University of Cassino
Economics and Business
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International Economics
International Finance
(International crises – chapter 12 - lecture 7)

Maurizio Pugno
University of Cassino

The crises throughout the world

- Increasing international economic integration has created opportunities for growth and development, but it has also made it easier for crises to spread from one country to another.
- The greatest worldwide crises are:

  - the Great Depression in the 1930s,

  - the Great Recession that began in 2008,

  - the Covid-19 crisis

  - the Ukraine war crisis (?).

The international crises of the 1990s

- Other ‘minor’ crises are:

  - in 1992, currency speculation against the British pound and the Italian Lira caused the collapse of monetary arrangements (well before the Euro system);

  - in late 1994, speculation against the Mexican peso led to its collapse and spread the crisis throughout South America;

  - in 1997, several East Asian economies (Malaysia, S.Korea) were thrown into steep recession by a wave of sudden capital outflows;

  - in 1998, Russia’s default on its international debt sent shockwaves as far as Latin America.

An overview on what the international crisis means

- Every historical international crisis has its own specificities.
- Here, we will look at the general characteristics of the international crises.

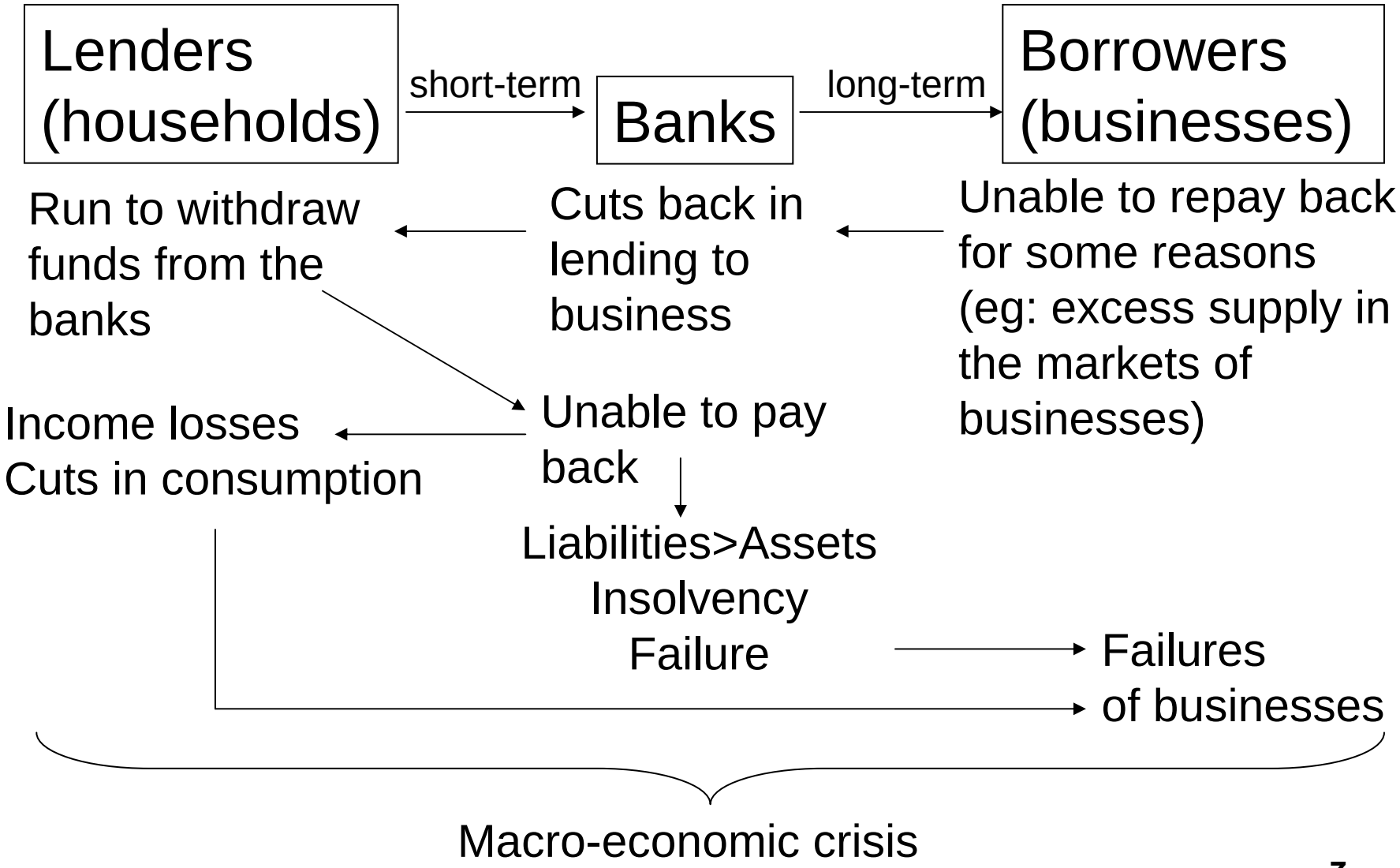
When financial crises arise

- A financial crisis arises when borrowers do not repay back the debt.
- This is often the case when borrowers are also lenders, and their debt is short term, while their credit is long term.
- Therefore a crisis usually started as a result of a massive withdrawal of short-term liquid funds while credits cannot be paid back because they are long-term.

