Global Financial Crises

Kimberly D Scott
Global Financial Crises
Abstract

The purpose of this research is to identify various global financial crises throughout the years. Global financial crises are not new to developed nations; however, they have grown more common and the financial burden has become loftier and explosive as time evolve.
Global Financial Crises

Financial crises are not a new marvel in less developed nations (emerging markets), but they have grown more common, and the financial flows involved have become loftier and more explosive in the past 20 years (Eichengreen et al., 1998). This passé corresponds generally with the era of "economic opening" in emerging markets, a time when most of the Latin American countries, the former Soviet republics, and several Asian countries theatrically reduced their barriers against foreign company undertakings such as imports, foreign direct investment, and foreign portfolio investment. Although, financial crisis origin can encompass a variation of elements, this assignment in particular will focus on three countries and their journey through a corrosive period.

The plan of the paper entails comparing the global financial crisis of the emerging countries during the nineties, the global financial crisis of 2008, and the current crisis of the euro. One of the objectives is to look at the aspects that those crises have in common, but mostly the unique aspects. In addition, a case will be made stating whether these crises will continue in the future, putting the entire global economy at risk (leading to the end of capitalism). Lastly, real life examples will be used relating to theories covered. Section I of the assignment will outline Mexico crisis (1994-95), Asian crisis (1997), Russian crises (1998), Global crisis (2008), and the current Euro crisis. The subsequent section will observe the aspects of the crisis, while the final section outlines a futuristic outlook of crisis and capitalism.

Section I: Crisis of Emerging Countries

Mexico Crisis 1994-95

The crisis that took place in 1994 was the first emerging crisis that began the 90’s crises campaign. The Mexican Peso crisis snowballed from a series of events that resulted into a large crisis. A closer look at the crises revealed a violent political rebellion of anti-government campaigners. Those proceedings sparked interest in observers, which placed doubt in the political stability of the country. The assignation of the leading presidential nominee in March intensified this unease. To no avail, in September, there was confirmation that capital flight was exhausting official foreign exchange reserves, which resulted in another round of funds outflows. In December, the newly elected Governor Zedillo announced the devalue of the peso slightly relative to the dollar, allowing it to float freely. This decision led to an increased outflow that pushed the peso from 3.4 pesos per dollar down to 6 pesos per dollar (later reached 7 pesos/per dollar) (Mudd, Grosse, & Mathis, 2002).

Quite different than Mexico’s 80’s crisis, the 1994-1995 Mexican Peso crisis were linked to an agitated domestic economy, which lacked a supportive foreign bank debt. It is relevant to know that the 90’s crisis was not due to external borrowing in the form of commercial bank loans, but could possibly be viewed as external borrowing in the form of short term investments by foreign investors who purchased Mexican securities (sell them due to fear of financial crisis). The country had been experiencing a current account deficit since 1988 (Mudd et al, 2002). Mexico had reached a point where the economy was growing so rapidly that domestic and foreign investors absorbed a large quantity of dollar-denominated debt instruments (treasured
issued Tesobanos). In fact, it was this action that became the main cause of risk in the crisis. With the peso reaching a 10% devaluation (floating freely in the market), investor apprehension, produced a huge capital outflow; ultimately, resulting in disaster loans from United States Treasury and International Monetary Fund (IMF) to manage with the catastrophe. In conclusion, and in chronological order the exchange rate crisis hit first, followed by the banking crisis, and this in turn was followed by a related overall economic crisis that lasted for most of 1995 and spilled over into several subsequent years (Mudd et al, 2002).

Asian Crisis 1997

Quite unique, the Asian crisis was less anticipated than Russia and Mexico crises. In other words, Asia had 20 year progression record that seemed solid in terms of recession. The devaluation of the Thai baht spread quickly to other Asian equity markets. The countries affected were Indonesia, South Korea, Malaysia, Philippines, Taiwan, and Thailand. In all, currencies together lost almost half their worth and their United States dollar denominated equity market returns plunged sevenfold after the crisis arose (Maroney, Naka, & Wansi, 2004). In this case, Krugman (1999) posits that leverage is a key feature of current financial crisis models, and that high leverage financed through extensive foreign currency borrowing starting after 1990 made Asian economies susceptible to financial crisis.

