The Economic Crises of the Last Two Decades - Ignored Warnings

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Abstract: Analyzing the evolution of emerging economies, with their openness to foreign investments and increasing country risk, there is in the same time a high degree of international spread of crises. Unsustainable macroeconomic policies, the fragile financial system and disorderly capital account liberalization are factors that have contributed to facilitate rapid propagation of crisis on these economies through various channels.

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1 Introduction

The complexity of the current international financial system and the different way of understanding it made very difficult identifying and solving vulnerabilities that characterize the current economic system.

However, after the crises of the last decade of the twentieth century in Latin America and South East Asia, it has increased the interest of specialists in the prevention of systemic crises. Although in economic literature there is a classification by types of crises, in practice we cannot support the idea that a crisis occurred in a country belonging to a particular type of the set (currency, banking, fiscal, foreign debt). Therefore, experts call into question the theoretical concept: twin crises. Thus, there may be and currency crises and banking crises as in Asia (1997-1998), the Russian crisis (1998) and there may be foreign debt and currency crises in Mexico (1994), Brazil (1999), Argentina (2001).

In modern economic theory we across a variety of models that analyze financial crises and their impact on the real economy. Given the events, the forms, causes and effects of these crises, those who analyzed them classified them into three generations of models. The first generation models of financial crises, introduced by Paul Krugman in 1979 and developed in 1984 by Robert P. Flood and Peter M. Garbe, refers to fixed exchange rates to fluctuate around those limits as well as explicit speculative attacks on them.

According to the first generation of models, under a fixed exchange rate, well above the massive expansion of credit money demand, gradually reduces the international reserves and ultimately speculative attacks on exchange rates. Investors know that their incomes will suffer losses if they continue to have currency they sell it when the exchange rate would exist in conditions where it would not be fixed (shadow exchange rate) is equal to that fixed on the currency market.

Following these actions, foreign reserves are depleted, and the fixed exchange rate is abandoned.

Researches carried out after the Gulcin F. Ozkan and Alan Sutherland in 1995, shows that the authorities give up the fixed exchange rate and due to other variables, not only decrease of the reserves. When a country carries a fixed exchange rate, increase in international interest rates implicitly leads to increased domestic interest rate. A high level of domestic interest rate increases financing costs for that country. Thus, in a large public debt, they will argue for abandoning the fixed exchange rate. Moreover, higher interest rates weaken domestic banking system and the authorities

must devalue the currency to avoid collapse which it would be more expensive. (Chang & Velasco, 1999, p. 11)

In this first generation of models we can fit the crises in Latin America, Mexico, Argentina, Brazil. Speaking the above crises, abandonment of fixed exchange rates was followed by significant losses suffered by the banking system, massive central bank intervention in the forex market, imposing restrictions on capital mobility.

A second generation of models was introduced in 1994 by Maurice Obstfeld and he analyzes how the government chooses to respond to changes in private sector behavior. Unlike the first generation of models that focus on linearity behavior of public and private sector, the second generation of models is based on nonlinear behavior of economic agents. (Obstfeld, 1994, p. 201)

The third generation of models initiated by Paul Krugman (1999), Roberto Chang and Andreas Velasco (1999), Philippe Aghion (2001) combines the first two models and focus on private sector balance sheets in particular firms or banks with debt currency. Krugman (1999) refers mainly to a small open economy that used to produce a homogeneous good two factors of production, labor and capital according to a Cobb-Douglas production function.

This generation of models was developed after the crises in Southeast Asia considered being part of the third generation of models.

Most crises in this region were not based on monetary or fiscal policy expansionary or abandonment of fixed exchange rates by the authorities (characteristic of the crisis in the first two generations of models), unemployment and inflation were within normal limits. The real problems that led to the triggering of the crisis were the balance sheets of banks and firms. One aspect of this crisis is moral hazard, based on strong links between financial institutions and governments that yielded the imprudent behavior from creditors, bad investment decisions and excessive indebtedness.

2 The Economic Crises of the Last Two Decades

Economic and financial crises of the past two decades, and the imbalances caused by these made experts in the field to reassess the role of international finance in the global economy. Roots of these crises, both economic and financial, are common, highlighting features depending on vulnerabilities and economic policies of each countries who faced such economic shocks.

