

Objectives for Chapter 27: International Financial Crises of the 1990s

At the end of Chapter 27, you will be able to answer the following questions:

1. What is a “**managed float**”?
2. Describe the **Plaza Accord** of 1985 and the **Louvre Accord** of 1987.
3. Briefly describe the **causes** of the **financial crises** in Mexico, East Asia, Russia, and Argentina.
4. What is a **hedge fund**? How did the activities of these hedge funds contribute to the financial crises of the 1990s?
5. What does it mean to “**sell short**”?
6. Briefly describe the **effects** of these financial crises on the economic performance of these countries. (Why did the financial crises cause severe recessions?)
7. Briefly describe the policies of the **IMF** in these crises. What effects did these policies have?
8. What is meant by “**herding behavior**”? Why does it occur?
9. What is a “**bail in**”?
10. What **criticisms** have been made of the IMF policies?
11. Why did the financial crises in Mexico, East Asia, Russia, and Argentina end?

Chapter 27: International Financial Crises of the 1990s

The Exchange Rate System After Bretton Woods

In previous chapters, we discussed various **exchange rate systems**. In Chapter 7, we discussed a freely floating exchange rate system. A freely floating exchange rate system means that exchange rates are determined only by the forces of demand and supply. In Chapter 11, we discussed the Classical Gold Standard. And in Chapter 25, we discussed the Bretton Woods system. The Gold Standard and the Bretton Woods system involved fixed exchange rates. You should review these now. We have already considered the advantages and disadvantages of freely floating vs. fixed exchange rates.

The Bretton Woods system collapsed in 1973, as was described in Chapter 25. The system that followed it can be called a “**managed float**”. Basically exchange rates were free to go to whatever level would be set by demand and supply. *However, as they deemed necessary, countries’ central banks would intervene in the foreign exchange market to change the exchange rate from the one that would have been set by the market.* Central banks would buy their own monies in the foreign exchange market in order to increase its value. Or they would sell their own monies in the foreign exchange market in order to decrease its value. There were no rules as to when a country could or should do this. As a result, this system has been called “**limited anarchy**”. Because of various problems that resulted from this anarchy (one country trying to gain an advantage over another), the governments of the largest trading countries have tried to create some order.

The situation from 1980 to 1985 was described in Chapter 7. There it was noted that high American real interest rates (combined with an expectation that the American dollar would appreciate) led to an appreciation of the dollar (a strong dollar). The exchange rate of the dollar rose by 78.7% between January of 1980 and January of 1985. American exports were badly hurt while American imports soared. The strong dollar was also not good for foreign countries because it hindered their attempts to reduce inflation rates. (The strong dollar raised the prices of their imports and also provided a reason for workers in the foreign countries to demand higher wages.) In September of 1985, the finance ministers (called the Secretary of the Treasury in the United States) and the central bank governors of the Group of 5 met at the Plaza Hotel in New York. (The Group of 5, or G-5, included the United States, Japan, Germany, France, and Britain.) In the so-called *Plaza Accord*, they agreed to depreciate the American dollar. This means that all five countries would sell dollars in the foreign exchange markets so as to reduce its value. Indeed, from that time until early 1987, the dollar fell 28.5% in value. Then, in 1987, the members of the Group of Seven (G-7) countries met at the Louvre in Paris (the G-7 includes the G-5 countries plus Canada and Italy.) In the so-called *Louvre Accord*, they agreed that the dollar should no longer be depreciated. Instead the dollar exchange rate should remain stable. (This meant that the central banks would buy or sell in foreign exchange markets if the dollar exchange rate changed by more than 5% in either direction.) And indeed, the dollar exchange rate changed very little on average between 1987 and 1995 (although it did vary beyond the prescribed 5% band on a few occasions)

Test Your Understanding

Draw the demand and supply curves for British pounds as of 1985. Label the exchange rate as P_1 . Then, show on the graph the results of the decision made at the Plaza Accord in 1985. What was the Federal Reserve Bank in New York committed to do? Show this on the graph. What was the Bank of England committed to do? Show this on the graph. Finally show the resulting depreciation of the dollar.

As will be discussed in Chapter 28, from 1995 to 2000, the United States pursued a *strong dollar policy*. The strong dollar was seen as one means of allowing the Federal Reserve to maintain the low interest rates necessary to increase business investment spending. **This means that, if the dollar had been weak, the Federal Reserve might have seen a need to raise interest rates as a way to appreciate it.** It might have done so because a weak dollar would increase American exports and reduce imports, thereby increasing aggregate demand (total spending) in the United States enough to increase the possibility of inflation. *Keeping the dollar strong would reduce exports by making them more expensive. It would increase imports by making them cheaper. Some imported products are used in production; cheaper imports would reduce costs of production. The combination of reduced export demand and lower costs of production would act to keep inflation low. Low inflation would reduce any need for the Federal Reserve to raise interest rates.*

How did the United States maintain a strong dollar from 1995 to 2000? **First, because of the strength of the American economy and the low rate of American inflation, foreigners found the United States a very good place in which to invest their money (both portfolio and direct investment).** To invest in the United States, they needed American dollars. Their demand for American dollar acted to appreciate (strengthen) the

dollar. **Second, the Clinton administration spoke frequently about a stronger dollar. This created an expectation that the dollar would indeed become stronger.** As foreign people believed the dollar would become stronger, they chose to buy it. Their buying of the American dollar did indeed make it stronger (a self-fulfilling expectation). **Third, the Federal Reserve intervened in the foreign exchange markets in order to strengthen (appreciate) the dollar.** To do so, the Federal Reserve bought dollars (sold foreign exchange) in the foreign exchange markets. (By agreement, the central banks of Germany, Japan, and the other G-7 countries did the same thing in their own markets.) The strong dollar policy was undertaken without any international agreement. It worked to benefit the United States. But as we will see below, it also acted to hurt some other countries.

