EC 380: Lecture 13

Global Finance: International Crises

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Fall 2022

Prologue

Global Finance

Upcoming Topics

- Broad look at international financial crises

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- Broad look at international financial crises
- Understanding Balance of Payments in National Accounting

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- Exchange Rate Dynamics

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- Broad look at international financial crises
- Understanding Balance of Payments in National Accounting
- Exchange Rate Dynamics

This will comprise the third and last stage of **EC 380**

Today

International Financial Crises

- Defining types of international financial crises

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- Defining types of international financial crises
- Vulnerabilities, Triggers and Contagion

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- Crisis Control

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- Vulnerabilities, Triggers and Contagion
- Crisis Control
- Post-Crisis Reform

Types

- Banking Crisis

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- Exchange Rate Crisis

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- (Sovereign) Debt Crisis

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- Balance of Payments Crisis

  > e.g. foreign currency reserves drying up

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Some percentages of businesses fail, banks must compensate for these bad debts through gains made elsewhere, through elevated interest rates.

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A bank is considered **insolvent** if even after completely liquidizing its assets, it cannot repay its outstanding liabilities owed to creditors.

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Remaining savings can be lost, causing households to reduce consumption. This can lead to ripple effects throughout the economy.

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- Indutries reliant on foreign credit suddenly see loss of liquidity, resulting in market price falls (e.g. housing market collapse)

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If debt held in a specific currency, that country presides over legal matters related to payment arrears and bankruptcy.

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Spread can occur in insolvency, in which other individuals go into bankruptcy because an intial set of individuals do.

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B assets fall in value $\implies$ becomes insolent too. Group C unaffected.

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- Bailouts are heavily politicized, often the distressed country is at the mercy of its neighbors
- Steep requirements can be placed on the burdened economy, extending the length of downturn to ensure bailout is provided

BoP Crises

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Ability to convert local currency into foreign debt repayment transfers also kicks in, furthering stress on **deficit country**.

BoP Crises

Contents lists available at SciVerse ScienceDirect

Journal of International Economics

journal homepage: www.elsevier.com/locate/jie

Capital flow waves: Surges, stops, flight, and retrenchment

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A R T I C L E I N F O

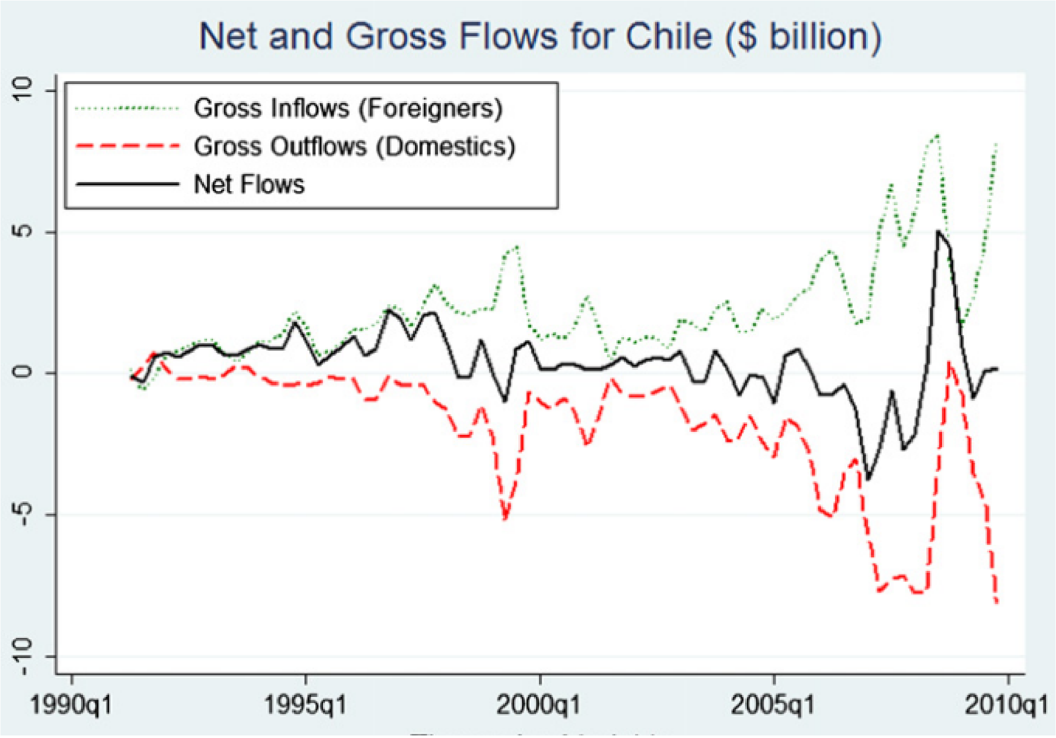
Article history:
Received 10 August 2011
Received in revised form 19 March 2012
Accepted 20 March 2012
Available online 29 March 2012