Analysis of main causes of these crises are identified as follows:

a) Disorderly Capital account liberalization

Capital account liberalization in the existence of disorder financial economic system, increased the volatility of macroeconomic events that led to the currency and banking crises in Latin America (Mexico, Argentina, Brazil), South East Asia (1997), Russia (1999), Turkey (2000).

b) engaging a fixed exchange rate regime

The danger of a fixed exchange rate regime practiced in emerging countries and we refer to crises in the last two decades, has resulted in crises that revealed the vulnerabilities of financial sector. Most of the crises started with the devaluation of national currency as a result of unsustainable monetary policies as the case of Mexico (1994), Argentina (2001) or due to increased speculative pressure on the national currency as it was the case of Thailand, South Korea (1997) and Russia (1998).

c) the unsustainability of the current account deficit

Most countries in South East Asia were faced with excessive current account deficits, financed mainly by attracting foreign capital flows for the short term. With capital mobility, most times, authorities lose control over monetary policy, and such an economy is more vulnerable to external shocks.

d) huge foreign debt

Sometimes, full mobility of capital is reflected in the indebtedness of countries that lead to external debt crises as was the case of Mexico, Argentina, Brazil, Russia, South Korea, where the external debt crisis overlapped the currency crisis.

e) increase interest rates

Liquidity problems arising in the financial system in Latin America have increased nominal interest rates and for South East Asia, it originally was intended as a measure to avoid the crisis proposed by the IMF, later becoming one of the causes which precipitated deepening crisis.

f) investment boom that led to overgrowth default volume of credit

As for actual economic and financial crisis, foreign investors and local euphoria following the rapid growth of asset prices led to increased lending often speculative purposes leaving countries more vulnerable to changes in credit availability.

Carelessness shown by the lenders in providing loans and then, East Asian crisis and now, the current crisis, shows that ignoring basic rules of caution is a serious and old problem that caused the most economic and financial crisis.

g) Poor regulation of the economy

Another factor contributing to the onset of most crises is the lack of an appropriate regulatory framework for companies and banks which allow developing unhealthy and corrupt links. This is true for the current crisis and the South East Asia, especially for South Korea.

In addition, at the origin of the crises we find causes which are less visible such as panic investors facing uncertainty, or large changes occurring in people's attitudes that Keynes called them manifestations of "animal spirit". All these irrational facts are encouraged by moral hazard that is the major cause of gravity of financial crises.

Although many economists have considered these crises, serious threats to international economic and financial stability there have been others who have considered small problems of domestic economy without affecting global macroeconomic stability.

Because of disputes, experts and policy makers have not agreed at that time, about the root causes of these crises (debate on this issue have held today) or on economic policies and reforms necessary to limit the negative effects prevention of future crises.

Financial crises of the 1990s were a surprise to many specialists even for IMF that, based on economic performance in previous decades, especially in East Asia, predicted for this region a very strong growth.

Besides the common causes that led to the onset of these crises, each of them have specific causes related by the characteristics and vulnerabilities of each economy and economic policies adopted. As a feature of Latin American crisis, it was also caused by massive government spending, relaxed monetary policy leading to higher budget deficits and inflation.

In contrast, Southeast Asian countries had budget surpluses and low inflation. A major problem in these countries was the high indebtedness of corporations (as was the case in South Korea industrial corporations). Other specific causes of crises from these regions were increased dependence on external financing in the short term, high prices of assets, especially real estate, crisis trigger being identical to the current crisis.

Causes of economic and financial crises were joined political causes that have hastened their outset, Mexico (1994), Indonesia (1997).

The Mexican economy problem was excessive value of the peso which made domestic goods prices exceed the competitiveness of the other markets. This has resulted in significant loss of exports and

imports. On the other hand, a current account deficit was not threatening the Mexican dollar reserves due to considerably increased by the end of 1993.

Mexican financial crisis of 1994 began with the devaluation of the peso resulting in more expensive debt in dollar, which caused serious problems with the solvency of the Mexic. Wanting to protect the national currency, the authorities decided to increase interest rates which caused an explosion in the cost of credit, weakening balance sheets of banks.