Test Your Understanding

Draw the demand and supply curves for Argentina pesos as of 1995. Label the exchange rate as P_1 . Argentina had committed itself to keeping its exchange rate absolutely fixed against the American dollar. Now, show on the graph the results of the decision made by the United States to have a strong dollar policy. What was the Federal Reserve Bank in New York committed to do? Show this on the graph. What was the central bank of Argentina committed to do? Show this on the graph. As the dollar strengthened, so did the peso. What effects would this have on the economy of Argentina?

International Financial Crises of the 1990s

The 1990s were a period of severe financial crises. The first involved Europe in 1992. A second involved Mexico in 1994. A third involved East Asia in 1997. A fourth set of crises involved Russia and Brazil in 1998. And a fifth set of crises hit Argentina in 2000 and Turkey in 2001. All of these crises followed a large increase in portfolio investment, especially short-term portfolio investment. (Portfolio investment involves lending to people in another country.) Advances in communications have made it possible for money managers to move billions of dollars around the world very easily. (About \$2 trillion is exchanged on foreign exchange markets every day.) In this chapter, we will consider each of the crises in turn. Then, we will discuss role of the International Monetary Fund (IMF). There have been many criticisms of their role. A final section will provide conclusions.

The European Crisis of 1992

The origin of the European crisis began with the reunification of Germany in 1990. When (the former communist) East Germany and West Germany were reunified, West Germany was much richer and more productive than East Germany. In order to bring the two regions into greater balance, **Germany undertook a major program of spending in the east.** Fearing that this large increase in government spending would cause inflation, **the German central bank responded by raising German interest rates.** The increase in German interest rates attracted portfolio investment from people in the United States, Japan, and the rest of Europe. This portfolio investment increased the demand for German marks. **The increase in demand caused the German mark to appreciate.**

The appreciated mark should have reduced German exports, offsetting some of the expansionary effect of the large increase in government spending.

The appreciation of the German mark created problems because, as was discussed in Chapter 26, **the countries of Europe had agreed to keep their exchange rates fixed as part of the European Monetary System.** In order to maintain a fixed exchange rate with the German mark, the central banks of countries such as Britain, France, Sweden, and Italy would have to increase their own interest rates. Given the economic situation these countries faced at the time, an increase in interest rates would have decreased aggregate demand (total spending) in these countries and plunged these countries into recession.

At first, the leaders of these countries pledged that they would do whatever was necessary to maintain the fixed exchange rates. Although these leaders stated that they were willing to accept the risk of a recession, foreign exchange speculators (especially one George Soros) did not believe them. **A speculator is one who tries to gain income by buying one currency and selling another, hoping that the price of the one bought will rise and the price of the one sold will fall.** The speculator is gambling. As we have discussed with fixed exchange rates before, a situation such as that of Europe in 1992 presents a great opportunity for these speculators. The great opportunity is to “bet” that the French Franc, British pound, Italian lira, and Swedish crown would lose value in relation to the German mark. That is, the speculators bet that these countries will not accept a recession and therefore will not maintain the fixed exchange rate. The speculators would “bet” by buying German marks and selling French Francs, British pounds, Italian lira, and so forth. If the speculators are right and the fixed exchange rates are not maintained, they can make a great amount of money. If the speculators are wrong and the fixed exchange rates are indeed maintained, they can sell the German marks they bought and get their money back. Either they win or they break even. Not a bad deal for a gambler.

Test Your Understanding

Show on the graph the demand for German Marks on the part of the British. Also show the supply of German marks. Finally, show the equilibrium exchange rate (from the point of view of the British). Then, show the actions of the Bank of England in maintaining the fixed exchange rate against the German mark.

Some of the countries tried to maintain their exchange rates. They bought their own money. So for example, Britain bought British pounds in the foreign exchange markets. The Bank of England paid for these pounds by using the reserves of other currencies that it had accumulated. It has been estimated that the Bank of England lost \$7 billion of its reserves in just a few hours by this process. The Bank of England could not go on losing reserves at this rate. So after awhile, it abandoned the system of fixed exchange rates. Britain did not become part of the European Monetary Union and, as of this writing, still uses the pound instead of the Euro. Another example was Sweden. At one time, it raised one of its interest rates to over 500%. But the speculators kept on selling Swedish crowns. Eventually, Sweden too was forced to abandon the system of fixed exchange rates.

