Drivers of Economic Crises

**Financial**

*Capital Flows*

1. The East Asia financial crisis is a significant example of a financial system gone haywire. Alba et al (1999) highlights three key points relating to the dynamics between micro and macroeconomic integration factors that contributed to vulnerability in the region. First, the policies used to mitigate excess demand pressures, resulting from heavy capital inflows, highlighted incentives for superfluous borrowing, and for the build-up of risky liabilities. Second, financial sector weakness combined with improper financial sector liberalization and inadequate regulation led to risky lending and poor management of balance sheet risk by financial intermediaries. Third, poor governance and false guarantees from corporates spurred speculative excessive borrowing and lending. The combination of these factors fomented financial and macroeconomic susceptibility to volatility. The capital account balance reveals how much how much capital countries spend and receive.

*Current Account Deficit*

2. Preceding the Mexican Peso crisis, the Mexican current account deficit rose to 8 percent of GDP and Mexico’s international reserves declined by two-thirds, resulting in a depreciated peso. After attempting, to no avail, to stabilize the peso through devaluation, the Mexican authorities left the peso to float freely, resulting in a diminished external value of the currency (Truman, 1996). Current account and balance of payments data are used to analyze countries’ current account deficits.

**Resilience**

*Levels of Freedom*

3. Financial liberalization is seen by some as an instigator of financial fragility (Stiglitz, 1993). This is because financial liberalization allows banks to take on greater risk without suffering from the potential negative effects of risky, short term lending. Demirguc-Kunt and Detragiache (1998) argue that countries that have liberalized financial systems are more likely to experience banking crises. It is important to note, however, that such crises are less likely if liberalization coincides with sufficient regulation and institutions in place to guarantee adequate supervision. An economic freedom index is used to calculate levels of economic freedom by showing how liberalized an economy is. Some factors that play into the index include access to capital, tax rates, and tariffs.

**Structural**

*Size of Financial Sector Relative to Non-Financial Sector*

4. The financial crisis of 2008 occurred at a time of vast deregulation. Crotty (2009) points to the flawed institutions and practices of the New Financial Architecture (NFA) and light government regulation as the cause of the financial aspects of the crisis. These factors combined with rapid financial innovation and moral hazard resulting from periodic government bailouts contributed to creating conditions that led to the crisis. Rapid financial innovation manifested itself in the form of inflated financial markets relative to the real economy. This means that asset prices were highly overvalued, a sign that a crash was bound to occur at any moment. Debt to GDP rose from 22% in 1981 to 117% in 2008. Corporate profits rose from 10% to 40% in the financial sector in roughly the same period (Crotty 2009). Data on debt service ratio and credit to the non-financial sector reveal the size of the financial sector relative to the non-financial sector by highlighting the ratio between the value of the real economy and the value of financial markets.

*Inflation*

5. We use BIS consumer prices to chart inflation because changes in consumer prices are strong indicators for inflationary pressures. We also incorporate real effective exchange rates in order to identify inflation through relative currency values. In a study analyzing economic data from 20 countries to find what drives economic crises, Eichengreen, Rose, & Wyplosz (1995) argue that governments’ attempts at spurring economic growth through expanding the money supply, known as expansionary monetary policy, often result in currency crises. More specifically, these countries attempt monetary policies that cause high inflation and reserve losses in an attempt to try and remedy domestic economic problems such as unemployment.

*Currency Shocks*

6. Exchange rate data reveals currency value fluctuations by exposing a currency’s value relative to another. As a result, this data is helpful for revealing currency shocks. As Khan (2004) argues, depreciation of the Thai baht led to the East Asian currency crisis. This is reinforced by Gerlach and Smets (1995) as their model shows that a speculative attack resulting in one country devaluing their currency might threaten the competitiveness of a trading partner. The significance of this risk lies in the exchange rate regime that a country pursues and how deeply their economic system is integrated into the global economy. This is because certain exchange rate mechanisms can impede monetary policy attempts at stabilizing economic instability.

*GDP Growth*

7. GDP growth rates are used to identify levels of economic growth due to the fact that dramatic changes in GDP are strong signifiers of economic health. For instance, Demirguc-Kunt and Detragiache (2005) execute a study that examines 77 countries, finding that low GDP growth, high real interest rates, and high inflation strongly correlate with banking crises. This study reveals that a combination of periods of weak economic growth and loss of monetary control are large contributors to economic crises. They also find that banking fragility can result from real interest rate risk. This is associated with the idea that, during the 1980’s and 1990’s, more volatile interest rates may have contributed to banking crises.

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