Three types of financial crises

- The banking crises
- The exchange rate crises
- The debt crises

The banking crises



A run to withdraw funds from the bank (Northern Rock – US – 2007)

The exchange rate crises

Premises:

- The country X needs financial capital from abroad in order to finance excess imports (eg necessary key inputs for industrial development).
- The country X borrows in a major foreign currency (eg the $) because (foreign) lenders worry (based on past experience) about being repaid with a devalued currency of the nation.
- An external shock occurs (eg $+\Delta i$ for internal reasons, change of government, international political or economic crisis)

The exchange rate crises (BoP crises)

–Δ foreign financial lenders' belief that the country X is able to repay the funds

+Δ sales of assets issued by X
+Δ supply of X's currency

+ΔE: devaluation of X's currency

+Δ value of the debt in terms of the X's currency (transfer of wealth to foreign lenders).

Banking crisis

Macro-economic crisis

The debt crises

Premises (alternative or together):

- The public sector increases its debt for various reasons (ie it sells bonds to finance excess expenditure over revenues). → +Δ public debt/GDP

- The private sector borrows funds to buy assets in the expectation of future capital earnings. → +Δ private debt ↓ The price of assets grows far more than the value they represent (BUBBLE). ↓ Asset price busts

  Excessive financial liberalisation. Lenders may ignore the risks of the assets. → The price of assets grows far more than the value they represent (BUBBLE).

The debt crises (cont)

- Debtors cannot pay and must restructure their debt.

  Restructuring debt means:
  - lowering the rate of interest,
  - lengthening the payback period,
  - partial forgiveness,
  - debt repudiation.
- The country loses credibility.
- Foreign lenders cut back lendings (deleveraging).
- The exchange rate tends to devalue.
- Policies become restrictive ($+\Delta T, +\Delta i$).

→ Macroeconomic crisis.

Stock market prices during the Great Depression (1929-1940)

