INTERNATIONAL FINANCIAL INSTITUTIONS AND POLICY – ECONOMICS (3000 word)

Coursework 3

“Why are currency crises often accompanied by banking crises?

The coincidence of the banking and currency crisis related with the Asian financial crisis has drawn the attention towards the similar factors, which has connected the two major phenomenons. The phenomenon of twin crisis is quite common in the financial liberalization within the emerging markets. Banking and the currency crises has appeared to occur virtually at the same period in Indonesia, Thailand, Korea and Malaysia in the year 1997-98 (Sebastian 1999). In fact, the twin crisis evidences are widespread that occurred in different parts of the world, in which it spread in Latin America during mid-1980s and in 1990s it occurred in Scandinavia.

The strong relation existing between the currencies and banking crisis within the emerging markets is quite robust, even after controlling the financial structure variables and host of microeconomics as well as expected simultaneity bias (Sebastian 1999). It is also explored that the occurrence of banking crisis offers better indicators of the currency crisis that too in emerging markets. The openness of the emerging markets towards the global capital flow combines with the financial structure makes vulnerable in twin crisis. The connection of banking and currency crisis and the twin crisis could be attributed with the various causation channels, such as banking crisis leads to the currency crisis; currency crisis leads to banking crisis or joint casualty (Sebastian 1999).

There are different theoretical models that have explained the connection between the banking and currency crisis. One causation chain emphasize over the Stanley (2004) that runs by the issues of balance-of-payments in banking crises. A starting external shock, like increase in the foreign interest rates, and its coupled with the commitment towards the fixed parity might result in the reserve loss. If it’s not sterilized then it might result into the credit crunch, and increase bankruptcy and financial crisis (Stanley 2004).

According to the third family of models, it was mentioned that the banking and currency crises holds similar causes. An example for this could be explored in the dynamics of the stabilization plan of the exchange rate based inflation, such as Mexico crisis in 1987. The facts and theories have suggested that the plan should have the well explained dynamics. As the coverage of inflation at global level is only gradual, there exists the marked cumulative appreciation of real exchange rate (Stanley 2004). Along with this, in the starting stages of the plan, there was a boom in the activities of import and export that were financed through the borrowing abroad. As the current account deficiencies were happening continuously, financial markets were convinced that the program of stabilization should be unsustainable, and fuel the attack against the local currency. As the boom is financed through the surge in the bank credit, as the banks borrow from overseas, when the inflow of capital becomes capital outflow and the asset market gets crash, then banking system give up (Stanley 2004).

Twin crisis leads to:

Insolvency of banking system

Banking issues could be traced easily, if there is a decrease in bank assets value. Asset value deterioration might occur, if there is a collapse in the prices of real estate or either increase in the bankruptcies in the nonfinancial sector. During twin crisis, values of asset also reduced substantially, and bank ends up with liabilities, which are more than assets, which means that banks has the negative capital and many banks went insolvent (Christopher 1999). There were some banks that had some capital, but it was less as required by the regulations.

During twin crisis, the insolvency increased in the banking system as well as in corporate and fiscal sectors. GDP measured in dollars also become highly unstable that tumbled from around US$20 billion each year in the 4th quarter of 1998 to around US$8 billion every year in 2000, and this even lead to collapse in the actual exchange rate. The debt-to-GDP ratio in public sector also increased from 81% in 1998 and 156% in 2000, but the 76% of increase was resulted due to the shrink in GDP (Christopher 1999). Solvency of banking system was also fast in 2000, and there were around 16 financial institutions that accounted to around 65% of the assets that were closed and even taken by the government. The issues of insolvency in the household and corporate debtors also pushed the government in June 2000 in order to restructure the debt (Christopher 1999).

Banks' losses on foreign currency denominated assets

Defaults might also get triggered through the local currency devaluation, when the huge fraction of the sovereign debt was denominated in the overseas currency and its revenue also depends on the non-tradable goods taxation (Kaminsky and Reinhart 1999). The magnitude of the crisis also triggered through the local currency devaluation and the same could be amplified through household’s currency mismatch; banking sector, and non-financial corporate sector.

Outflows of deposits as foreigners withdraw funds

In the starting stages of the plan; there was a boom in the activities of import and export that resulted due to the borrowed finance from abroad. As the deficit in the current account continued to get broaden, financial market got convinced that the program of stabilization was unsustainable, and fueled attacked against the domestic currency (Kaminsky and Reinhart 1999).

As the boom was mainly financed through the surge in the bank credit, banks started borrowing from overseas market, and that leads to capital outflow and crash of asset market, and the same resulted into the cave of banking system.

High interest rates as authorities try to support the currency

One of the most challenging questions in front of monetary authorities is how to conduct the monetary policy during crisis. On one side, tightening monetary policy increased domestic interest rates that made it more attractive for holding the domestic currency and also increase the cost of speculation against the currency (Kaminsky and Reinhart 1999). Therefore, increase in interest rate holds the potential to provide the relief to the currency that was under pressure. During the period of Asian financial crises, 1997, the prescription of policy in various crises-stricken countries was related to conduct the tight monetary policy for all these reasons (Kaminsky and Schmukler 2002). However, there were various negative consequences related to tightening of monetary policy. High interest rates reduce the asset value held through the backings system by higher flow of discounting in future, but more crucially by the financial distress to the borrowers and banks and it resulted into economic loss and distressed liquidity.