In a few months, the system of fixed exchange rates was over and a new system of floating exchange rates had begun. The system had been undone by the economic

differences between the member countries and by the actions of the international foreign exchange speculators. George Soros has made billions of dollars. Later in the decade, most of the countries of Europe decided to try fixed exchange rates once again. Only this time, they decided to move to eliminate their national currencies entirely and create a common currency, the Euro. This way, their system cannot be undone by speculators buying one of their currencies and selling another (just as speculators cannot sell California money and buy Texas money).

The Mexican Crisis of 1994-1995

The crisis that began in Mexico in 1994 came as a surprise, as there was no reason to expect it. Mexico's government budget was in balance in 1994. There was no reason to expect any significant inflation. Mexico had privatized its government-owned businesses and had opened its financial sector (allowing foreign financial institutions to operate freely in Mexico). Mexico had joined with the United States and Canada in a Free Trade Agreement (NAFTA). The exchange rate between the Mexican peso and the dollar seemed to be about at the right level (3.4 new pesos per dollar). The Mexican crisis shows how the expectations of international foreign exchange speculators can affect economies. It also illustrates how volatile these expectations can be --- that is, how easily they can shift.

The year 1994 was a presidential election year in Mexico. That year began with a guerilla uprising in the province of Chiapas. The year also saw several political assassinations. To the foreign exchange speculators, these events indicated that there could be growing political instability in Mexico. The speculators acted by selling Mexican pesos and buying dollars. Mexico tried to keep the exchange rate stable at 3.4 pesos per dollar by buying pesos (selling dollars) in the foreign exchange markets. In 1994, Mexico spent about \$50 billion of its reserves to stabilize the peso. By the end of the year, Mexico had nearly run out of dollar reserves, with only about \$5 billion left. At that point, Mexico had to let the peso float. By early 1995, the peso was trading at over 7 pesos to the dollar.

The problem for the Mexican government was that it had borrowed \$23 billion from American financial institutions. It had done so by selling short-term securities (called "tesobonos") that were tied to the American dollar. This means that the American lenders would be protected against any depreciation of the Mexican peso. As the peso depreciated, the Mexican government would need more and more pesos to buy the dollars to be able to pay its debts. This increased the possibility that the Mexican government would have to default on its debts, especially as Mexico had only \$5 billion left in dollar reserves and owed \$23 billion in tesobono debts. Defaulting on its debt would have caused Mexico's foreign trade to decline drastically, a catastrophe for Mexico. (Much foreign trade is financed with debt. If the Mexican government defaulted, lenders would be very reluctant to lend the money to finance trade.) The other option for Mexico was to raise interest rates in Mexico to try to keep the exchange rate stable (by attracting dollars). But doing so would have generated a severe recession in Mexico --- also a catastrophe. Mexico did not have good options.

In this crisis, the problem was resolved by the United States government. The administration of President Clinton made a \$40 billion loan to Mexico, bypassing the Congress of the United States. The IMF also loaned Mexico a significant amount of dollars. These loans allowed the Mexican government to have enough reserves to maintain the exchange rate and also allowed it to be able to refinance its loans. When these new loans were made to Mexico, the excessive pessimism of the international foreign exchange speculators died down. They began to remember that Mexico was basically a healthy economy. The crisis of Mexico was short (about six months) and was followed by a return to economic growth. Mexico was able to repay its loans to the United States and the IMF ahead of schedule. However, Real GDP in Mexico did fall by about 10% from the middle of 1994 through 1995, causing great economic problems for the Mexican population.

Test Your Understanding

Show on the graph the demand for Mexican pesos on the part of the Americans. Also show the supply of Mexican pesos. Finally, show the equilibrium exchange rate as 3.4 pesos equals \$1. (You will have to show this as \$0.29 equals one peso). Then, show the results of the actions of the speculators. Finally, show the results of the actions of the Bank of Mexico in acting to keep the exchange rate stable.

The East Asian Crisis of 1997-1998

For many years, the countries of East Asia had been models of economic success. As with Mexico, few suspected that this area would experience the most significant financial crisis since the end of World War II. The crisis began in 1997 in Thailand. Between 1986 and 1996, the Thai GDP had grown at the very rapid annual rate of over 9% per year. The country had grown from a very poor country to a middle-income country. The Thai government's budget was in surplus. Inflation was relatively low.

Thailand had maintained a fixed exchange rate against the American dollar of 25 baht to one dollar. As we saw earlier, the dollar became strong after 1995 as part of the economic strategy of the Clinton administration. By keeping its exchange rate fixed to the dollar, the Thai baht also became strong (that is, it appreciated in value). That made Thai exports more expensive. In addition, the world demand for electronic components weakened in 1996. Thailand was a major manufacturer of these electronic components. As a result, Thailand's exports declined and it experienced a trade deficit.