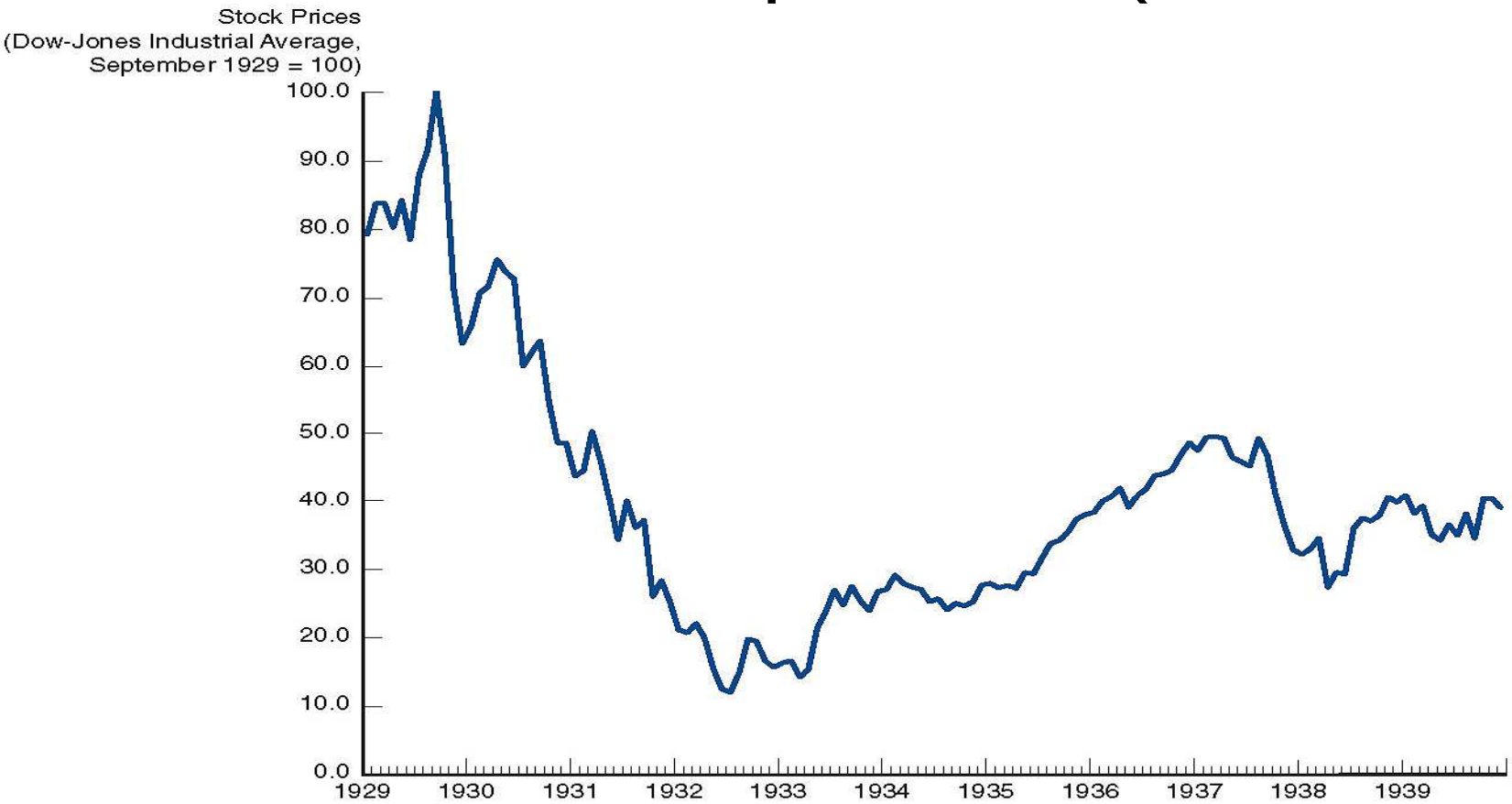


FIGURE 8.2 Stock Price Data During the Great Depression Period

Stock prices crashed in 1929, falling by more than 60%, and then continued to fall to only 10% of their peak value by 1932.

Source: Dow-Jones Industrial Average (DJIA), http://lib.stat.cmu.edu/datasets/djdc0093.

Stock market prices during the Great Recession (2007-2010)

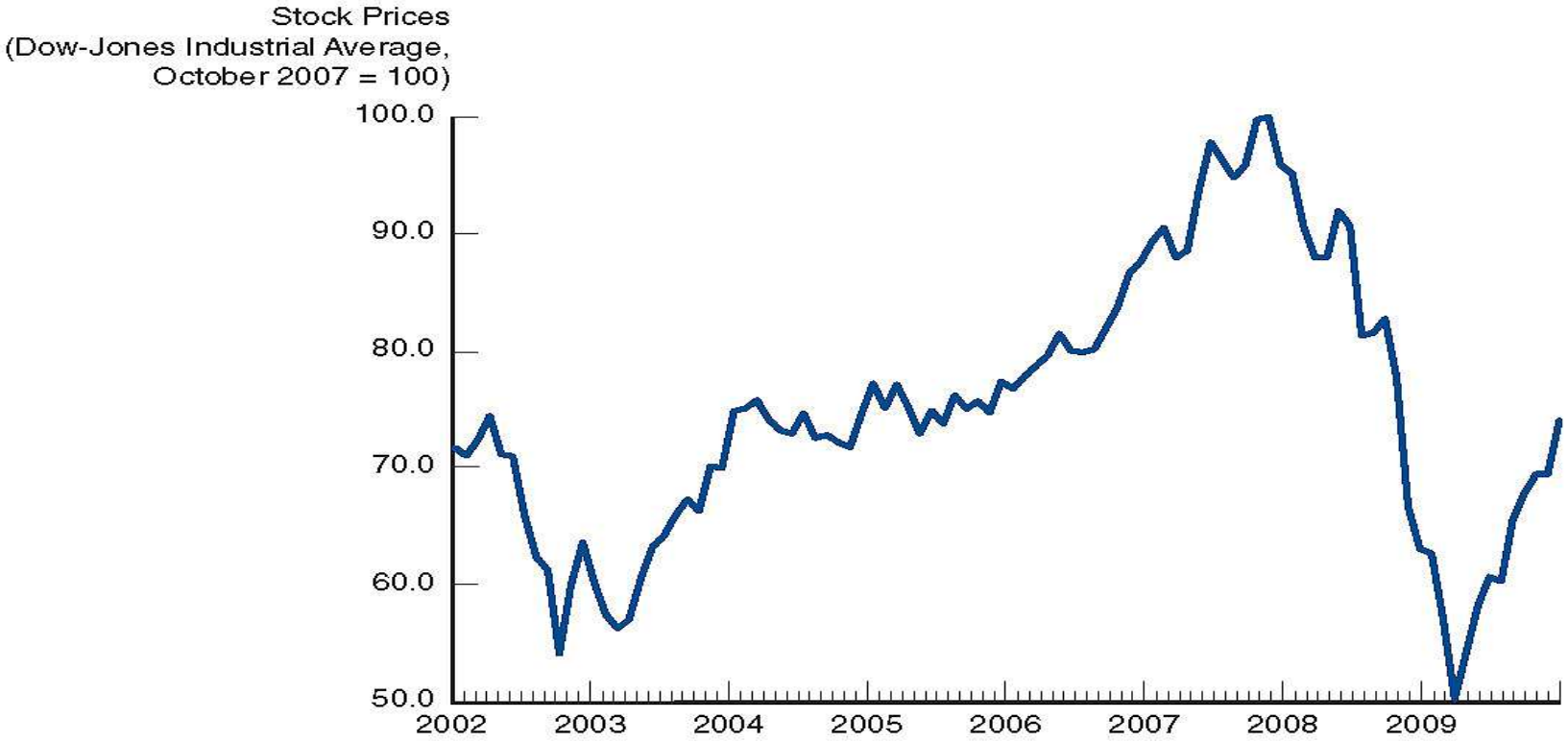


FIGURE 8.5 Stock Prices and the Financial Crisis of 2007–2009

Stock prices fell by 50% from October 2007 to March of 2009.

