMF as international fire department
 - IMF holds big pot of reserves to help countries in crisis
 - Goal of an IMF intervention
 - Prevent runaway devaluation
 - Prevent spread of crisis to other countries
 - Methods of an IMF intervention
 - Support foreign reserves directly
 - Bring mobile capital back by raising interest rates
 - Support debt payments with fiscal discipline
- Conditions imposed in exchange for funds

Conditionality

IMF is best source of funds during a financial crisis + Local leadership sensitive to crisis outcome

IMF has significant leverage

- IMF can impose “conditions” for access to its funds
 - But what policy changes to insist on?
 - IMF traditionally pro-market: privatization, free trade, unrestricted capital flows, respect for property rights, etc
- IMF sometimes criticized for choosing the wrong conditions
 - Sometimes accused of bias toward rich country interests

Criticism: The Agony of Victory

- The agony of victory: *the IMF is too cruel*
- Tactic #1: Bring mobile capital back by raising interest rates
 - But high interest rates stifle investment
 - Result: worse economic contraction
- Tactic #2: Support debt payments with fiscal discipline
 - Reduce other government expenditures and/or raise taxes
 - Result: worse economic contraction
- IMF response to this criticism
 - Must stop crisis, everything else secondary
 - Pool of funds is limited, must use a mix of measures
 - If there's no pain, there's no incentive for governments to avoid crises in first place...

Criticism: Moral Hazard

- Moral Hazard: *the IMF is too nice*
- The IMF insures investors/governments against bad decisions
 - Knowing that there will be an IMF bailout if things go wrong, the IMF encourages risky behavior in the first place
 - Standard tradeoff between insurance and incentives
- Do IMF bailouts cause future financial crises?
 - Generous bailout of Mexico in 1994 causes Asian flu?
- IMF response to this criticism
 - True to some extent, but not important
 - Bailouts are plenty painful...

Summary: Criticism of the IMF

- Dimensions of IMF criticism
 - The agony of victory: Is medicine worse than disease?
 - Moral Hazard: Bailouts encourage risky investments
 - Conditionality: Is IMF excessively pro market?
- Critics on all sides: Is the IMF right in the middle?
- Last Word: Is the IMF a convenient punching bag?
 - Domestic political leaders have every incentive to blame the IMF for domestic problems
 - “You are greatly responsible for what happened in Argentina.”
-- President Kirchner to IMF Managing Director, 2003

END