Various forms capital control scan and discuss the conventional view on capital mobility before offering reasons why controls on some types of capital flow may nonetheless be desirable

Conventional wisdom recommends that permitting the international capital flow enhances the domestic investment and leads towards growth through providing the extra resources by the international capital markets, yet the flow could be misallocated to the low quality domestic investment or finance speculative (Alberto, Grilli and Milesi 1994). Applying the dataset of panel, that covers 78 countries between 1995-2009, mentions that policies of capital control can promote the economic growth by applying the countries de facto capital flow level; controls the capital flow that could support in economic growth of the country, but also controls the outflows; and put restrictions on various types of asset that could impact growth in different ways (Alberto, Grilli and Milesi 1994). Capital controls placed on the equity type of flow are not that effective than the controls placed on debt type flow or the direct investment. Just like various issues discussed in the global economics, the focus is placed over the capital controls and it has only one reborn with the market liberalization failure (Alberto, Grilli and Milesi 1994).

The capital movement control could be analyzed through the economic policy for limiting the international capital mobility and to bring change in the state of capital account in context of financial transactions (Eswar, Rogoff, Wei and Kose 2003). If one talks about the various types of capital controls, it might take the taxation types, quality and price restrictions or the direct international operations prohibition with the different financial assets (Robert and Sala-I-Martin 1995). The international capital flow control is distinguished into direct and administrative controls, and the same can be indirect or market based controls. When countries face the issues of large scale movements of financial resources, then in that case capital controls are helpful tool of economic policy (Eswar, Rogoff, Wei and Kose 2003). The administrative control tries to limit the operations with the related payments along with transfers of monetary funds through the way of quantitative limitation, direct prohibition or through the procedure of the official approval (Robert and Sala-I-Martin 1995).

Administrative control tries to regulate the classic global capital transactions. It’s quite a common characteristic that it forces the financial sector to place the additional obligations

(Robert and Sala-I-Martin 1995). On the other side, indirect control tries to prevent the capital movement and associated transactions by the cost systems (Eswar, Rogoff, Wei and Kose 2003). Market based controls is undertaken in different ways that is referred as the set of exchange rates, measures of price based regulations, and latent and obvious taxation (Eswar, Rogoff, Wei and Kose 2003). All the explained controls, whether its directly imposed or either indirectly imposed will leave an impact on both the volume and price of financial transactions (Robert and Sala-I-Martin 1995).

In the past few years, various scholars have argued over the free capital mobility that is produced in the macroeconomic instability and also contributes towards financial vulnerability in the emerging nations. For instance, in the critique of International Monetary Fund and U.S Treasury, Michael, Mathieson and Rojas-Suarez (1997) has argued that pressuring the emerging as well as transition countries for relaxing the control on capital mobility, during the period of 1990s was the big mistake (Michael, Mathieson and Rojas-Suarez 1997). According to him, the ease of control place on capital mobility was placed at center of the currency crisis in the emerging markets, like East Asia in 1997, Turkey in 2001, Mexico in 1994, Brazil in 1999, and Russia in 1998, during past decade (Trevor 2006).

In those days, even the International Monetary Fund could criticize the mobility of free capital and offers support for the capital controls. During 2003, the visit to Malaysia, Horst Koehler, who was the managing director of IMF, has praised about the policies of Mahathir PM and especially his use of capital control in the aftermath of currency crisis happened in 1997 (Trevor 2006). Capital control supporters has also argued that placing restrictions on the capital mobility has two significant potential advantages, such as it minimizes the vulnerability of control towards financial crisis and external shocks, and it also permits the countries, who are suffering from currency crisis to reduce interest rates, implement the policies of pro-growth, and emerge through the crisis very soon (Trevor 2006). As per this perception, controlling of the capital outflows might provide crisis countries with the additional time for restructuring the financial sector in orderly way (Trevor 2006).

Capital flow might take various forms, and it's the great interest to analyze whether the capital control effectiveness relies over the types of financial assets, which are imposed and whether the control on the capital inflow and outflow has various impacts (Trevor 2006). Instead of applying the capital control aggregate measures, it is better to adopt the disaggregate set of capital control variables for measuring the capital control effectiveness (Stanley 1998). It is also better to employ the dynamic system of panel data that could generate the methods related to moment estimation for understanding the dataset of panel yearly that covered 88 countries between the years 1995-2010.

