Financial Crises in Developing Countries

International Finance 2

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Stages of Financial Crises in Developing Countries

Stage 1: Initiation

Path one: mismanagement of financial liberalization

- Weak supervision and lack of expertise.
- Domestic banks borrow from foreign banks.
- Fixed exchange rates give a sense of lower risk.
- Securities markets not well-developed.

Path two: severe fiscal imbalances

- Governments force banks to buy government debt.
- When government debt loses value, bank net worth down .
- Additional factors:
- Increase in interest rates (from abroad)
- Asset price decrease
- Uncertainty linked to unstable political systems

Initiation of Financial Crisis 1

Additional Factors

- Increase in interest rates (from abroad)
- Asset price decrease
- Uncertainty linked to unstable political systems

Stage 2: Currency Crisis

Bank loses lead to currency crisis.

- Governments cannot raise interest rates (doing so forces banks into insolvency)...
- ... and speculators expect a devaluation
- Foreign and domestic investors sell the domestic currency.

Stage 3: Full-Fledged Financial Crisis

- The debt burden in terms if domestic currency increases.
- Banks are more likely to fail if: (1) individuals are less able to play of their debts, and (2) debt denominated in foreign currency increases (i.e. value of liabilities increases).
- Routinely, ordinary citizens bear the costs of adjustment.

Financial Crises

Mexico (1994-1995)

- Financial liberalization in the early 1990s: Lending boom, coupled with weak supervision and lack of expertise. Banks accumulated losses and their net worth declined.
- Rise in interest rates abroad.
- Uncertainty increased (political instability).
- Domestic currency devaluated on December 20, 1994.
- Rise in actual and expected inflation.

Financial Crises

East Asia (1997-1998)

- Financial liberalization in the early 1990s: Lending boom, coupled with weak supervision and lack of expertise. Banks accumulated losses and their net worth declined.
- Uncertainty increased (stock market declines and failure of prominent firms).
- Domestic currencies devaluated by 1997.
- Rise in actual and expected inflation.

Financial Crises

Argentina (2001)

- Government coerced banks to absorb large amounts of debt due to fiscal imbalances_.
- Rise in interest rates abroad.
- Uncertainty increased (ongoing recession).
- Domestic currency devaluated on January 6, 2002
- Rise in actual and expected inflation.