Keywords:
Capital flows
Sudden stops
Bonanzas
Surges
Risk
Capital controls
Pull versus push

A B S T R A C T

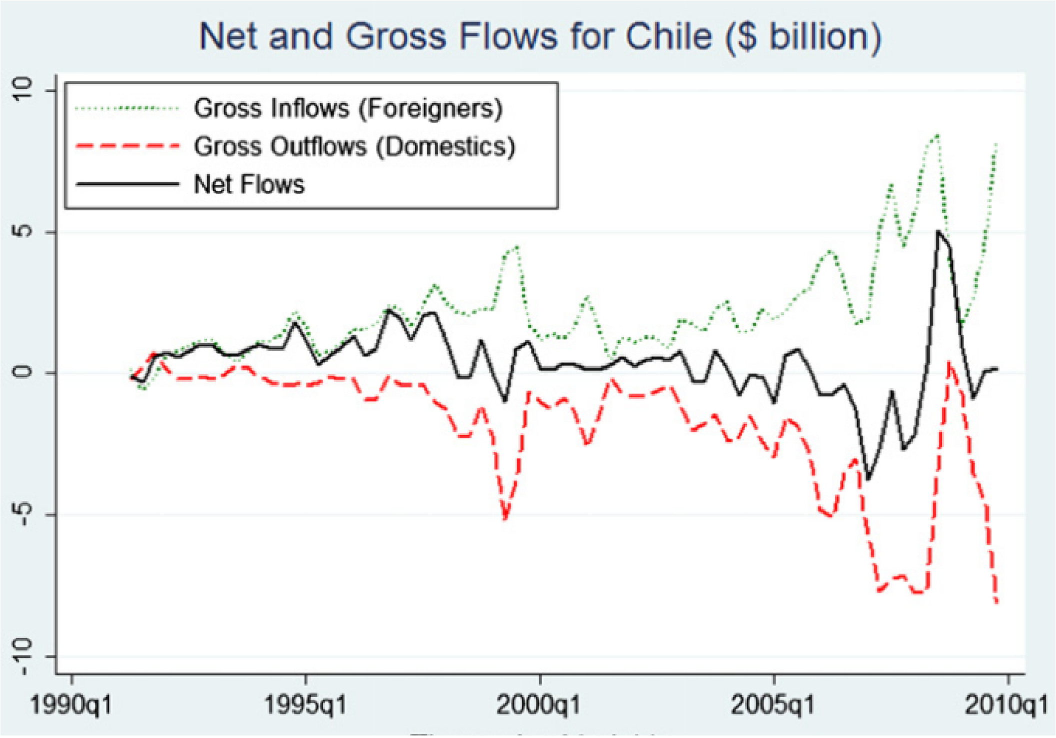
This paper analyzes waves in international capital flows. We develop a new methodology for identifying episodes of extreme capital flow movements using data that differentiates activity by foreigners and domestics. We identify episodes of "surges" and "stops" (sharp increases and decreases, respectively, of gross inflows) and "flight" and "retrenchment" (sharp increases and decreases, respectively, of gross outflows). Our approach yields fundamentally different results than the previous literature that used measures of net flows. Global factors, especially global risk, are significantly associated with extreme capital flow episodes. Contagion, whether through trade, banking, or geography, is also associated with stop and retrenchment episodes. Domestic macroeconomic characteristics are generally less important, and we find little association between capital controls and the probability of having surges or stops driven by foreign capital flows. The results provide insights for different theoretical approaches explaining crises and capital flow volatility.

