FINANCIAL CRISSES IN EMERGING MARKET ECONOMIES

DYNAMICS OF FINANCIAL CRISSES IN EMERGING MARKET ECONOMIES

- *Emerging Market Economies:* economies in an earlier stage of market development that have recently opened up to the flow of goods, services, and capital from the rest of the world.
- High growth rate, less restrictions
- Mexican crisis in 1994
- East Asian crisis in 1997-98
- Argentine Crisis in 2001-02
Stage 1: Initiation of Financial Crisis

- Path 1: Mismanagement of Financial Liberalization/Globalization
  1) Eliminating restrictions
     Fixed Exchange Rate
     Interest Rate increases
  2) Weak Supervision
  3) Moral hazard problems and adverse selection
  4) Deterioration in bank’s balance sheets
  Example: Mexico East Asia

- Path 2: Severe Fiscal Imbalances
  1) Government runs deficit
  2) Banks are forced to purchase bonds
  3) As bonds price declines, banks asset value decreases.
  4) Lending contraction
  Example: Argentina
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- Other Factors
  - Interest Rate
  - Stock market decline
  - Uncertainty on political system

- Stage 2: Currency Crisis
  - To hold fixed exchange rate, government needs to hold large amount of foreign reserves.
  - Speculative attack: speculators engage in massive sales of the domestic currency until it collapses.
  - Government runs out of foreign reserves
  - Domestic currency depreciates
Example: East Asian Financial Crisis
- Quantum Endowment Fund

Stage 3: Full-fledged Financial Crisis
- Debts increases in terms of foreign currency
- High Inflation Rate
- Banks fail