Rudiger (1998) explains that the argument about removing the capital controls will improve the efficiency of economy, which is derived through the two core propositions of the economic theory, such as Efficient Market Hypothesis (EMH) and Fundamental theorem of welfare economics (FTWE) (Rudiger 1998). The FTWE deals with the real economy and presume about the perfectly competitive economy that has no externalities, where else EMH tries to portray that the financial markets holds the efficiency, which gather and transmit the information (Rudiger 1998). Both of them present the economic efficiency picture that depicts the efficiency of economy that depends on the free markets of labor, goods, minimalist state, and finance (Eswar, Rogoff, Wei and Kose 2003). Within the theoretical proposition, the capital control removal that is also defined as inefficient is considered as more beneficial (Rudiger 1998). This happens to be the perfect consonance in the non-liberal ideology.

It is also observed that the average per capita income of the groups that are financially open, growth of the economy take place in more favorable way as compared to groups, having less financially open economy (Rudiger 1998). There are certain empirical studies that have mentioned that there is no strong, uniform and robust help for the theoretical argument that the financial globalization could deliver with high economic growth rate (Rudiger 1998).

In fact, there are some countries having the liberalization on capital account and even had experience on output collapse, which links with costly banking as well as currency crisis. As per Martin and Horioka (1980), the advantages related to capital flow doesn't come with cost, as capital flow could complicate the economic policy or even act as the source of instability; therefore, government should apply the capital control for limiting its impact (Martin and Horioka 1980).

There are many economists like Jagdish Bhagwati, who feel that there is a wide difference among the free capital mobility and free trade, and therefore, they argue for the free capital mobility with the similar type of arguments that are used for free trade and that's irrelevant (Jagdish 1998). In the words of Bhagwati, when the fog of assertion is penetrated, and which revolve around the free capital mobility, one could realize the ideology and idea of the free trade and its advantages and this also extends towards the trade liberalization in goods, finances and other services of World Trade Organization, which is hijacked through the capital mobility proponents (Jagdish 1998). It is rightly said that economics can only become successful, if the economist holds similar ability like the dentist for addressing and solving the practical issues (Jagdish 1998).

The potent way for countering the issues is through imposing the control over capital flow. Sebastian (1999) argues that if it is effectively used as the important strategic part of the state intervention in conjunction with the measures of complementary policy, then in that case capital controls could be beneficial for the economics in different ways (Sebastian 1999). Firstly, capital control are the meaningful tools that are used for protecting and insulating the local economy through the volatile flow of capital and various other negative external developments; mainly in the wake of experiences gained by local countries through rapid flight of capital, loss of autonomy in case of monetary policy, and foreign exchange reserves depletion (Sebastian 1999).

Secondly, Eswar, Rogoff, Wei and Kose (2003) contends that various types of social control placed over capital are desirable and critical, which owns the significance of capital for developing the improvement of local savings as well as its direction in the productive domestic investment as per the development plans (Eswar, Rogoff, Wei and Kose 2003). Thirdly, capital controls support the countries in attaining the bargaining power and in asserting the power during the time of negotiation with the private sector, multilateral financial institutions and foreign capital. Fourthly, the government can try to maintain the expected foreign reserve level and try to channelize the trade terms in order to protect the local items from global competition through create influence of exchange rate (Eswar, Rogoff, Wei and Kose 2003). Fifthly, capital controls are mainly important for developing countries as it helps them in saving the foreign exchange for capital goods, imports and debt servicing.

The most cited advantage of the capital control is its ability to protect the economy through the financial crisis. The most advanced countries that come under the important part of the globalization process have been ravaged through these crises. Therefore, one must mention that the experience of various financially connected economics with the time, destabilizing capital flow and the one leading towards financial crisis has tried to strengthen the capital control case (Eswar, Rogoff, Wei and Kose 2003).

Gabriel (2002) points out that the conventional wisdom related to the economics profession is related to whatever issues of destabilizing capital flow or either fixed exchange rates, in which capital controls are ineffective and try to impose additional cost on economics, which often outweigh any benefits (Gabriel 2002). Capital controls have various purposes and therefore various potential standards through which its efficiency is judged. Therefore, there are administrative controls, which range from the prohibitive controls towards the quantitative limits, discretionary rules and then towards the market based controls that might include the multiple-dual exchange rates, indirect taxes, and tax impose on cross border capital flow along with regulatory controls on banks (Gabriel 2002).

Capital controls are also categorized into quantity based controls, which also includes explicit limits or either the prohibition on transactions of capital account. It also includes price based controls, which tries to alter the price of capital transactions with a perception to discourage the specific class of flow and encourage the set of flow (Gabriel 2002). Third is regulatory controls that could be price based or either quantity based, and this kind of policy package mainly treats the non residents less as compared to residents; for example, requirements of unremunerated reserve (Gabriel 2002). Still other ways to divide the control is mentioned as controls on inflows in comparison to controls on outflows. Whereas, control on inflows are usually imposed for bringing change in the nature of capital flow within the country, it also tries to encourage the long term capital flow, and even discourage the short term flow, for example, foreign investment is prohibited in Indian real estate sector (Gabriel 2002). Where else, controls on outflows are used for preventing the capital flight, where crisis knocks the door of country, for example, Malaysia after the crisis of South East Asia.

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