International Crises and the Global Economy

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I. ABSTRACT

The increasing interconnectedness of the global financial system has made international financial crises spread very far, very fast, and made domestic financial crises spread to other countries in the region as well. Both the onset and elimination of such crises has rippling effects globally. This paper gives a (very) brief overview of international financial crises with examples. It then analyzes whether preventive or eliminative measures directed at those crises cause unacceptable damage to the global economy. It concludes that while much work has been done in reforming the financial system and some work remains to be done, it must be done so on an international level.

II. TYPES & EFFECTS OF INTERNATIONAL FINANCIAL CRISES

International financial crises can be grouped into four categories, as per the IMF (2013) – currency crises, sudden stops, debt crises, and banking crises. The former two can be classified as quantitatively definable, and the latter two as qualitatively definable, as per the distinction laid out by Reinhart and Rogoff (2009) and echoed by the IMF (2013).

A. Currency Crises

The IMF (2013) discusses three "generations" of currency crisis models. The first was applied to the currency devaluations of Latin America in the 1990s, such as the 1999

devaluation of the Brazilian real and the 1994-1995 Mexican currency crisis. According to it, investors start dumping domestic currency when they anticipate the instability and possible end of a fixed exchange rate regime due to the government running excessive deficits financed by central bank credit, they start dumping the domestic currency. The central bank consequently rapidly depletes its foreign currency reserves or liquid assets.

The second generation of models were inspired by crises such as the European Exchange Rate Mechanism (ERM) crisis of 1992 (i.e., "Black Wednesday"), which forced the United Kingdom to withdraw from the ERM. It is similar to the first generation in that it also arises from a decline in investor confidence in the government's willingness (or ability) to maintain the exchange rate regime. It is slightly different because it stresses the importance of "multiple equilibria."

The third generation of models explores how "rapid deteriorations of balance sheets associated with fluctuations in asset prices, including exchange rates, can lead to currency crises" (IMF 2013). These models were motivated by the Asian financial crisis of the late 1990s that involved, among others, Thailand, which was forced to abandon the fixed exchange rate regime with the USD and let the Thai baht (THB) freely float, leading to considerable depreciation of the THB. The Asian financial crisis is often popularly referred to as the "Asian flu."

While the definition of a currency crisis itself has evolved over time, the basics of it still stay true – rapid devaluation of depreciation of domestic currency which lead to foreign

investors divesting of their domestic currency-denominated portfolios and replacing them with investments in foreign currency-denominated assets in order to maintain the value of their portfolio.

B. Sudden Stops in Net Capital Flows

This type of financial crisis stresses more on the importance of disruptions in external financing – sudden stops in net capital flows (which can either be due to reduced inflow of foreign capital or increased outflow of domestic capital). These models can account for the current account reversals and the real exchange rate depreciation typically observed during crises in emerging markets. Such sudden stops can either precede or succeed currency or banking crises, and therefore often act in tandem with other crises.

Such declines in net capital flows are usually preceded by an asset price "bubble" – an episode of large and sustained increases in asset prices (Reinert, 2012, pp. 309). Vogel (2010) explains that bubbles occur when assets trade at prices which are higher than their true value, which leads to speculative trading. When this mass exodus of capital occurs, it leads to a period of asset price deflation, as demand for those assets drops significantly.

The currency crises in Asia in the late 1990s was succeeded by a sudden reversal of capital flows as investors lost confidence in the economies of Thailand, Indonesia, and Philippines, among others.

C. Domestic and Foreign Debt Crises

Both types of debt crises are similar in that they involve sovereign default on debt obligations to creditors or the substantial restructuring of this debt. Such a debt crisis is caused after a period of large capital inflows into the country, i.e., investors buying large amounts of public debt. When it becomes clear to investors that their debt will not be repaid, it leads to a mass exodus of capital. Therefore, such debt crises also lead to rapid capital outflows. Indeed, many of these crises seldom occur in isolation, and most major financial crises have involved the breakdown of multiple financial systems of a country or groups thereof.

An example of a debt crisis is the European Sovereign Debt Crisis which occurred during the Great Recession ("the recession"), specifically the part of it concerning Greece. After its 2009 general election, Greece announced a budget deficit forecast of 12.7% of GDP, double the previous estimate (Lane 2012), and revisions of fiscal accounts showed much larger deficits. These high debt figures coupled with the effects of the recession made it clear that Greece was not creditworthy, and it could not repay the debt without massive sovereign debt restructuring financed by the IMF, European Central Bank (ECB) and European Commission (EC).

D. Banking Crises

These involve the occurrence of bank runs, shutdowns, mergers, bailouts, etc. that break the banking machinery of a country or groups thereof. Both Reinert (2012) and the IMF (2013) say that the fragility of banking institutions is due to their role in borrowing short-term and lending long-term. Any loss of confidence in the banking system can lead

to phenomena such as a bank run, where large numbers of depositors try to withdraw their money and other liquid assets from a bank, which leads to the bank running out of money and having to liquidate its assets, highly increasing the likelihood of a collapse as liquidating assets worsens its financial stability.

A common example of a banking crisis is the collapse of Lehman Brothers during the Great Recession. It had heavily invested in mortgage-backed securities and acquired many mortgage lenders. As the housing bubble started to burst, mortgage defaults reached new highs, with major impacts on the firm's earnings and loss of investor confidence. It eventually declared bankruptcy.