Source: Dow-Jones Industrial Average (DJIA), available at http://finance.yahoo.com/q/hp?s=%5EDJI.

The housing bubble in the US

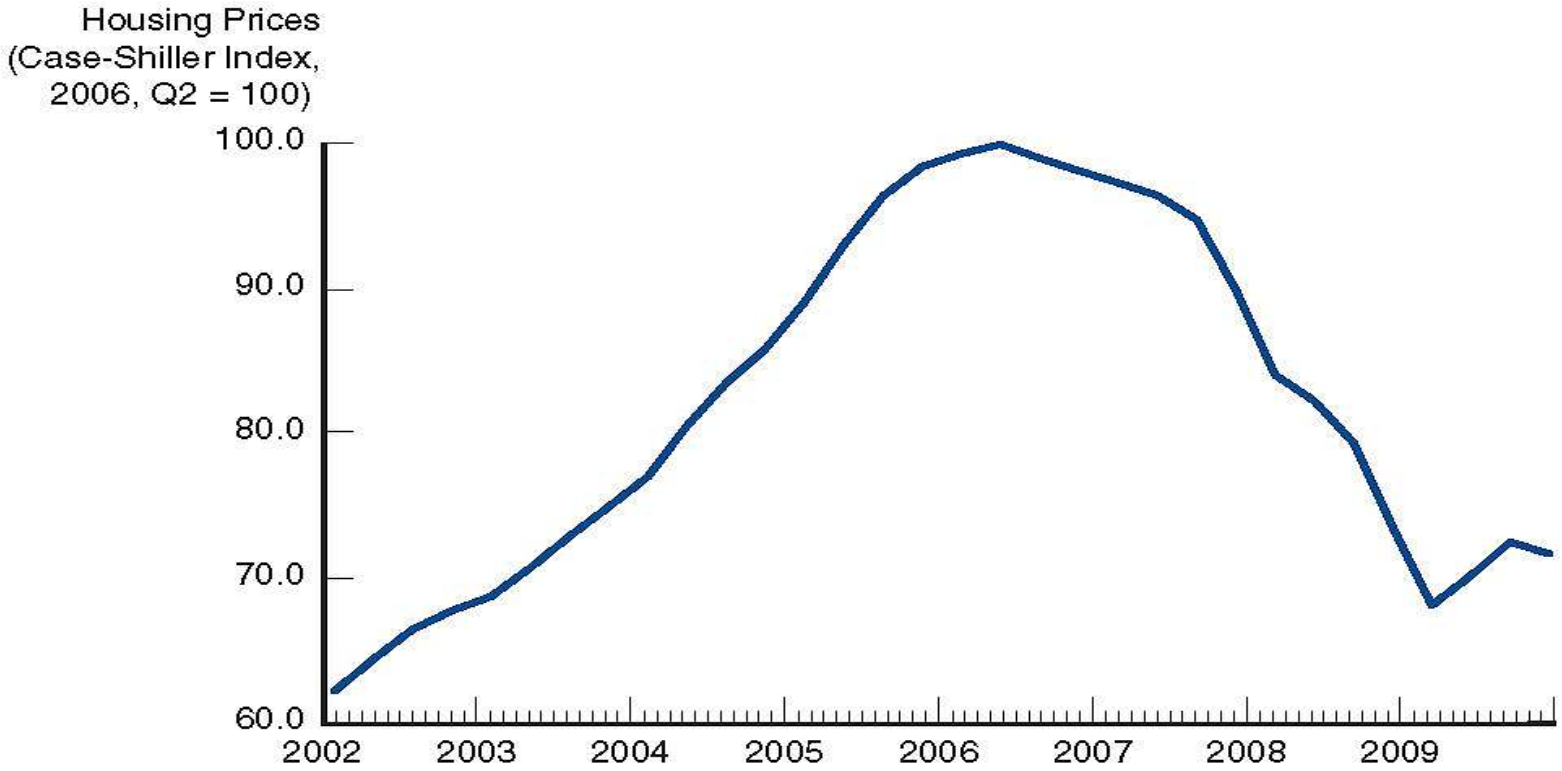
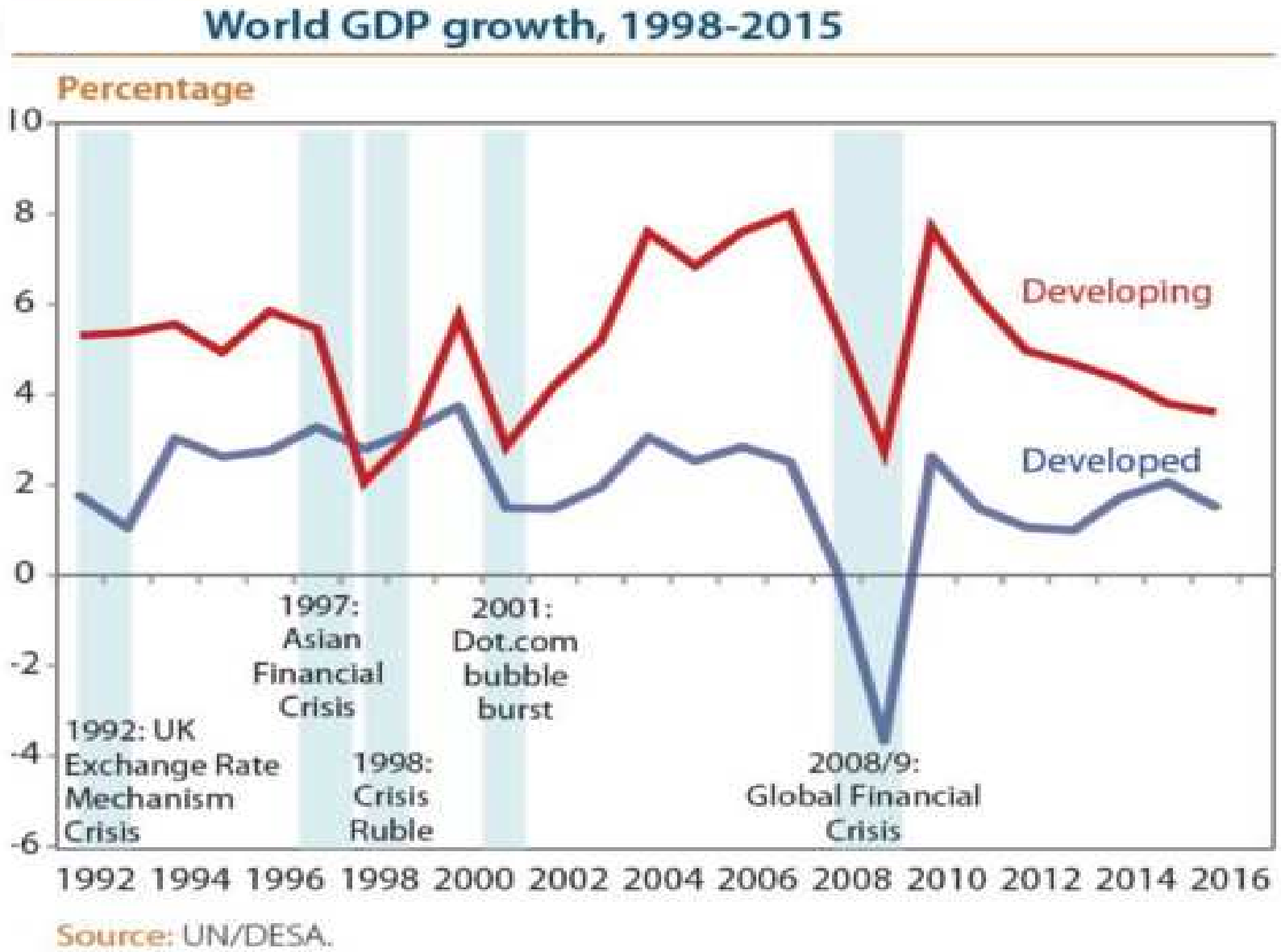


