

International Banking Crises (4/12/2011) Econ 310-008

Definitions

- **exchange rate crisis** – (aka balance of payments crisis) big depreciation in the currency; drain of foreign reserves forcing a devaluation or switch to float
- **banking crisis** – bank panics leading to massive bank failures; when banks and other institutions face losses, insolvency, and bankruptcy
- **default crisis** – government default on sovereign debt; when governments are unwilling or unable to honor principal/interest payments on their debt
- **twin crisis** – 2/3 of exchange rate, banking, and default crises
- **triple crisis** – 3/3 of exchange rate, banking, and default crises
- **currency premium** – exchange rate risk premium; higher interest rate that must be paid to compensate for possibility of fluctuations in the exchange rate (i.e., the peg is not credible)
- **country premium** – default risk premium; higher interest rate that must be paid to compensate for possibility of government expropriation of private investment or default on sovereign debt
- **sovereign default** – repudiation of debt; country government default on its bonds
- **partial repudiation** – declaration by government that it won't pay back part of its debt (or will pay pennies on the dollar)

Equations

- $Y - (1 + r_L)L > Y - cY$ sovereign default equation (repay if true; default if false)

Variables

- $Y \equiv$ nominal output
- $L \equiv$ amount of loan (bonds)
- $r_L \equiv$ loan rate of interest
- $c \equiv$ % of output lost in default

Principles

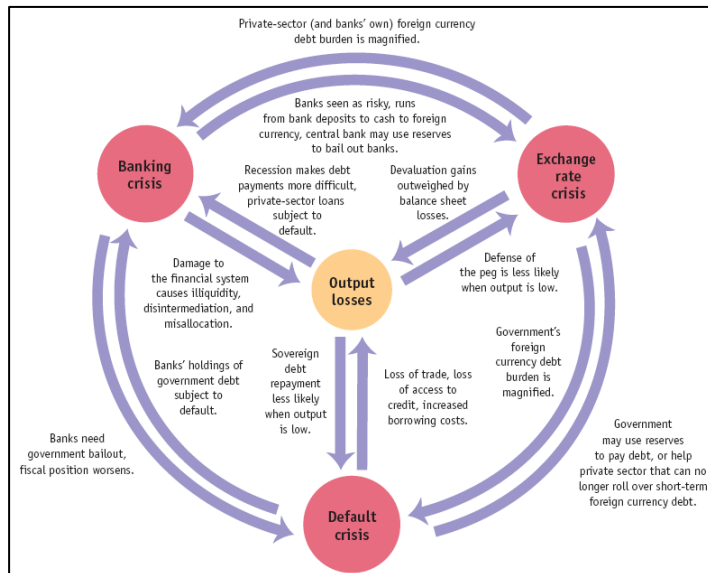
- Often these crises occur together (twin or triple crises).
- In general countries that default on their sovereign debt get hit with a 4-5% country risk premium for the next 3-10 years.
- Argentina suffered a triple crisis (2001-2002): exchange rate, banking, and default.

Types of international crises

- exchange rate crisis
- banking crisis
- default crisis

Costs of defaulting

- financial market penalties
 - can't borrow until resolved
 - downgrade in credit ratings
 - higher country risk premium
 - can't borrow in own currency
- broader macroeconomic costs
 - bank panics
 - financial disintermediation
 - lost investment, trade, output



Argentina (2001-2002)

- fixed exchange rate
 - 1:1 peg (peso to dollar)
- current account deficit
 - imports > exports
 - ↓ foreign exchange reserves
- future devaluation feared
 - bank runs began
 - convert pesos to dollars
 - withdraw money
- government devalues peso
 - 1.4:1 new peg (pesos to dollars)
 - force converts bank accounts
 - dollar accounts to pesos
 - 30% of wealth seized
- devaluation ramifications
 - more bank panics
 - foreign investors avoid bonds
 - don't roll over debt
 - macroeconomic consequences
 - tax revenue declines
 - social welfare spending up
 - government debt unsustainable
- government repudiates debt
 - only default on foreign held debt
 - arbitrage opportunity
 - people buy foreign held debt at discount
 - so default on all debt
 - partial repudiation
 - pennies on dollar for most
 - IMF paid in full
- effects
 - triple crisis
 - exchange rate
 - banking
 - default
 - unemployment hit 25%
 - inflation peaked at 10%/month
 - all bank accounts frozen for 1 year
 - massive exchange rate devaluation
 - from 1:1 to 4:1 (pesos to dollars)