Chapter 13

Emerging market economies – economies in an early stage of market development that have recently opened up to the flow of goods, services, and capital from the rest of the world – resemble those found in advanced countries,

Credit boom and bust, the seeds of a financial crisis in an emerging market economy are often sown when a country liberalizes its domestic financial systems by eliminating restrictions on financial institutions and markets, a process known as financial liberalization.

Opens up its economy to flows of capital and financial firms from other nations, a process called financial globalization.

The less developed a financial system is, the more vulnerable it is to external shocks propagated through financial globalization.

Credit booms that accompany financial liberalization in emerging market nations are typically marked by especially risky lending practices, sowing the seeds for enormous loan losses down the road. The financial globalization process add fuel to the fire b/c it allows domestic banks to borrow abroad.

The capital inflow is further stimulated by government polices that fix the value of the domestic currency to the U.S. dollar, which provides foreign investors a sense of comfort.

Principal-agent problem, powerful domestic business interests are encouraged by the prospect of high payoff to pervert the financial liberalization process. Politicians and prudential supervisors are ultimately agents for voters-taxpayers (principals): that is, the goal of politicians and prudential supervisors is, or should be, to protect the taxpayers’ interest.

Powerful business interest that contribute heavily to politicians’ campaigns are often able to persuade politicians to weaken regulations that restrict the business interest’s banks from engaging in high-risk/high-payoff strategies.

Powerful business interests also have acted to prevent supervisors from doing their jobs properly in advanced countries.

When governments in emerging market countries face large fiscal imbalances and cannot finance their debt, they often cajole or force domestic banks to purchase government debt.

Investors who lose confidence in the ability of the government to repay this debt then unload the bonds, which causes their prices to plummet.

Increase in interest rates abroad that raise domestic interest rates can increase adverse selection and moral hazard problem and result in a further collapse of lending.

When uncertainty increase, it becomes hard lenders to screen good credit risks form had ones and to monitor the activities of the firms to which they have loaned money, again worsening adverse selection and moral hazard problem.

Speculative attack, in which speculators engage in large-scale sales of the currency.

As the currency sales flood the market, supply far outstrips demand, the value of the currency collapse, and a currency crisis ensues. High interest rates abroad, increase in uncertainty, and falling asset prices all play a role.

Defending their currencies by raising interest rates should encourage capital inflows, but if the government raises interest rates, banks must pay more to obtain funds, this increase in costs decrease bank profitability, which may lead them to insolvency

If they raise interest rates too much, they will destroy their already weakened banks and further weaken their economy. If they do not, they will not be able to maintain the value of their currency.

When government budget deficits spin out of control, foreign and domestic investors begin to suspect that the country may not be able to pay back its government debt and so will start pulling money out of the country and selling the domestic currency. Recognition that the fiscal situation is out of control thus results in a speculative attack against the currency, which eventually results in its collapse.

Currency mismatch, an unanticipated depreciation or devaluation of the domestic currency in an emerging market country increase the debt burden of domestic firms in terms of the domestic currency.

The decline in net worth then increases the adverse selection and moral hazard problem and decrease lending, describe earlier. A decline in investment and economic activity follows.

A currency crisis, with its resulting depreciation of the domestic currency, leads to deterioration of firms’ balance sheets that sharply increase adverse selection and moral hazard problems.

Sharp rises in interest rates also have a negative effect on banks’ profitability and balance sheets. Even more problematic for the banks is the sharp increases in the value of their foreign-currency-denominated liabilities after the devaluation. Bank balance sheets are squeezed from both sides – the value of their assets falls as the value of their liabilities rises.

Beef up prudential regulation and supervision of banks: First, regulators should ensure that banks hold ample capital to cushion losses from economic shocks and to give bank owners, who have more to lose, an incentive to pursue safer investments.

Prudential supervision can also help promote a safer and sounder banking system by ensuring that banks have proper risk management procedures in place, including 1) good risk measurement and monitoring systems, 2) policies to limit activities that present significant risks, and 3) internal controls to prevent fraud or unauthorized activities by employees.

For prudential supervision to work, prudential supervisors must have adequate resources with which to do their jobs. A more independent regulatory and supervisory agency can better withstand political influence, increasing the likelihood that prudential supervisors will their jobs and limit bank risk taking.

A collapse of a domestic currency causes debt denominated in foreign currencies to become particularly burdensome because it has to be paid back in the more expensive foreign currency, thereby causing a deterioration in firms’ balance sheet. Governments can limit currency mismatch by implementing regulations or taxes that discourage the issuance by nonfinancial firms of debt denominated in foreign currencies.

Monetary policy that promotes prices stability also helps by making the domestic currency less subject to decreases in its value as a result of high inflation, thus making it more desirable for firms to borrow in domestic rather foreign currency.