FIGURE 8.4 Housing Prices and the Financial Crisis of 2007–2009

Housing prices boomed from 2002 to 2006, but then fell by more than 25% subsequently.

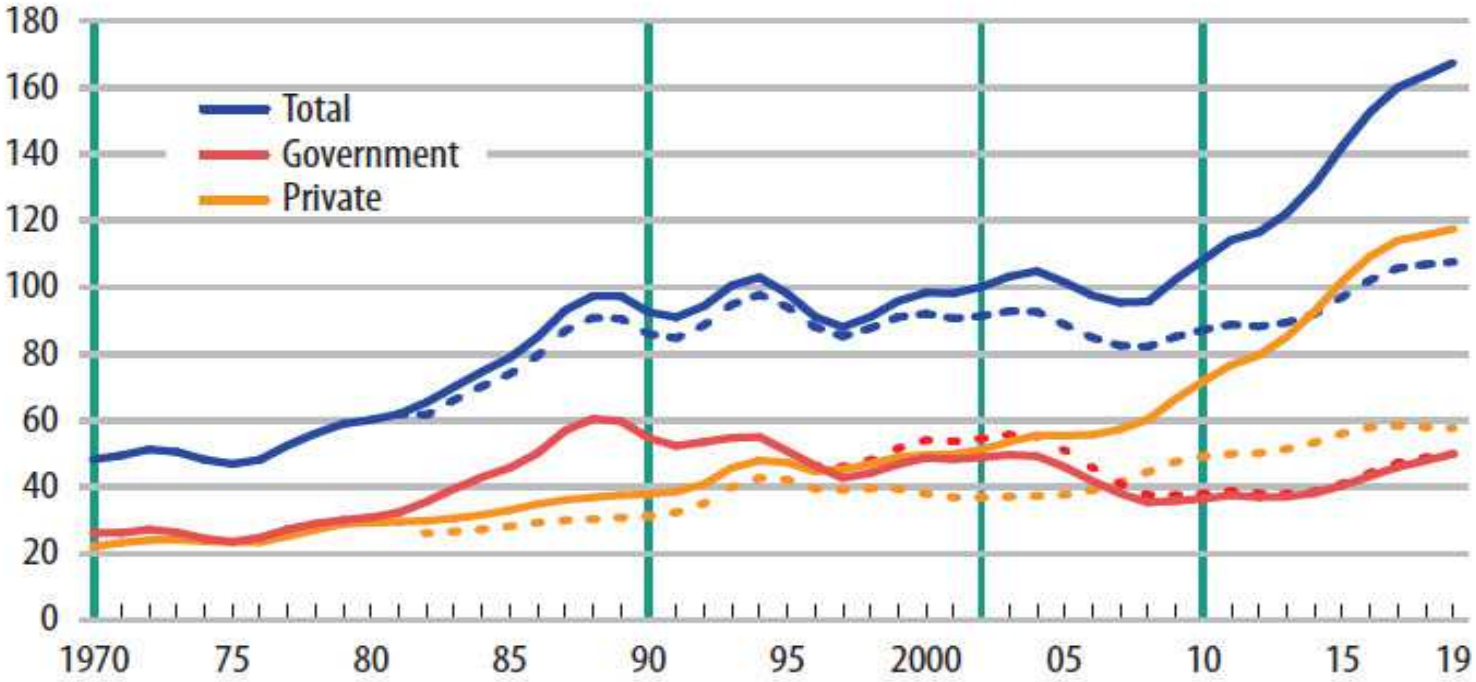
Source: Adapted from Case-Shiller U.S. national composite house price index, available from http://www.macromarkets.com/csi_housing/index.asp.


World GDP growth, 1998-2015
Percentage
10
8
6
4
2
0
-2
-4
-6
Developing
Developed
1997: Asian Financial Crisis
2001: Dot.com bubble burst
1992: UK Exchange Rate Mechanism Crisis
1998: Crisis Ruble
2008/9: Global Financial Crisis
1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016
Source: UN/DESA.

Ballooning debt (1970–2019)

During the past decade, total debt in emerging market and developing economies rose to a historic peak.

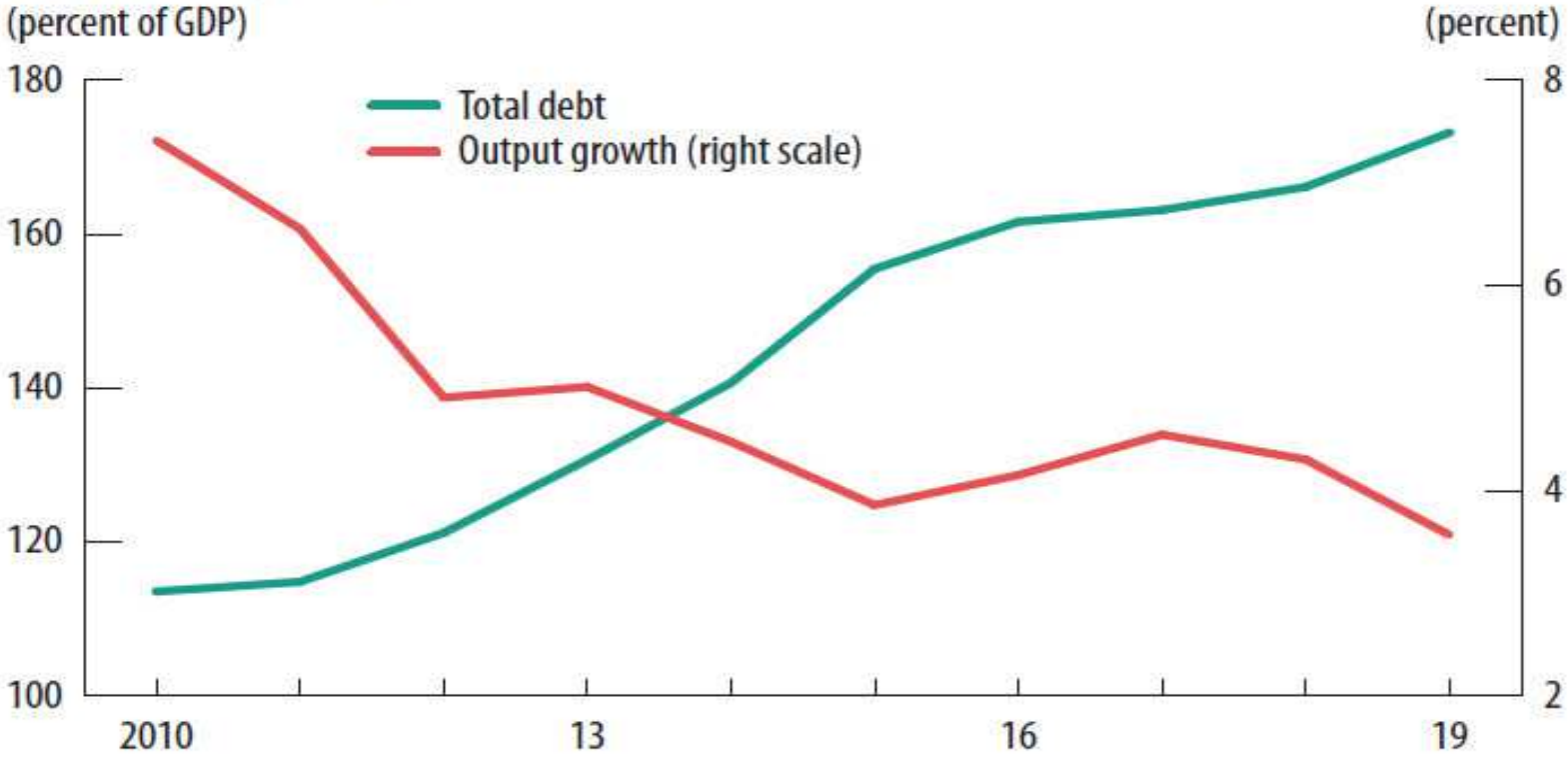
(percent of GDP)