Thailand's finance companies had financed some of the growth of the economy by lending to Thai consumers and businesses. They had raised some of the money to lend by borrowing from foreign financial institutions. This borrowing was often for a very short time period and commonly required the Thai finance companies to repay the foreign financial institutions in dollars. This had not been considered a problem, as the exchange rate was fixed. The foreign financial institutions were only too happy to lend to Thai finance companies because the interest rates they could get in Thailand were several points higher than the interest rates at home. But when exports declined in 1996, the Thai economy slowed considerably. Some of the loans of these finance companies had been to people to buy stocks. With the slowed economy, stock prices fell 35% and many of the Thai borrowers could not repay their loans. Other loans had been made to buy property for development. But it was becoming apparent that there was too much

building being done. Some of the property would not earn the expected income, leaving those borrowers also unable to repay the loans. By the beginning of 1997, some 20% of the loans the Thai finance companies had made to Thai businesses were “non-performing” (meaning that the payments that were due were at least six months late). Depositors in these finance companies became anxious about the ability of the finance companies to survive. This anxiety led the depositors to withdraw their deposits.

The above analysis focuses on the problems within Thailand. But to understand the nature of the financial crisis more fully, we need to examine the financial institutions in the United States and Europe. One of these financial institutions played a prominent role --- hedge funds. There are perhaps 3,000 **hedge funds** in existence. **A hedge fund raises money from rich investors. The money is used to speculate in the foreign exchange market.** One technique in such speculation is called **short selling**. One does this when one believes that the price of something will fall. **A short seller borrows a financial instrument and then sells it at the current price. He or she will then buy the instrument at a later date and pay back what has been borrowed.** If the seller is correct and the price falls, the short seller can buy the instrument back at a lower price than was received and pocket a nice profit. Seeing the rising trade deficits in Thailand, the slowing economy, and the problems of the Thai finance companies, some hedge funds (including the one run by famous financier George Soros) began to sell the Thai baht short. In a free market, the price of the Thai baht would fall because of this selling. But the Thai government was committed to a fixed exchange rate. To maintain a fixed exchange rate, the Thai central bank would have to buy baht in the foreign exchange market. It would pay for them with its reserves, depleting the balance of \$38 billion. Notice that the central bank buying baht decreases the money supply (of baht) in Thailand. A decrease in the money supply causes interest rates to rise. Higher interest rates act to reduce aggregate demand (total spending). This reduction in aggregate demand was the opposite of what was needed as the Thai economy was weakening.

Despite the attempt of the Thai central bank to maintain the fixed exchange rate, the hedge funds continued to sell the Thai baht short. While this was happening, the foreign lenders were demanding that the Thai finance companies repay their loans. (In the past, when the short-term loans came due, the foreign lenders would simply make new loans. But this time, they would not.) Therefore, the Thai finance companies had to sell baht to get the dollars they needed to repay these loans. All of this selling made it harder and harder to maintain the fixed exchange rate. Within a few months, the reserves that had once totaled \$38 billion were nearly gone. Finally, the central bank could no longer maintain the fixed exchange rate and the baht was allowed to float. It fell from 25 baht to the dollar to 56 baht at one time.

The problem for Thailand was compounded by some very poor decisions by the IMF. As it had with Mexico, the IMF agreed to lend \$4 billion in reserves to Thailand. Combined with loans from Asian nations and the World Bank, the total amount loaned to Thailand came to \$17.2 billion. **But as a condition of the loan, the IMF insisted that Thailand raise taxes and also reduce government spending by an amount equal to 3% of GDP.** The conditions imposed by the IMF have been called “**austerity**”. They involved reducing government spending (and possibly raising taxes) to reduce or eliminate the budget deficits as well as decreasing the money supply (with the resultant

rise in interest rates). Combined with the decline in exports and the decline in the money supply, these policies created a very severe recession. In 1998, GDP declined in Thailand by a 10% -- an enormous decline in one year. Unemployment rose from 2% to 6% while wages fell by an average of 8%. The IMF later admitted its mistake and the Thai government began to undertake policies to expand aggregate demand (total spending). These policies plus the closing of the financially distressed finance companies began to bring about some economic recovery.

Test Your Understanding

Show on the graph the demand for Thai Baht on the part of the Americans. Also show the supply of Thai Baht. Finally, show the equilibrium exchange rate as 25 baht equals \$1. (You will have to show this as \$0.04 equals one baht). Then, show the results of the actions of the hedge funds. Finally, show the results of the actions of the Thai central Bank in acting to keep the exchange rate stable.

The decline of the Thai baht set off a speculator panic. In July of 1997, investors started selling the Philippine peso, forcing it to depreciate. A few days later, investors started selling the Malaysian ringgit, forcing it to depreciate.

Test Your Understanding

Imagine that you are the money manager for a large international financial company. Why would you start selling Philippine pesos and Malaysian ringgit just because the Thai baht had depreciated? After all, there seemed to be no economic problems facing the Philippines or Malaysia.

Within a few days in July of 1997, the speculator panic spread to Indonesia. From 2400 Indonesian rupiah per dollar, the rupiah depreciated to 15,000 per dollar within six months. Production in Indonesia fell 14% in 1998, one of the largest declines in a year ever experienced by any country. Real wages fell 30% in rural areas and 40% in cities. This occurred in a country that had averaged growth in Real GDP of 7% per year from 1979 to 1996 and had not experienced any significant inflation. Millions of Indonesians fell into abject poverty. The result was large-scale unrest that ultimately forced the President of Indonesia to resign in May of 1998.