III. ELIMINATION

In a Tedx talk, Michel Girardin (2020) of the University of Geneva said that financial crises have been happening since 1471, every ten years on average, frequently for the same reason – too much debt in the financial system. Lund et al. (2018) echo this fundamental idea, saying "It all started with debt," about the recession. Indeed, we can see from the examples above that in all major categories of financial crises, debt plays a notable role, either directly or indirectly.

Russia's sovereign debt default of 1998 led to a "massive" devaluation of the ruble (RUB) (i.e., a currency crisis – as established before, a financial crisis is seldom confined to just one breakdown in the financial system) led to some experts questioning the idea of an integrated global financial system, as private capital flows from developed countries to

less-developed countries (LDCs) mushroomed by 764% between the 1980s and 1990s (Summers 2000).

Yet as we know, this did not lead to a drive towards a complete disintegration of the global financial system, nor did it give rise to major restructuring of said system as these crises keep happening again (while the Asian flu occurred at roughly the same timeframe as the Russian crisis, we have had others such as the Brazilian currency crisis and, of course, the Great Recession). Today, investments go where returns are higher, and capital is put to use where it is most productive. This increases output and therefore consumption, leading to an overall healthy economy. The global market system's interconnectedness is paralleled by the intertwining of the financial system. While the market system uses these allocative benefits and efficiencies and brings them to fruition, the financial system's ability to introduce these benefits and efficiencies is crucial to it. Without this intertwining, the potential for growth in the emerging market and developing countries would not be able to be financed by the enormous savings of the developed countries (or rather, the citizens of those countries).

While an international financial crisis would not occur in a world full of closed economies, the kinds of economic prosperity that we have now become all too accustomed to will also cease. Hence, a considerable disintegration of the financial system is highly undesirable.

Many financial crises (notably those of Indonesia and Malaysia) partially started due to the structural linkages and spillover effects of the Thailand crisis, i.e., due to contagion. The existence of contagion is due to the intertwinedness of the global (or regional) financial system, and that one cannot have its benefits without its drawbacks (much like in monetary policy, where a country faces the impossible trinity trilemma and cannot have perfect control over all three macroeconomic objectives). Some contagion-driven drawbacks are not in the control of the financial system, such as investor irrationality and herding which has led to indiscriminatory withdrawal from multiple markets in the past (Summers 2000). Others, such as asset-market correlations can be due to capital mobility. However, free capital mobility is a fundamental policy measure towards higher economic development, especially in LDCs and emerging market economies. In such countries, restrictions on capital flows can stifle economic growth. Since such economies see rapid growth in industrial and manufacturing sectors, a decline in foreign direct investment (FDI) into such sectors can not only lead to adverse economic effects domestically but also supply-side shocks in the global markets.

However, Lund et al. (2018) note that in the decade post the Great Recession, capital flows have shifted to long-term, less volatile forms, such as FDI instead of short-term flows. This points towards a shift in strategy in the functioning of the integrated financial system than a departure from it, which does retain the benefits of said integration without the drawbacks of the excess money supply that plagued the global financial markets during the recession. It also, as Lund et al. (2018) explain, reduces the risk of contagion as banks rethink the ways in which they expand in foreign markets.

Yet, as Wolf (2019) argues, the cyclical nature of the financial system is mirrored in the cyclical nature of reforms. “We do, in fact, learn from history — and then we forget.” Borio (2012) explains that the same debt that plays a facilitating role in an economic boom becomes a “forcing variable” when the asset bubble pops and abundant cash flows fall. It is important, therefore, to contain the economic boom so that it does not, in a procyclical way, transition into a financial crisis as it becomes unsustainable. In the banking sector, adding a number of buffers such as capital and liquidity standards (as some set by the Basel Committee). We have seen such reforms be enacted in countries like the United States, which was, in many ways, the centrepoint of the Great Recession. The “too-big-to-fail” ideology was done away with, and there are stricter standards that banks have to comply with.

One of the mainstays of financial crisis resolvance has been emergency assistance in the form of loans and bailouts. Notable examples of this include Greece, which received some of the largest bailouts in history. Even though his ideas were written before the Great Recession, Dodge (2002) says that we should not be in a situation where debtors and creditors assume that official bailouts (i.e., those by the government or organizations such as the IMF) will always be a cushion to fall back on, since that would create the possibility of “moral hazard.” However, the scaleback in official assistance strategy must be calculated, otherwise it runs the risk of making the financial system too inflexible, leading to losses in output and market shocks whenever there is any hiccup.

Many scholars agree that the overconfidence of both creditors and debtors, combined with companies taking too much risk in the absence of much-needed regulatory oversight, was responsible for the Great Recession (Meier et al. 2020). Yet, unlike others, Meier et al. (2020). argue that the way forward is certainly through more oversight, but on an international level. Quoting other researchers, they say that more internationally uniform agreements and information exchange is desirable to achieve "transnational financial stability.

IV. CONCLUSION

This paper merely begins to capture the underlying issues of international financial crises (through theory and examples) and how to prevent them. However, it is clear that the creation of a more robust financial system is not contingent on reducing its international intertwinedness. Rather, it is dependent on the expansion of such international connections.

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