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# The 1990's

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## Structure

Global Financial Crisis

Overview of Czech Transformation

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# Global Financial Crises

- Financial crises which occurred in those years leading to inevitable rescues by the IMF.
  - The global world which we now have in finance may mean that the huge cross-border flows of money can be a **destabilizing influence** when things go wrong and **lead to crises** which threaten the world financial system itself.
  - Examples are crisis in **Mexico** (in late 1994), in the **Far East** (in July 1997), in **Russia** (in August 1998), in **Brazil** (in late 1998) about general worries about **Japan and China**.
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# Mexico

- The first crisis of any note in this series occurred in Mexico in December 1994.
  - The new government of President Ernesto Zedillo announced a controlled **devaluation of the peso** – 4 % per year.
  - Almost at once money flowed out.
  - Investors were worried about
    - the current account deficit,
    - high government spending and
    - political instability.
  - The foreign liabilities of Mexico were largely in marketable **short-term paper**.
  - The inevitable **IMF bail-out** allowed holders of dollar short-term paper to escape, leaving holders of equity, long-term bonds and peso denominated debt with losses.
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# The Far East

- Far more important was the series of events beginning in **July 1997** and generally known as the '**Far East Crisis**'.
  - On 2nd July, Thailand floated the baht, which had been **linked to the dollar for 13 years**. The baht plunged more than 17 % against the dollar the same day. All the region's currencies fell
    - South Korea, Malaysia, Indonesia and Singapore.
    - Nervousness over investor losses and the effect on world trade led to a **fall in major stock markets**
      - The Hang Seng index in Hong Kong fell 25% in four days
      - On 27<sup>th</sup> October, the Dow Jones fell 554 points – a fall of 7,2% in one day.
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# The Far East

- The fear continued to run around the world.
    - In November 1997 Brazil doubled interest rates of 43 %
    - Korea stopped supporting the won and led it move into free fall
    - Thailand imposed exchange controls
    - Japan's fourth biggest securities house, Yamaichi, went into liquidation.
    - In January, Indonesia suspended debt service payments.
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# The Far East

- The IMF stepped in during these months with a series of rescue packages
    - 17,2 billion for Thailand in August
    - 42,3 billion for Indonesia in November
    - 58,4 billion for South Korea in December
  - There was worries about the amount of money the IMF actually had available.
    - If the IMF wanted to have the same levels of funding in relation to the GDP of members that it had in 1945, its funds today would need to be three times as large as they are.
  - The IMF money was clearly needed.
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# The Far East

- The Far East is a major trading partner for Japan, and the crisis heightened worries about the weakness of Japan's economy.
  - In April 1998 Moody's downgraded Japan's debt and in June US and Japan took action to prop up the yen.
  - **Commodity prices fell** some 11% in the second half of 1997.
    - Commodities are 60% of Chile's exports and oil is 40% of the revenues of the Mexican government
    - Asia and Japan have a 26% share of world trade.
  - This is how financial contagion can spread.
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# Russia

- Russia had funded its **fiscal deficit** by selling **large amounts of government debt** (especially Treasury bills) to foreigners.
- Continual **fiscal weakness** due to **poor tax collection**, **corruption** and **inefficiency** meant that investors were unwilling to continue to lend at this rate.
- On 17 August 1998 Russia **devalued rouble** and announced a **30 day moratorium on external debt servicing**.
- On 26 August the rouble was effectively **allowed to float**.
- Russia had already had an IMF package of 21,2 billion pounds lent to it in 1996 and further loans were made.
- Foreign investors faced losses of at least **50 billion \$** following the **Russian default**.
  - Bank in the City of London alone were estimated to have lost 7,5 billion pounds in 1998 as a result of losses in emerging markets, but especially in Russia.



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# Russia

- On 29<sup>th</sup> September the Fed calmed nerves by lowering interest rates by  $\frac{1}{4}\%$  (the first time in three years) and by another  $\frac{1}{4}\%$  on 15<sup>th</sup> October.
  - Russia's bank system was built following the collapse of communism, without the capital or credit skills needed for long term.
  - At one point, 40 new banks were being set up each week and Russia ended with 2500 new banks.
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# Japan

- The Japan's economy has been in troubles for several years, with **poor or nonexistence growth rates**, a **stock market collapse**, a **fall in property values** and **huge bank bad debts**.
  - It has also led to a weakening of the yen
    - Which helps Japan to export more
    - But makes imports more expensive.
  - Sales to Japan are the equivalent of
    - 12 % of Malaysia GDP and
    - 6 % of Indonesia GDP
  - Relevance of Japan's problems to problems elsewhere.
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# Japan

- The banks kept weak firms going, the government kept weak bank going.
- Many firms was borrowing to invest in project with low return.
- In the middle of 1998, **total bank debts in Japan were estimated at 80 trillion yen or 12% of GDP.**
- For the future, Japan faces the problem that pensioner will be the equivalent of 56% of the population within 20/30 years.
- The government finally decided to the more serious action and, in June 1998 formed **Financial Services Agency** to take over the job of supervising banks from the Ministry of Finance.
  - In particular, its task was to force banks to face up to writing off bad loans with government financial help to enable them to do so.
- Also set up was a **Financial Reconstruction Committee**
  - Which issued bonds to fund bank reform. It put forward credible rescuing plans which led to more mergers and alliances.
- **62 billion \$** was injected into 15 of Japan's leading banks, who in turn **wrote off 46 billion \$ of non-performing loans.**
- By early 2002, the FSA pronounced the nation's leading banks to be in “basically sound” health.
  - After a brief return to profit in 2000 – 2001, the 121 Japan's banks in the world's top 1000 reported combined losses of 50,1 billion \$.
  - The top four banks alone incurred losses totaling 22,7 billion \$.
- The banking system therefore may be out of crisis but remains weak for foreseeable future.