Part of the problem in Indonesia resulted from its own economy. Despite considerable economic success through 1996, **the Indonesian economy was beset with corruption and nepotism.** Indonesian banks had been forced to make business loans to members of the President's family. By 1997, perhaps 25% of these loans were not being repaid. In addition, Indonesian banks and corporations had borrowed heavily from foreigners because foreign interest rates were lower than those at home. These loans had to be repaid in dollars. As the rupiah depreciated, these banks and corporations had a more difficult time meeting their debt obligations to foreigners. As the poor condition of the Indonesian banks became known, there was a large run on the banks. Indonesian people were taking their money out of the banks and then trying to get their money out of the country. (This means that they would sell their rupiah in the foreign exchange market in order to open accounts in the United States, Europe, or Japan.)

The IMF entered the picture in November of 1997. **It created a package of loans worth \$33 billion.** This means that the \$33 billion could be used to buy rupiah on the foreign exchange markets in order to keep the rupiah from depreciating. Once the rupiah was supported, it was hoped that the speculator panic would subside. **The deal with the IMF required the usual austerity --- contracting the money supply and keeping interest rates high.** The austerity policy helped worsen the recession in Indonesia.

Test Your Understanding

Show on the graph the demand for Indonesian Rupiah on the part of the Americans. Also show the supply of Indonesian Rupiah. Finally, show the equilibrium exchange rate as 2400 Rupiah equals \$1. (You will have to show this as \$0.0004 equals one rupiah). Then, show the results of the actions of the speculators. Finally, show the results of the actions of the Indonesian central Bank in acting to keep the exchange rate stable.

The crisis next spread to **Korea**, an economy that had been one of the most successful in the world. Per capita income in Korea in 1996 was about 100 times the level it had been in 1953. But the resulting recession of 1998 would reduce Real GDP by 7%, reduce real wages by 10%, and increase the unemployment rate to nearly 9%. The story in Korea is similar to that of the other East Asian countries. Some Korean banks were in trouble, plagued by a significant number of loans that were not being repaid. Korean corporations were heavily in debt (about 80% of assets of Korean corporations were financed by debt compared to about 50% of assets for American corporations). Many of these loans had been with foreign banks, because interest rates there were lower. Much of this borrowing was short-term and had to be repaid in dollars.

The behavior of financial institutions has been called **“herding behavior”**. Faced with potential losses from loans in Thailand and Indonesia, financial managers started to reduce their holdings in other countries that they saw as similar. (Each manager was afraid that other financial managers would sell off their holdings, causing the value of those holdings to decline. Fearing this, each financial manager would sell his or her holdings in order not to be blamed for failing to spot a trend that was obvious to everyone else.) This means that foreign banks that had extended loans to Korean companies were demanding payment in full as the loans came due. Korean companies scrambled to buy the dollars they needed, causing the Korean won to depreciate (from 915 to the dollar to 1,712 to the dollar by December of 1997). Korean companies never considered default because they feared they would never be able to get the loans they would need in the future if they did default.

As with the other East Asian countries, **Korea arranged a loan from the IMF**, this time for \$57 billion, the largest such program ever undertaken by the IMF. Of course, the IMF support program came with the usual conditions of **austerity**. As large as it was, the \$57 billion was not large enough to deal with Korea’s short-term foreign debt. The crisis continued and there was great fear that Korea would have to default on its loans. So, in this case, something new was added --- what has been called a **“bail in”**. Under the leadership of the American Federal Reserve Bank of New York, those banks that had loaned to Korean banks and corporations were persuaded to roll over their loans and also to convert these loans from short-term to longer term. These banks gave up \$22 billion of short-term loans in exchange for bonds that were fully guaranteed by the Korean government. The foreign banks suffered no losses despite lending large amounts of

money to Korean companies that were already excessively in debt. The Korean people, of course, were not so fortunate --- suffering the effects of a short but sharp recession.

Test Your Understanding

There are certainly three contributors to the Asian financial crisis. One is the Asian countries themselves --- their banks, their businesses, and the governments. A second is the foreign (especially American) financial institutions, especially the speculators. And a third is the IMF. Write a short essay describing how each of the three contributed to the Asian financial crisis of 1997-1998. If you had to assign blame, which of the three deserves the most blame? Why?

By the end of 1998, Korea and Thailand began to recover. By early 1999, the crisis was essentially over, except for Indonesia. We will discuss the IMF in more detail below.

The Financial Crisis Spreads to Russia

The transition from communism to capitalism in Russia is discussed in Chapter 28 of Microeconomics on my web site. By 1997, Russia had become one of the most popular destinations for financial managers in the United States and Europe to invest their money. Portfolio investment in Russia was high yielding. The stock market was rising. And there was a belief that if any problem occurred, Russia would be bailed out by the IMF. Russia, after all, was too big and too nuclear to be allowed to fail.

By 1997, Russia had a government budget deficit. As with any other country with a government budget deficit, it financed this deficit by borrowing. The Russian government borrowed on a short-term basis from foreign financial institutions. (These were called GKO's.) Unlike the Asian countries, these loans were payable in rubles, not dollars. But the ruble – dollar exchange rate had been quite constant. The foreign financial institutions liked these loans because they paid interest rates in the 20% to 30% range and because their short term (3 months) made the risk seem low.