However, in a detailed analysis of the crisis, research discloses that the causes of the crisis can be viewed from a financial and trade aspect. One of the unanimity is that the crisis was simply initiated by the illiquidity in Thailand, and this indication is by the ratio of short term debt reserves (Kanaoka, 2012). In fact, Radelet, Sachs, Cooper, and Bosworth (1998), Bussière and Mulder (1999) and Caramazza, Ricci and Salgado (2000) found in their regression analyses that the ratio of short-term debt to reserves was strongly associated with the crisis. The increased short-term debt was due to large capital inflows from overseas. Radelet et al. (1998) indicated that the ratio of the capital account to GDP was strongly associated with the crisis. All the more interesting, the ratio correlated with the crises was proven through regression analysis by Glick and Rose (1999).

From a financial perspective, in local economies, capital inflows enticed by high interest rates in Asian economies, were overly paying their current account deficits, and the additional capital inflow produced lending booms, which results in a swift rise in the claims of the financial sector on the private sector, which cause a large fraction of nonperforming loans (correlated to the crisis) (Radelet et al, 1998). As for trade aspect, Blanchard et al. (2010) determined from their regression studies for 29 countries that the variables of "unexpected trading-partner growth" were significant in clarifying "unexpected GDP growth" in emerging economies. Llaudes (2010) found that "emerging market economies with higher reliance on demand from the progressive economies experienced harsher falls in output during the crisis."

Russian Crisis 1998

In mid-1998, the Russian government was required by a growing payments crisis to devalue the ruble, default on its domestic debt, and pronounce a freeze on payment by Russian commercial banks to foreign creditors. As a result, inflation control, a stable ruble, and a fragile turnaround of growth domestic product (GDP) growth evident toward the end of 1997 came to
an end. Chronologically, the Russian government had a deficit issue caused by bad tax collections, soviet era payments on subsidies, as well as defectively constructed social programs. A budget deficit successfully at 5-9% of GDP (1994-97) borrowing requests were hefty and became threatening (Mudd et al, 2002). Another factor to the timeline was the banking sector and its exposure to government issued ruble debt. Banks did not earn through loans, but mostly through high interest government short term bills. To conclude, account surplus existed, but there were also capital flight and foreign earnings that did not find their way into either the domestic or external debt service (Mudd et al, 2002).

To add to the chaos, the crisis had its share of spillovers. The undermining of investors' confidence took place as other crises reported in the assignment. Such issues are assumed to have driven capital flight from Brazil, which resulted in generating a devaluation of the Brazilian real. Another real life example of the crisis lead to a near liquidity crisis for high ranking United States banks, whose exposure was due to highly leveraged positions of Long Term Capital Management in European junk bonds (Poirot, Clifford, 2001). Long Term Capital Management, a prominent hedge fund, was forced to liquidate its positions and reorganize. Its exposure was sufficient to threaten liquidity in the U.S. market (Eichengreen and Matheson, 1999).

Global Crisis 2007-2009

Since 2008, the chief highlighting of the public, the business world, politicians and economists has been on the global financial crisis. This crisis by now called the "Great Recession" due to its strong and long-lasting effects resulted in social and political instability in various parts of the world (Vukovic, 2011). Assertions were made that it would outmatch the Great Depression of the 1930s in its deep and lasting penalties. Although, discussed extensively through the week’s discussion forum, many assumptions, ideas, and theories have transpired surrounding the cause of the crisis. However, the ultimate cause is traced back to the government policies and regulations.

From a political perspective the central government regulators encouraged the policies of affordable housing and mortgage investments. Extensive debt accrual and risk-taking shared with house inflation upon which the growth of the financial sector was powered were all costs of government dogmas (Vukovic, 2011). The banks and other financial institutions trapped in the downward spiral were only following the decisions the government regulations were guiding them into.