BoP Crises



Net and Gross Flows for Chile ($ billion)
Gross Inflows (Foreigners)
Gross Outflows (Domestics)
Net Flows
10
5
0
-5
-10
1990q1
1995q1
2000q1
2005q1
2010q1

BoP Crises



Help from allies and IMF act as stopgaps to slow decline. Deficit must shrink until confidence in the country is restored.

Vulnerabilities

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Long-run underlying issues for domestic economy may lead to over-reliance on foreign debt and over-leveraged credit status across households.

Can be the result of either of these two scenarios.

Economic Imbalances

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Doubt in government ability may result in government bond yields needing to rise to continue accessing foreign debt. Limits ability of government to service the economy.

Volatile Capital Flows

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These volatile movements of large sums of capital within these transition periods can be **highly costly for the emerging host countries**.

Contagion

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Local shocks are increasingly likely to trigger worldwide reprecussions due to greater degree of **financial interdependence.**

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- Encourages banks to become large enough to **force bailouts** in between episodes of them over-leveraging themselves

This is defined as the **moral hazard problem** in which bankers are able to transfer high risks to the government and taxpayer.

Lets consider three measures a country can take to reduce exposure to financial crises

CC: Exchange Rate Policy

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- Requires monetary authority to restrict money creation, making it **anti-inflationary**
- Often leads to severe overvaluation of **real exchange rate**, increasing vulnerability to crisis

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Malaysia enacted this policy during the Asian Financial Crisis in late 90's but failed to experience much of the warnings surrounding losses from poorer investor confidence.

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Political feasibility of these moves is up for question, hard to implement during economic strife.

Greek government was quickly voted out after agreeing to Germany/IMF austerity plans

International Reform

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- Limits to borrowing for countries
- Loans conditional on economic conditions

Three Crises

- 1990s East Asian Financial Crisis

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- Fixed exchange rate policy $\implies$ significant **external borrowing**
- US interest rate increases as period of pronounced growth began, USD value up
- Currency peg to USD $\implies$ suddenly exports are less competitive
- Huge capital drain to meet elevated **current account deficit**

East Asian Crisis

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- Triggered **series of bankruptcies** which would accelerate more capital flight
- Temporary policies to maintain peg were quickly exhausted (interest rate hike, domestic currency purchases)
- **Higher interest rates** further pressured these economies

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  > Required countries to reduce government spending and deficits, allow insolvent banks and financial institutions to fail, and aggressively raise interest rates.

- Critics noted the contractionary nature of policies
- In a recession the expected response was to increase government spending and yield greater liquidity through lower interest rates

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- A large proportion of interbank lending was channeling excessive Germany savings into these peripheral countries

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Leading Up

- In the early 2000's various EU member states at different points in business cycle
- **Portugal, Italy, Greece, Spain** all experience boom periods
- A large proportion of interbank lending was channeling excessive Germany savings into these peripheral countries

Irish banks became highly reliant on foreign borrowings and offered excessive amounts of subprime mortgage loans

Great Recession (Ireland)

Crisis

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- Irish housing prices tanked, as did employment in construction sector
- **34,500 people** left the country from April 2009 to 2010, the **largest net emigration since 1989**

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Response

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- Macroprudential policy measures introduced to stabilize housing market

EU Debt Crisis

Ireland among many EU countries acquiring government debt

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- Widespread requirement of austerity plans
- International assymetry in business cycles combined with lax macroprudential rules prior to the crash
- More recently, countries are now held to macroeconomic monitoring with penalities imposed if countries allow their current account balances, inflation or GDP to get out of control

EU Debt Crisis