By early 1998, foreign financial institutions became less willing to buy the Russian government debt. First, the recession in East Asia reduced the demand for oil and natural gas, Russia's main export. Second, because of herding behavior, the problems of East Asia caused financial managers to look more negatively at all emerging markets, including that of Russia. Faced with the unwillingness of foreign financial institutions to lend the money it needed, the Russian government was forced to raise the interest rates it would pay. In one month, these interest rates topped 150%.

The reduced willingness of the financial institutions to lend to Russia should cause the Russian ruble to depreciate (because fewer people were buying it). Both the Russian government and the IMF desired that the ruble – dollar exchange rate remain stable. So, in July of 1998, the IMF arranged for a \$22.5 billion loan to Russia to help support the ruble-dollar exchange rate. In return, Russia promised to lower its budget deficit significantly (partly by collecting the taxes due from those that had been avoiding paying their taxes). In addition, part of the short-term debt of the Russian government was exchanged for longer-term bonds. These bonds were to be repayable in dollars.

The new bonds of the Russian government had been bought mainly by Russian private banks. The Russian banks had paid for these bonds by borrowing in dollars from foreign financial institutions. As the government increased the supply of these bonds (and it

increased considerably), their prices fell. As the bonds of the Russian government fell in price, the value of the assets of the Russian banks declined. The foreign financial institutions feared that the Russian banks would not be able to pay their debts. So the Russian banks received calls from the foreign financial institutions to pay their debts immediately. Hearing this news, the Russian people feared a collapse of the Russian banking system. Because of this fear, they withdrew their accounts at the Russian banks and tried to convert them into dollars. As the runs on banks continued, the Russian banks could not pay their debts to the foreign financial institutions. **Ultimately, on August 17, 1998, Russia defaulted on its international borrowing.** Because of Russia's default, foreign investors lost considerably. This changed their market psychology, causing them to refuse to lend to other countries for which they thought that the Russian experience could possibly be repeated.

Test Your Understanding

Make-up a balance sheet of a Russian bank. For one of the assets, be sure to show the long-term bonds of the Russian government. Show how the decline in the price of these bonds could cause the Russian banks to become insolvent (review Chapter 20). Why would this threat of insolvency cause a run on the Russian banks – first by foreign lenders and then by Russian depositors?

The Financial Crisis in Argentina

Argentina is a country that had once experienced extremely high rates of inflation (almost 5,000%). But inflation had been reduced greatly by 1991. From 1991 to 1997, the Argentine economy grew at the very high annual average rate of over 5% per year. **Argentina was one of the countries that followed the “golden straightjacket” most closely.** There had been a large reduction in the government budget deficits, mainly through reductions in government spending. Many government-owned enterprises were privatized – telephone, water, oil, gas, electricity, railroads, subways, airlines, and even the postal service. As of now, only one of the ten largest banks in Argentina is owned by natives of Argentina. Restrictions on foreign direct investment into Argentina were eliminated completely. Wages were held down. The Argentine currency, the peso, was tied precisely to the American dollar. (This was similar to the old gold standard, only with the American dollar serving the function that gold had played. Argentina could not increase its own money supply unless it had an equal amount of American dollars in its reserves.)

While Argentina had increased its exports greatly, its exports were not sufficient to pay for all of its imports. So Argentina had to rely on foreign borrowing to make up this difference. This borrowing from other countries became the only way for Argentina to increase its reserves of dollars and therefore to be able to expand its economy by increasing its money supply (since the peso was tied precisely to the dollar). But given the past history of the country, foreign lenders were unwilling to lend on a long-term basis. So, most foreign lending was for one year or less.

Then, a series of unfortunate events occurred for Argentina. Brazil devalued its “real”; this gave Brazil an advantage over Argentina in the export market. This disadvantage for Argentina was significant in that about 1/3 of Argentina's exports had gone to Brazil. In 2000 and 2001, oil prices rose, increasing Argentina's imports. And

the global economic slowdown, especially the recession in the United States starting in 2001, reduced the demand for Argentina's exports. Thus, Argentina's trade deficit increased, as did its need for borrowing.

By 2001, the Argentine people were showing signs of significant opposition to the cuts in government spending programs. This worried the foreign lenders. To induce the foreign lenders to keep lending to Argentina, interest rates were increased. Despite this, foreign lending to Argentina slowed. This should cause the peso to depreciate (as fewer people would be wanting it). But Argentina had fixed its exchange rate precisely to the dollar. To maintain this exchange rate, Argentina's reserves declined by 40%. The IMF also loaned money to Argentina to be used to support the peso. But the IMF required that government spending be reduced sufficiently to eliminate the budget deficits altogether, further inflaming the opposition.

When the President de la Rúa, took over in December of 1999, he raised taxes, cut government spending again, and had a labor flexibility law passed. As of the beginning of 2002, unemployment in Argentina was running at 18% and Argentina had defaulted on \$132 billion worth of short-term loans.