A real life example of the lax guidelines that contributed to the global financial crisis, the housing market became promising to many families. In fact, as people approached the housing sector, prices rose and housing took off as a result. At one point, home prices rose by 9.8% while other sectors of the economy remained sluggish. Where I am currently located here in Florida, 14% of the job growth was in construction. Builders initiated the construction of 1.8 million single family dwelling houses (not since 1990). This contribution was three times more than what it had been. Again, such eagerness to capitalize with little or lax guidelines contributed to the global crisis which is still felt by many today.
Current Euro Crisis

Until today, decisions made by Eurozone countries at the start of the second decade of the twenty-first century will decide whether the Euro becomes a competitor on the world stage and contest the dollar, collapse after uncontrollable defaults with Greece, Ireland, Iceland, Portugal, and Spain, or wind up somewhere irrelevantly between (Castleberry, Maniam, & Subramaniam, 2014).

Eurozone leaders find the mission of stabilizing the euro challenging, since bailing out indebted nations is not perceived well among respective voters and adversely affects re-election projections. The ineffectiveness of the European Central Bank is unresponsive to crisis. This is due to the struggles of the balance between fiscal sovereignty of member Euro nations and common needs. The current weakness of the euro lies in the need of member Eurozone countries to keep a certain level of sovereignty. Therefore, the act of bailing out Greece was frowned upon by other members. In retrospect, the plan to establish a single currency originated twenty years ago. The objective was to have a unified currency to gain power and leverage in the world market, alleviation of currency exchange burdens when traveling or doing business with other businesses in Europe eliminating bank fees (Castleberry et al, 2014).

A topic that could be discussed in great length, the euro declined after it was introduced in 1999 (relative to the dollar). Schnatz (2004) posits two reasons for the decline: The first is due to a unique increase in the value of the dollar at that time and secondly the euro decline against the dollar is instability in Eurozone labor markets as well as overall perception of European countries using accounting methods to falsely show healthy economies to enter the single currency (Arestis, Biefang-Frisancho Mariscal, Brown & Sawyer, 2002). Today, Europe is not as healthy as a whole now as it was before the Euro was accepted, although the short term, the Euro did seem to gain in health until later debt crisis (Candelon & Palm, 2010). The projected Debt/GDP ratio at the end of 2011 (IMF estimate) equals 365 billion Euro in debt and 136 billion Euro in GDP or 165% (Castleberry et al, 2014).

Aspects of the Crises

As mentioned within each section of each crisis there are unique aspects that each crisis whether in the 90’s, 2000’s or currently have in common. For example, the Mexican Peso crisis snowballed from a series of events that resulted into a large crisis. A closer look at the crises revealed a violent political rebellion of anti-government campaigners. Those proceedings sparked interest in observers, which placed doubt in the political stability of the country. A look at other crisis beginnings mimic’s similar events with the exception of the Asian crisis that occurred abruptly. Another example of a unique aspect is the devaluation of the currency during each crisis; poor regulations, policies, and standards played a key role in the devaluation process. Lastly, risk taking, free floating, flight earning, and fear were all unique in the concoction of the crisis.
Case for Future Crises

Every crisis listed in this assignment allow countries, government, and researchers the opportunity to gather, collect, and interpret possible causes of those crisis to better prevent future crisis. However, whether it is the banking sector or the government sector, crisis are inevitable and at times produce massive devastating events that last throughout history. It leaves many to wonder about the future of financial regulations, nevertheless, any attempt to improve the current regulatory approach, must be guided by the lessons drawn from the crisis. The question that is asked is whether the crisis could lead to the end of capitalism? It is important to understand that a crisis is not a single event. Therefore, it is vital that researchers understand that the core premise of capitalism rests on the simple notion that free markets and the free enterprise system they promote are the optimal and most efficient means by which any society can allocate its scarce resources of labor, capital, and land.

Conclusion

Financial crises are not a new marvel in less developed nations (emerging markets), but they have grown more common, and the financial flows involved have become loftier and more explosive in the past 20 years (Eichengreen et al., 1998). This passé corresponds generally with the era of "economic opening" in emerging markets, a time when most of the Latin American countries, the former Soviet republics, and several Asian countries theatrically reduced their barriers against foreign company undertakings such as imports, foreign direct investment, and foreign portfolio investment. Although, financial crisis origin can encompass a variation of elements, this assignment has focused on three countries and their journey through a corrosive period that have written history.
Reference