Precipitation of political and economic phenomena has reduced foreign exchange reserves in just four weeks with 11 billion dollars.

Failure in adopting of prudential norms by Mexican banks meant increased the bad loans in their portfolio.

After these events, followed the peso crises. The Interest rates have increased rapidly, the peso plummeted and Mexico was tightened credit market. In short time Mexico lost its reputation as the government's ability to maintain a stable exchange rate and sound financial policy.

Asian crisis started in Thailand in 1997 and spread rapidly and violently on the first countries in Asia and then Russia, Argentina, Brazil both by the commercial and finance channel.

Currency crisis, accompanied by a crisis of confidence and inadaptability structural measures have led to slower growth in this country for a long period of time.

After the currency crisis in Thailand, contagion effects have become more visible when the crisis was spreading rapidly from an emerging country to another.

In 1997, Indonesia's economy, like that of Thailand, seemed a healthy but, unlike Thailand, Indonesia had low inflation rate, a solid banking sector, a commercial surplus and reserves by over 20 billion dollars.

Violence with which the crisis hit Indonesia was caused mostly by the economic problems faced Asian countries (Japan, South Korea, Thailand only a month) following the withdrawal of capital from this region which, practically it was the only engine of economic growth.

Along with performances of Indonesian economy, and some vulnerabilities have been identified which favored the crisis spread to this country: strong capital inflows associated with foreign debt growth since 1994, a fragile banking system as a result of cronyism and corruption and interventionist policies such as "family capitalism" that has strangled the free market economy.

In November 1997, South Korea, the second largest economic and industrial power in the region, member of the Organization for Economic Cooperation and Development, seemed to be spared the financial problems faced by emerging countries in Asia. However, at the end of 1997, the existence of structural similarities and contagion force extended the crisis this country.

To support large industrial concerns (chaebol) and make them globally competitive, Korea turned to short-term loans denominated in foreign currency without thinking about the dangers of increasing interest rates and depreciation. In fact, some of these large industrial corporations, due to huge debts, went bankrupt before the crisis.

However, depreciation of national currency, the large number of bankruptcies of industrial corporations and the inability of government, have led to huge recession.

Another country that has not escaped the contagion effect through the financial channel has been Malaysia.

In the mid of 1997, after the crisis broke in Thailand, Malaysia has faced some financial market shocks. The main vulnerabilities of Malaysia were fall of the capital market by almost 50% by the end of the year and a large deficit and capital account. Were worrying also growing domestic demand as a result of too lax lending, increasing asset prices and their impact on the banking system.

Two other less affected countries by the Asian crisis were the Philippines and Singapore.

Although we cannot speak of a miracle for this country, as was a moderate economic growth, structural reforms have been well implemented, especially in the trade and investment sector. Trade liberalization and privatization of large companies has been made in normal and prudent macroeconomic policies led to the economic recovery in the years that followed.

About the crisis in South East Asia countries, many mistakes are attributed to policies adopted by the International Monetary Fund:

1. encourage these countries to liberalize as quickly as financial and capital markets;
2. promoting measures based on increasing interest rates which, under a high degree of leverage, it has facilitated the road to collapse;
3. promotion of strict fiscal policy while the East Asian countries had no imbalances. Thus the IMF imposed austerity measures deepened the crisis.

Asian crisis, when installed, was transmitted through contagion, both commercial and financial channel to other regions and even on other continents.

Financial sector problems were quickly sent to the real sector causing lower imports with a real negative effect on international trade.

Import volume contraction in Asian countries affected by crisis have contributed to lower demand for exports to Japan, Russia and Latin American (Brazil, Argentina, Chile, Peru). Not only was affected but traded volume and price of products.

Through financial contagion manifested by foreign and local investors panic that affected sources of capital, the Asian crisis was rapidly transmitted to neighboring countries: Indonesia, Philippines, Malaysia, Singapore, South Korea.

As a result of financial interdependence, the Asian crisis was also sent off continent, having a negative impact on the country extremely sensitive to movements of capital as Russia, Brazil, Argentina.

