

# Global Financial Architecture

- Dr. Greg Anderson -

Essay:

“Why, and in what ways, has the stability of the international banking and financial system in recent decades been shaken by country debt and financial crisis? Illustrate your answer with reference to any two particular crisis with which you are familiar.”

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In recent decades financial crisis is a vivid concept in world economy. It took place in big economies as well as small ones. I will write about causes and effects of financial crisis in this essay which took place in the 1980s, 1990s and in 2000s. By this I will try to contrast them in the means of their characteristics. I will begin with a brief explanation of new economic system created after the Second World War and the effects of it on new economic era. I will follow by crisis in Mexico in 1980s, Thailand in 1990s, and Turkey in 2000s by mentioning about their causes and effects. At the end I will try to make some conclusions with respects to these three crises occurred in three different decades. I have written about three crises instead of two as I wanted to put a third small crisis with two big ones as I am familiar with it.

After the Second World War the Bretton Woods System is established with its institutions World Bank and International Monetary Fund. The Bretton Woods System has created a stable environment for recovery and international trade, with contributors such as Marshall Aid. In 1960s the recovery has finished and the international trade boosted thanks to convertible US dollar. New investments (waiting since the pre-war era) made and the liberal economies began to be interdependent. After the recovery of developed countries World Bank and IMF has began to deliver funds for Less Developed Countries (LDC) for development and begin to make their contributions to trade. Funds crated by them are followed by liberalisation of capital markets, and establishment of share markets. The accumulation and flow of capital as Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) contributed the prosperity in the liberal economies. In Bretton Woods System, in contrast with pre-war era; countries don't have to balance their payments, so in the new global system the countries enjoyed financing their balance of payments deficits with capital flow in. But in poor governance capital flow doesn't always goes to productive investments.

The after war economic system was depending on the expending of USA and the money flow to USA. But in the 1960s USA start to loose its competitiveness in production compared to other countries and its trade deficit has became bigger than ever. Also dealing with communism has put huge spending on US balance of payments. After the recovery European economies has started gaining strength and was on the track again so European currencies Frank and Mark has gained strength. These caused to world to loose confidence on dollar. With these pressures; at the beginning of 1970s the convertibility of US dollar has cancelled by US government.

Prosperity and investments made, created an inflationary effect in commodity prices. This gave a significant rise in oil price at the beginning and at the end of 1970s. Resulting a heavy burden on debtor countries to cover their balance of payments, and created a huge capital accumulation in OPEC countries. This capital again found place in financing balance of payments.

Stopping convertibility of US dollar started exchange rates to float. Because a debtor country pays its loan at the borrowed currency it created an exchange rate risk for debtors. That may even mean folding the debt of the country which has happened to Mexico in 1982. Sudden rise in oil prices has contributed cooling down the world economy so debtor countries which pay their debts by export earnings had difficulties even it is an oil exporting country such as Mexico. Mismanagement of funds—that funds didn't take place in productive investments rather went to excessive public spending. When the reasons above aggregated with exchange rate changes, the picture forced Mexico to announce moratorium. Mismanagement of funds mainly caused this moratorium by depleting the reserves in the central bank.

Moratorium caused private institutions to stop financing not only Mexico but other Latin America countries even they are stable or not. IMF forced to find a solution to Mexico's debt problem and created a scheme with a loan package but even that couldn't stop Mexico to suspend servicing its debt for short term. America also helped Mexico by supplying loan and aids to its neighbour for not to be a target of illegal migration which may cause unemployment in US.

Mexico's crisis has contagion to Latin America because the portion of loans supplied by private financial institutions folded in 1970s. Financial institutions such as banks or funds seeking lucrative investments may oversee some risks such as currency risk and political risks. Private institutions have no power to make deals with governments, like World Bank and IMF can do, in order to decrease risks either. Accumulation of huge amount of capital in the hands of private institutions also causes a herd effect on debtor countries. They flood so quick that funds may take wrong places and flow so sudden that may even causes a payment crisis in the debtor country.

In contrast with Mexico, Thailand in 1997s has experienced a crisis even it didn't have any budget deficits. Slowing growth and exports made pressure on Thai baht in 1996. One year later forced Thailand to diminish value of its currency which was pegged to US dollar.