Test Your Understanding

1. In what ways were the crises in Russia and Argentina similar to the ones in East Asia?
2. From reading this section, do you believe that the crises in Russia and Argentina would have occurred if there had not been the previous crises in Mexico and East Asia? Why or why not?

Some Lessons from the Financial Crises

There is no agreement as to what has been learned from the international financial crises (this chapter did not describe similar crises affecting Brazil in 1998 and Turkey in 2000) or what can be done in the future. Many economists debate the specifics of a new "international financial architecture". But there are some similarities worthy of note.

First, all of the countries experiencing financial crises in this period had maintained fixed exchange rates against the American dollar. There are many advantages in fixed exchange rates, as noted in earlier chapters. **But the unwillingness to depreciate the currency when it was needed forced these governments to raise interest rates to very high levels, reduce government spending, and raise taxes. All of these measures brought on very severe recessions.** The fear of depreciation caused many natives to take their money out of their own countries. Much of the money the IMF loaned to the countries experiencing crisis ended up in accounts in New York, London, or Switzerland owned by the wealthy people of those countries. Today, fewer countries are using fixed exchange rates. **Second, all of the countries that experienced financial crises in this period had relied on short-term foreign borrowing.** Much of this debt was denominated in American dollars. The fact that these debts were denominated in American dollars made it hard for the governments to these countries to depreciate their currencies (as that would raise the cost of paying back these loans and risk default). Chile now acts to tax foreign capital that is loaned for only a short period. Some have suggested that emerging countries use this method to reduce their reliance on short-term borrowing. **Third, short-term portfolio investment is subject to seemingly irrational contagion ("herding behavior").** Financial institutions started getting rid of loans to emerging countries that had no major economic problems as a part of this contagion. Problems

spread and the entire global economy is put at risk. **Fourth, the countries themselves were responsible for some of the problems.** All had had budget deficits. Many had problems within their banking systems. And many were rife with corruption. **Fifth, there were some problems with the institutional institutions, especially the IMF.** These are discussed below. **Finally, these financial crises ended when the foreign lenders agreed to write down some of the debt and reschedule the rest with longer repayment periods.** Getting the private foreign financial institutions to agree to do this proved very difficult. Yet most of the crises were over in a relatively short period. In all but one of the countries experiencing these crises, economic growth has resumed. Globalization has brought many benefits to both rich and poor countries, as noted in the previous chapter. But globalization has definitely made economic life around the globe much more risky.

Assignments

1. This chapter has given a brief survey of each of the financial crises. Form into groups. Go to the Internet. Choose one of the above crises. Find the information you need. Write no more than two pages providing a much more detailed explanation of the crisis and the steps that were taken by all parties. Bring the story up to the current date for the country you have chosen.
2. One of the financial crises not discussed in this chapter is the crisis in Brazil in 1998. Form into groups. Find the information you need. Then, write a one-page essay describing how the Brazilian crisis was similar to (or different from) the ones described in this chapter.

The Case Against the International Monetary Fund (IMF)

Let us recall the origin of the International Monetary Fund (IMF). The IMF was created at the end of World War II as part of the Bretton Woods System (see Chapter 25). Its function was to hold the monies of its member countries. These then would be lent to countries to maintain the system of fixed exchange rates that was part of the Bretton Woods system. As we saw in Chapter 25, the system of fixed exchange rates among the industrial countries basically ended in 1973. Beginning in the early 1980s, the IMF seems to have taken on a new role. In this case, it is still lending money (mainly dollars). But now, it lends the money to Third World countries (now called emerging markets). And it lends the money with many restrictions, as we have seen in the above cases.

It is these restrictions imposed on Third World countries that have generated the greatest criticism. As we have noted, the IMF (as well as the World Bank) have been pushing a particular ideology. Some have called this “**market fundamentalism**”. As mentioned, one journalist called it the “**golden straightjacket**” and others have called it the “**Washington Consensus**” (pushed by the American Treasury Department, the IMF, and the World Bank – all located in Washington D.C.)

One main criticism of the IMF has focused on its consistent policy of promoting “austerity”. As noted earlier, austerity means that the IMF forces countries to undertake policies that decrease aggregate demand (total spending) as a condition of the loans. **The countries are forced to decrease government spending and possibly raise taxes to reduce or even eliminate budget deficits. The countries are also forced to decrease their money supply and therefore keep interest rates high.** (High interest rates help maintain the exchange rate at a time that the exchange rate would otherwise be depreciating). This policy made sense when the countries involved had a problem of

very high rates of inflation (as was true of many Latin American countries in the 1980s). But this policy has been imposed on all countries, including ones that had not experienced serious inflation. **The result of contracting aggregate demand (total spending) is a recession and the resulting high rate of unemployment and an increase in poverty.** The increase in poverty, without adequate social programs, has increased social instability in several countries.

The IMF has pushed opening markets to foreign trade as well. **Opening markets to foreign trade combined with high interest rates can lead to unemployment.** The idea of opening to foreign trade is that people and resources will shift from into production of goods and services for which the country has a comparative advantage. But with high interest rates, it is very hard for people to gain access to the money needed to start these new kinds of businesses. Often people are forced out of their old jobs (because their employers cannot compete with imports) and have no other employment available. The emphasis of the IMF seems not to have been on the increase in unemployment and poverty. (Yet, evidence shows that the overall affect of opening to foreign trade on employment in poor countries has been quite small.)