Argentina's currency regime and its connection to the international financial system are likely to explain not only the Argentine crisis but before the period of rapid growth and strengthen its financial system.

But Argentina had a huge foreign debt and to cover them need new government loans.

Fixed exchange rate made imports cheaper, generating a progressive worsening foreign reserves, and Argentina's industrial infrastructure which eventually led to high unemployment.

Departure of foreign capital in Argentina had a strong impact on it. Crisis of confidence from foreign investors threaten the stability of the banking system. With the onset of the crisis has been increasing country risk, which was reflected in lower stock prices and liquidity problems arising in the Argentine financial system was responsible for the increase in nominal interest rates.

The crisis that crushed Argentina for several years was accompanied by external shocks as the Brazilian real devaluation and international revaluation of the dollar. This decreased competitiveness of Argentina before his partners, the largest being Brazil and the euro area.

Argentina’s real depreciation against the U.S. dollar pulled down a large economy like that of Brazil. But the Brazilian crisis has its original, a few years ago, in 1994, with implementation of the "Real Plan".

In 2001 the Brazilian economy showed signs that it recovers, recording a growth rate of almost 4%. But the Argentine crisis and internal problems both economic and political caused again a slowdown of macroeconomic indicators.

In Russia, the contagion effects had a greater impact, Russian crisis was a combination of a currency crisis and a sovereign debt crisis.

Decline in commodity prices, especially crude oil following the collapse that swept East Asian countries had a devastating impact on the Russian economy. Russia was the largest exporter of crude oil and tax revenues were an important part of the state budget.

Deep roots of the crisis in Russia are found in the country's economic structure, institutional environment, and policy makers at the political level. Analysis of the Russian crisis of 1998 reveals many common points with the Asian crisis and Latin American countries.

Poor management by the Kremlin of the transition process since 1990, reflected by the financial markets and trade liberalization to foreign investors has exposed existing vulnerabilities and failures of internal and external economic policies.

All these macroeconomic problems was added a huge debt and increasing interest rates following the crisis in East Asia has made more difficult the economic situation of Russia.

Overvalued exchange rate, trade balance deficit, the country's inability to produce consumer goods and lower investment led economy towards a major crisis.

Even if economic shock was strong enough, shortly after the devaluation of the ruble, Russia's economy began to recover shyly registering positive growth rates of macroeconomic indicators. Recovery was installed much faster than expected economic analysts and international organizations. The main and most important reason of recovery Russian economy was growing demand for oil and its price.

Measures were taken to overcome the crisis and return to growth economies were different from one country to another depending on the nature and specifics of the crisis. Most countries have turned to IMF for financial assistance.

In Latin American countries main measures to help the financial institutions were:

a. reduction in public expenditure;

b. increase in tax revenues;

c. exports stimulation;

d. stimulating domestic consumption by replacing imports with domestic goods and services;

e. fiscal and monetary tightening;

With regard to Southeast Asia, measures have been taken:

a. devaluation of national currency;

b. recapitalization of banks;

c. financial restructuring of troubled companies;

d. exports stimulation;

e. austere fiscal policy (elimination of subsidies, higher prices).

In Malaysia, which it did not adopt an IMF-supported program, measures were quickly successful, being the first country to economic growth after the crisis. Authorities were concerned with stimulating employment, financial restructuring of enterprises and ensure a continuous funding stream. (Stiglitz, 2006, p. 153)

3 Conclusions

Even if there were signals of those outbreaks of crisis, investors have underestimated the risk associated with the high expected returns, existing a large discrepancy between perceived risk and country risk indicators. (Bari, 2010, p. 403)

Crises in Latin America, East Asia, Russia and the mechanisms by which a crisis has spread from country to country and even to another continent would have to draw a strong warning, or if there was, it certainly was ignored.

Imbalances in economic and financial systems of these countries and unsustainable economic policies played a major role in the changes in their fragility trade flows and facilitating the spread of financial crises over the world.

Lessons learned from the external dimension of the crises in East Asia, Latin America, Russia stands out clearly exuberance and irrational behavior of investors in terms of entry and exit to and from emerging markets. To these is added the lack of transparency and lack of information on existing structural weaknesses in the emerging and the developed economies.

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