*“In the first half of 1997 speculation about a possible devaluation of the baht led to an accelerating loss of foreign exchange reserves, and on July 2 the country attempted a controlled 15 percent devaluation. As in the case of Mexico in 1994, however, the attempted moderate devaluation spun out of control, sparking massive speculation and a far deeper plunge.”(International Economics Theory and Policy; 5<sup>th</sup> ed.; Paul R. Krugman, Maurice Obstfeld; page 704)*

Thai baht loosed a significant amount of value and caused financial crisis that spread to Eastern Asia, even to Southern Korea which was far away of any critical situation. We can see that investors didn't want to take an exchange rate risk and flew to calm shores. Similarities in financial crisis seen in both crisis is falling in debt/export ratio so the percentage of exports loan payments fall, probably by a recession in world economy. Increase in oil prices, especially has a big effect on oil importing countries such as Thailand that puts another burden on their balance of payment. The other cause is folding foreign debt because of change in exchange rates, and difficulties of serving them without having reserve problems. Contagion happens as the crisis has found place in other neighbouring countries as institutions start to re-assess risk parameters. Also affects other developing economies around the world. IMF has again obligated to be Lender of Last Resort (LOLR) and formed a loan package with structural reforms to sustain credibility of Thailand and other “Asian Tiger” countries.

In 2001 Turkey was using an incrementally changing exchange rate, which was under pressure and speculation for half the way it has announced. But before 2001 Turkey has experienced a big banking crisis in 2000 and a big earthquake in 1999. Earthquake affected economy deeply as the area was one of the most populated and industrialized ones. The government made an economic plan to decrease chronic inflation and that was forcing economic aspects. But everything was still so far so good in a balance. But a fight which took place at the top of the government, with prime minister and president, has collapsed the fragile balance. A portion of FPI has flown out immediately not to experience a loss under a governmental risk. This has followed by releasing pegged rate to save the reserves in central bank. That caused nearly 80% fall value of lira against to US dollars within few days. In those days central bank overnight rates reached 7000%. Financial institutions stop lending more debt to Turkey in that week and the interest rates folded. A new ministry has crated in that week as Ministry of Economics to save the situation. IMF created a loan package to turnover short-term loan. Structural changes has made to sustain the development and stability which the most important was giving central bank self governance. Earthquake slowed down economy, and banking

crisis- as government has bought all the debt of banks, has put heavy debt burden on the budget but the crisis in Turkey shows how sensitive markets to political risks. The crisis in Turkey didn't spread like the other ones as it was caused because of political reasons and has no echo geographically like others.

A debtor country serves its debt by its trade surplus fundamentally. In this concept a debtor country has to trade its interest and loan with a preferably value added product. While main source of the capital which took place in investments is from developed countries, also they are the countries which developed the technology that the LDCs invest in by building production facilities and so. The technology that took place in LDCs are mostly in moderate age meaning that they have to compete with the developed countries with a disadvantage. Financial institutions made their investments due to an expectation of a growth and in a situation of recession when the growth has been ceased they tend to take their capital to less risky, developed countries. Tax, profits, and wealth in developing countries are very vulnerable these kinds of changes as investment and loan terms start to differ. Political risk is another effect on crisis as it is less sensed in the liberal economy nowadays, and as the funds waiting to be invested are so much, but it still creates the background of a financial crisis rather than financial aspects.

Pegged exchange rates are coming with their speculations. They may help to boost the trade but it is hard to sustain it and in the end, rational or not, the rate will be broken and get out of control. Especially in the global economy, a crisis effects all markets and economies in the world and may crate a domino effect for weak or vulnerable ones.

Financial crisis has caused severe losses for private institutions, as they happen to be target even the debt may be guaranteed by the government. But the crisis hits the countries as socially as well as economically. Economists try to track or sense financial crisis before it happens but it is hard to characterize them. But it seems heavy debts compared to GDP and exports, herding effect of private investors, repeating balance of payment deficits, and pegged or fixed exchange rate is typical characteristics of them. Financial crisis are easy to contagion to other economies and this make them more expensive. IMF is obligated, especially by developed countries, and tries to deal with crisis but it is also subject to criticisms always and no body sure if IMF is successful or not in dealing with them.