

Exchange-Rate Regimes, Capital Flows, and Financial Market Instability

1. A Short History of 'Manias, Panics, and Crashes', 1980-1997
2. Theories of Financial Market Crises
3. The Economics of the Asian Crisis
4. Was the Asian Crisis good for Political and Economic Development in Asia?
5. Capital Controls Revisited
6. Moral Hazard, Argentina, and the Role of the IMF in International Financial Market Crises

Kaminsky and Reinhart 1997, p. 477 – 478

Summary: Financial Market Crises, Balance-of-Payments Crises, and Banking Crises are a Common Feature of the World we're living in.

But what determines financial market crises?

What is a financial market crisis?

What is a Balance-of-Payments crisis?

What is a banking crisis?

Three Theories of Financial Market Crises

1. Crises as Consequence of Political Failure and Ill-headed policies, (Krugman 1979)

focus: traditional balance-of-payments crises
i.e. the debt crisis, 1982 .. ≈1987

monetary and fiscal policies generate unsustainable current account deficits

investors may still finance these current account deficits if they believe they will be the first to leave the sinking ship

often: misaligned fixed exchange-rates cause huge current account deficits,

2. Herding Behavior and Irrationality

focus: the Asian crises

investors irrationally withdraw credits from otherwise stable and 'healthy' economies

initial capital flight causes a reduction in the value of assets that causes capital flight (rational herding behavior)

the first crisis affects other countries, since investors begin to remove assets from seemingly similar countries

→ self-fulfilling speculative attacks (Radelet and Sachs)

3. Twin Crises

focus: the Asian crises

the private (banking) sector in Asian countries overborrowed abroad, transferring foreign credits into domestic lending (often to family and relatives) without securing the exchange-rate risk

investor confidence declined as the private debt of Asian countries exceeded public reserves

investors stopped revolving credit lines of Asian banks

Banking crisis and runs on banks

the government had to spend reserves on private debts

public debt rose, the exchange-rate collapsed

(Kaminsky and Reinhart, Krugman)

Summing-up

modern theories of financial market crises combine the analyses of monetary and fiscal policies with analyses of private sector behavior, especially bank behavior

The Asian Crisis

Some information

Haggard 2000: 17

The Political and Policy Consequences

Thailand:

- reformist party (Democrats) won elections of 97
- constitutional reform
- 4 letters of intent were signed to the IMF (mostly on fiscal and monetary policy reforms)

Korea:

- long-time dissident Kim Dae Jung elected
 - quote: "Democracy supports the development of the market by preventing activities like corruption."
- comprehensive corporate restructuring (Haggard 2000: 102-103)

Indonesia:

- 21 May 1998, Suharto resigned, reluctant democratization
- Habibie government
- 1999 elections Megawati's PDI-P dominant party, but seat share app. 30%
- civil wars

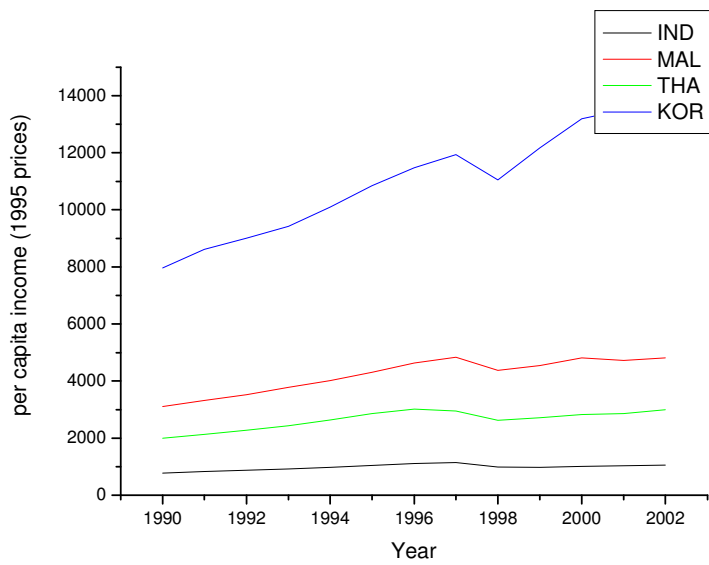
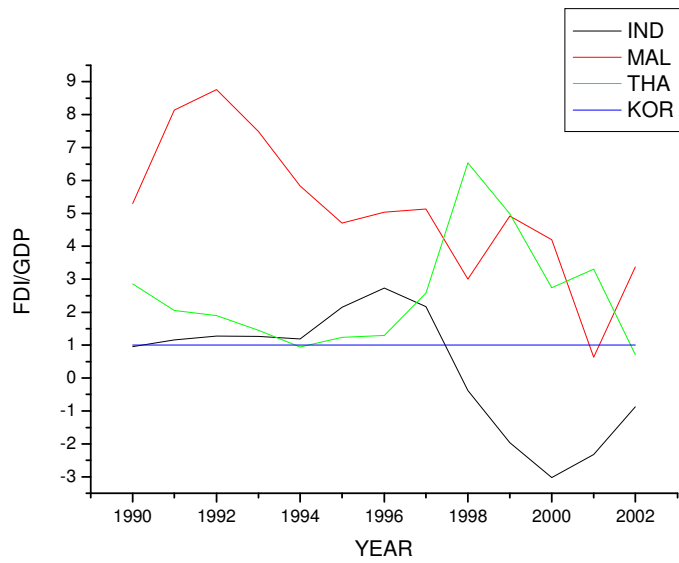
Malaysia:

- no substantive changes (Barisan Nasional Parti Islam)
(non-democratic regime that survived the crisis intact)

Sum-up: economic crises may but do not need to lead to political change,

democratization possible

FDI and Economic Growth in Four Asian Countries



Moral Hazard and the IMF

The concept of moral hazard refers to a situation, in which agents behave less risk-averse than possible because they are insured.

→ Since the IMF bails-out investors/ countries in case of a financial market crisis, the likelihood of crises increases because capital-owners invest in risky markets and because governments fail to implement a sound banking regulation and choose an unsustainable fiscal policy.

Milton Friedman among others suggested to 'abandon the IMF'.

Alternative views?