A second criticism of the IMF is that it forced the emerging countries to remove all restrictions on portfolio investment and foreign direct investment. In many cases, the restrictions were removed before the countries were ready. The result has been great instability and the financial crises described in this chapter. The argument is that most of the benefits of increased trade, portfolio investment, and foreign direct investment seem to have gone to the rich Western countries, not to the poorer developing countries. Those who argue against the IMF believe that this has occurred because the IMF and the World Bank not democratic institutions (see below). Those countries that opened themselves to the global economy gradually and without IMF conditions seem to have performed better economically.

A third criticism of the IMF comes because of its insistence at maintaining fixed exchange rates. In the countries discussed in this chapter, **the exchange rates were fixed at levels that were too high.** Maintaining the exchange rate, as we have seen, required that interest rates be high. The high interest rates hurt domestic businesses and threw many people into unemployment and poverty.

A fourth criticism involves what has been called “moral hazard”. The foreign financial institutions made loans to the developing countries believing (quite correctly) that, if the loans were in jeopardy, the IMF would provide a bail out. With the help of the IMF, the borrowing countries would be able to repay all that they owed. Knowing this, the lenders have much less incentive to be careful about their lending practices. **Instead, they have an incentive to take risks they would not be willing to take if they were the ones who had to bear the loss.** Because of this “moral hazard”, there have been calls for an international bankruptcy law similar to the Chapter 11 bankruptcy that is available to American companies.

A fifth criticism is that the IMF has focused on privatization as part of its “market fundamentalism”. We have not discussed privatization in this chapter. It is

true that government agencies may be wasteful and unproductive. But government can also be used to foster economic growth, as shown by the East Asian countries prior to 1997. Russia decided to privatize quickly at the insistence of the economists of the IMF. China has not privatized significantly yet. China's economic performance has been outstanding while Russia's has been abysmal. (See Chapter 28 of my Microeconomics textbook and my Monograph on the Chinese economy --- both on my web site).

A sixth criticism is that the IMF (and also the World Bank) is not a democratic institution. They represent basically the commercial and the financial interests within the rich countries. For example, the IMF reports to the Ministers of Finance (called the Secretary of the Treasury in the United States) and to the heads of the central banks. The policies of the IMF affect millions of people in the developing countries. But these countries have no real say in the formulation of these policies. In the United States, the Secretary of the Treasury almost always comes from a large Wall Street investment company.

Also, the conditions imposed by the IMF have undermined national sovereignty and corrupted domestic politics in the developing countries. This is important because reforms in developing countries have generally not worked unless large numbers of people in those countries were in support of them.

Test Your Understanding

Form into groups of three. Go on to the Internet. Do a Google Search under IMF to find the information you need. This section has provided the criticisms of the IMF. Write a paragraph or two naming some of the arguments used by the IMF to defend itself against these criticisms.

Conclusion

The 1990s experienced some of the most severe financial crises the world has seen since the 1930s. It is important that the world not repeat the experience. It does seem that those countries that have closely followed the "Washington Consensus" have not done well economically on the whole. And what economic growth they have experienced seems to have been accompanied by widening inequality (see the previous chapter). On the other hand, the countries that have performed the worst (basically sub-Saharan Africa and the Middle East other than Israel) have been the least integrated into the global economy. And most of the countries that experienced a financial crisis in the 1990s recovered relatively quickly. As of now, a major debate is underway concerning what is called "**a new international financial architecture**". The hope is to find a way to make reap the benefits of globalization while avoiding the problems it has caused.

Practice Quiz for Chapter 27

- The exchange rate system since 1973 can be characterized as
 - a Gold Standard
 - a fixed exchange rate system
 - a floating exchange rate system
 - a managed float system
- The organization that lends reserves to countries that need reserves in order to maintain their exchange rates is called the
 - World Bank
 - Federal Reserve
 - IMF
 - United Nations

3. A policy of **austerity** requires which of the following?
 - a. a decrease in government spending
 - b. an increase in taxes
 - c. a decrease in the money supply
 - d. all of the above
4. The **European crisis of 1992** had which of the following?
 - a. an increase in German government spending
 - b. an increase in German interest rates
 - c. fixed exchange rates between the European countries
 - d. all of the above
5. The **Mexican financial crisis** was resolved because of a/an
 - a. loan from the United States
 - b. increase in Mexican government spending
 - c. suspension of NAFTA
 - d. appreciation of the Mexican peso

6 through 10. Match the definition with the following.

- a. Getting banks together to agree to restructure the loans of the developing countries experiencing financial crisis
 - b. Lenders taking risks because they know that if their loans can't be repaid, the IMF will bail them out
 - c. One financial manager sells a currency so all of the others have to sell it too
 - d. Borrowing a financial instrument and selling it in order to buy it back later at a lower price.
 - e. A financial institution that raises money from rich investors and uses the money to speculate in foreign exchange markets.
6. Hedge Fund
 7. Selling Short
 8. Herding Behavior
 9. Moral Hazard
 10. Bail In