Sources: International Monetary Fund; Kose and others (2020); and World Bank.
Note: Aggregates are calculated using current US dollar GDP weight and are shown as a three-year moving average. Dashed lines show debt, excluding China. The vertical lines represent the beginning of debt waves in 1970, 1990, 2002, and 2010.

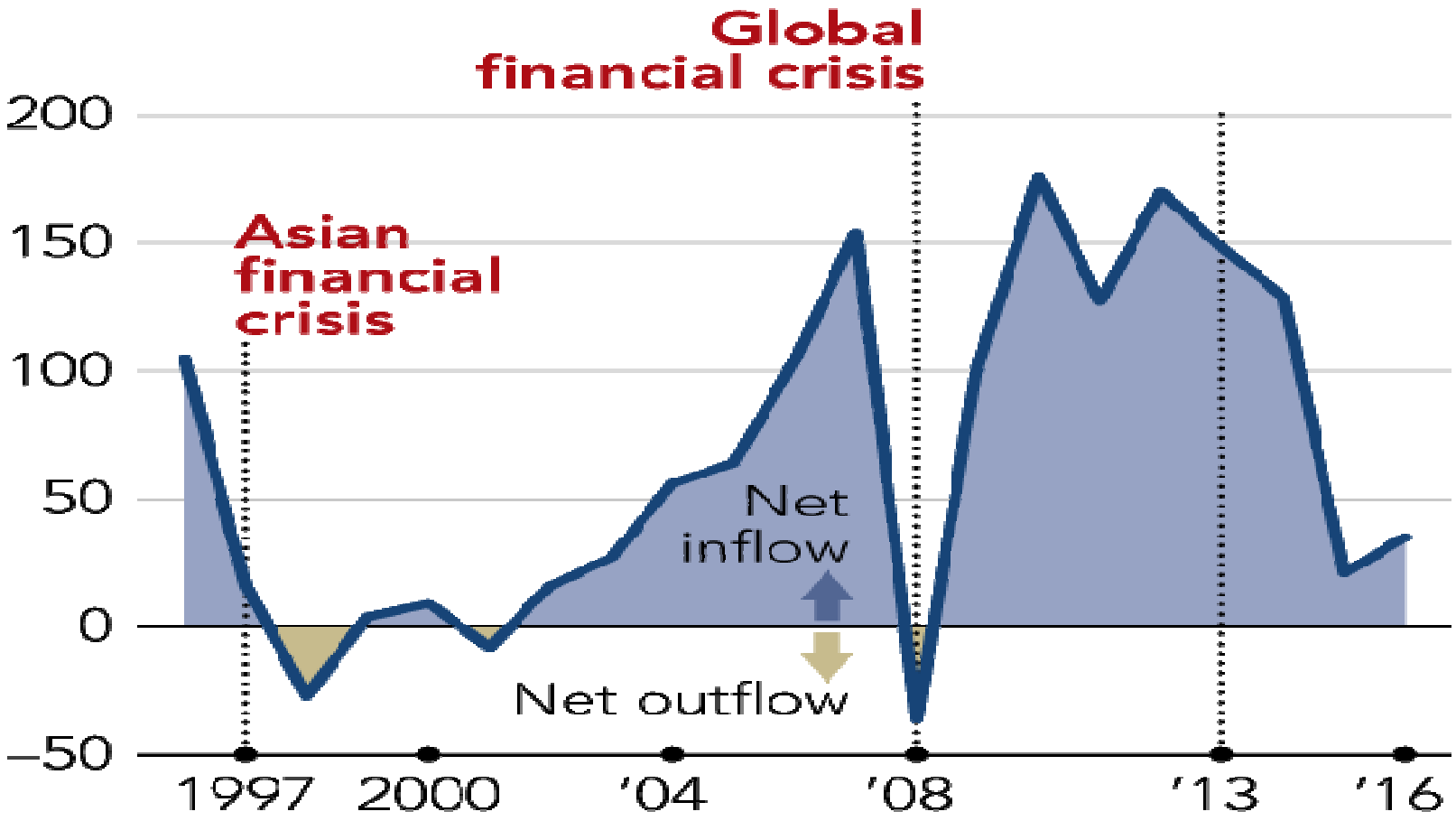
Growth and debt (2010–19)

Accompanied by higher debt in emerging market and developing economies, growth has repeatedly disappointed.



Sources: International Monetary Fund; Kose and others (2020); and World Bank.
Note: Total debt (in percent of GDP) and real GDP growth (weighted by GDP at 2010 prices and exchange rates) in emerging market and developing economies.

Capital flows for emerging Asian economies *(in billions of dollars)*



Figures for five countries: Thailand, Malaysia, Philippines, South Korea, Indonesia
Source: Institute of International Finance

Vulnerabilities to crises

- Banking, exchange rate, and debt crises are more likely when the economy is weak and vulnerable.
- However, economic vulnerabilities do not predict crises with certainty.
- The outbreak of the crisis is often unexpected.
- If lenders expect the crisis, they accelerate it by taking back their credits. I.e., the expectations of lenders matter a great deal.

Vulnerability from macro-imbalances

- The main macroeconomic imbalances are:

  1. more public debt than economic growth ($+\Delta debt/Y$), due to recurrent $T–G<0$,

  2. large current account deficits ($CA<0$).

  3. overvalued E,

  4. high levels of private sector debt (recurr. $S–I<0$).

- The case of both $T–G<0$ and $CA<0$ (twin deficits problem) is due to insufficient resources produced:

  $I=(T-G)-CA+S$ If less I, then less T, more M and less S.

Relative macro-imbalances

- Macro-imbalances are relative to the imbalances of other countries, or to international turmoils. Speculators attack the most vulnerable country.
- The moment of crisis onset is unpredictable, but unless the underlying conditions are corrected, it is almost certain to occur eventually.

Vulnerability: the role of poor policy

- Poor fiscal or monetary policy may make the country vulnerable through large budget deficits or high rates of inflation.

  - The need to finance budget deficits can make governments vulnerable to a change in the perceptions of lenders about their probability of being repaid.

  - Inflation with a fixed exchange rate creates vulnerability through a real appreciation of the currency and a loss of competitiveness.

Vulnerability from capital volatility

- Volatility of financial capitals means high and quick movements of in- and out-flows.
- Vulnerability arises when capital inflows build up a great stock of foreign liabilities, so that a <u>sudden change in investor expectations</u> may be a triggering factor of a financial crises.
- The underlying weakness is the need for such great stock.

Causes of volatile capital flows

- Liberalisation of capital markets.
- Technological advances in communication and in moving capital flows.
- The discovery of large emerging markets.
- The need of financial investors in high-income countries to diversify their portfolios.
- The increasing availability of savings in some high-growing countries.

Vulnerability from the financial sector

- A financial sector is in a weak position if:

  - it takes short-term loans from the international markets,

  - and uses them to fund long-term loans (such as real estate) on the local market.
- An outflow of funds from the country can be interpreted as bad news about the underlying economic conditions, and lead to an avalanche of capital flight.

Why the crises are unpredictable

- First, there are multiple possible outcomes—or in economic terms, there are multiple equilibria—depending on the responses of international lenders.
- Second, one of the possible outcomes is a crisis, but the crisis is self-fulfilling. It is not predetermined, nor is it necessary.
- Third, the crisis affects banks that are fundamentally sound, but that have mismatches between the maturities of their debts and their assets. In other words, they are illiquid, but not insolvent.

Contagion

- Most crises are domestic. Only some of them become international.
- Many crises, however, spill into other countries, and even if they do not become a global crisis, they nevertheless affect more than just the country where it originates.
- Banking or other financial linkages may not be visible or known until a crisis begins, but ultimately they will be exposed if the crisis persists or is deep enough.

Early warning signals of E crisis

	Signal	*Warning is issued when:*
1	Real exchange rate	The domestic currency is overvalued
2	Trade deficit	The value of exports fall and/or the value of imports rise
3	Official reserves	Too small relative to domestic supply of money
4	Stock prices	The stock market index declines
5	Public debt	The debt/Y increases
6	Inflation	Poor policy
7	Foreign debt	Financial sector is weak

End of the 7th lecture
of
International Finance
M. Pugno