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# Brazil

- Brazil like Mexico and Argentina, had **pegged** its currency **to the dollar** to control inflation.
  - The confidence was falling by the second year 1998 particularly with a **fiscal deficit of 8 % of GDP**.
  - A flight into dollars from August to September weakened the country's foreign exchange reserves.
  - Attempts to set new floor levels for real failed, and the IMF stepped in in November with 41,5 billion \$ rescue package.
  - Brazil floated the real in January 1999.
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Why did it all happen

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# Short-term Capital Flows

- What we do see is **massive foreign capital flows** into emerging markets, which leads to **over-investment** and **excessive expansion** of the money supply.
  - As a **confidence falls**, **money are withdrawn**.
  - Many loans are in short-term and subject to **periodic renewal** them.
  - They are then withdrawn in the event of a crisis.
  - Because the loans are in a foreign currency, collapse of the domestic currency increases the real value of repayment and leading to further losses
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# Short-Term Capital – Hot Money

- One of these factors is the **short-term nature of the loans** and the fact that they are **in foreign currencies** and that investment in stock markets has been short-term and speculative.
  - Linked with this there is the afford of many countries to maintain a fixed exchange rate.
  - But huge foreign debt is a risky way of financing economic development.
  - We tend to think of funds flowing to emerging markets which have a low level of domestic savings and need foreign money in order to exploit opportunities.
  - Curiously, in this case, many Asian economies actually had good level of domestic savings.
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# Transparency

- Lack of transparency also plays a role.
  - We have new markets and techniques
    - Euromarkets, junk bonds, securitization of assets, derivate products, huge increase in forex volumes.
    - Today's **capital market are global** but they are **supervised on a national basis**.
    - There is **no official institution** which is **responsible for the global capital markets** or **responsible for monitoring** them on worldwide basis.
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# IMF/World Bank Role

- There is, finally, some criticism of the role of the IMF and confusing between its role and the role of World Bank.
  - History of IMF is related with Bretton Wood fixed exchange rate regime
    - The role of IMF was to help countries with temporary balance of payment difficulties.
  - With the arrival of floating rates much of the IMF functions disappeared.
  - Suddenly, both organizations playing same role, leading to disagreement.
  - In 1998, e.g. the World Bank announced a 1,25 billion \$ loan to Argentina when IMF was withholding financial support.
  - As a results,
    - The Fund to have primary responsibility for exchange rate matters, the balance of payments and growth-oriented stabilization policies
    - The Bank to be responsible for development programmes
  - The handling of the Asia Crisis generated criticism
    - IMF does not have enough money. During the 1997 crisis, the World Bank had to support it with short-term liquidity.
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# The Solutions?

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# Avoiding Fixed Exchange Rates

- There seems to be widespread agreement that **fixed exchange rates**, or **exchange rate “pegs”** are potentially dangerous.
  - Small, open economies do not have the breadth of financial markets to withstand sharp fluctuations in exchange rates.
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# Exchange control

- Inward control (restricting capital coming in)
  - Outward control (not letting people to take capital out)
  - In general, adoption of capital controls has attracted criticism. It is pointed out that this undermines access to capital markets, may increase the risk of inflation and promote misallocation of investments.
  - In spite of the almost universal criticism Paul Krugman argue that the failure of the IMF to act in time has legitimized the adoption of exchange controls as a temporary measure.
  - The country can stimulate the economy without risking the exchange rate.
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# The Czech Republic in the 1990's

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Overview

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# Preparation of transformation

- Year 1990 preparation of the “Strategy of the economic transformation” (published in September 1990).
    - Two parties:
      - Central planned economists from Ministry of Finance
      - Liberal economists from Academy of Sciences (Prognostic Office)
    - Final conception of Minister of Finance – V.Klaus
    - At the end of the 1990 devaluation of the Czech currency (for two times)
      - To face accelerating imports that were stimulated by preannounced expected devaluation.
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# 1991

- In 1991 in 1st January came in effects main package of stabilization measures:
  - **Liberalization of bulk of prices** (not included so-called regulated prices like electric energy, rent, medical care, etc.)
  - **Liberalization of the foreign trade** +internal convertibility of the Czech currency (obligatory surrender of foreign exchanges)
  - **Last devaluation** of the Czech currency 1DEM approximately 18 CZK
    - Setting of fixed currency exchange rate to 5 currencies, etc.
- The first steps of transformation were penetrative.

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# 1991

- In the 1991 inflation rate **rose to 56 %** (the highest rate in the history)
    - It meant decline in real value of savings and wages.
  - Break up of RVHP led to massive decline in foreign trade and slow orientation in west European countries.
  - Because of all these inside and outside factors **decline in GDP about 15 %**.
  - These transformation decline was typical for all post soviet countries.
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# 1992-1993

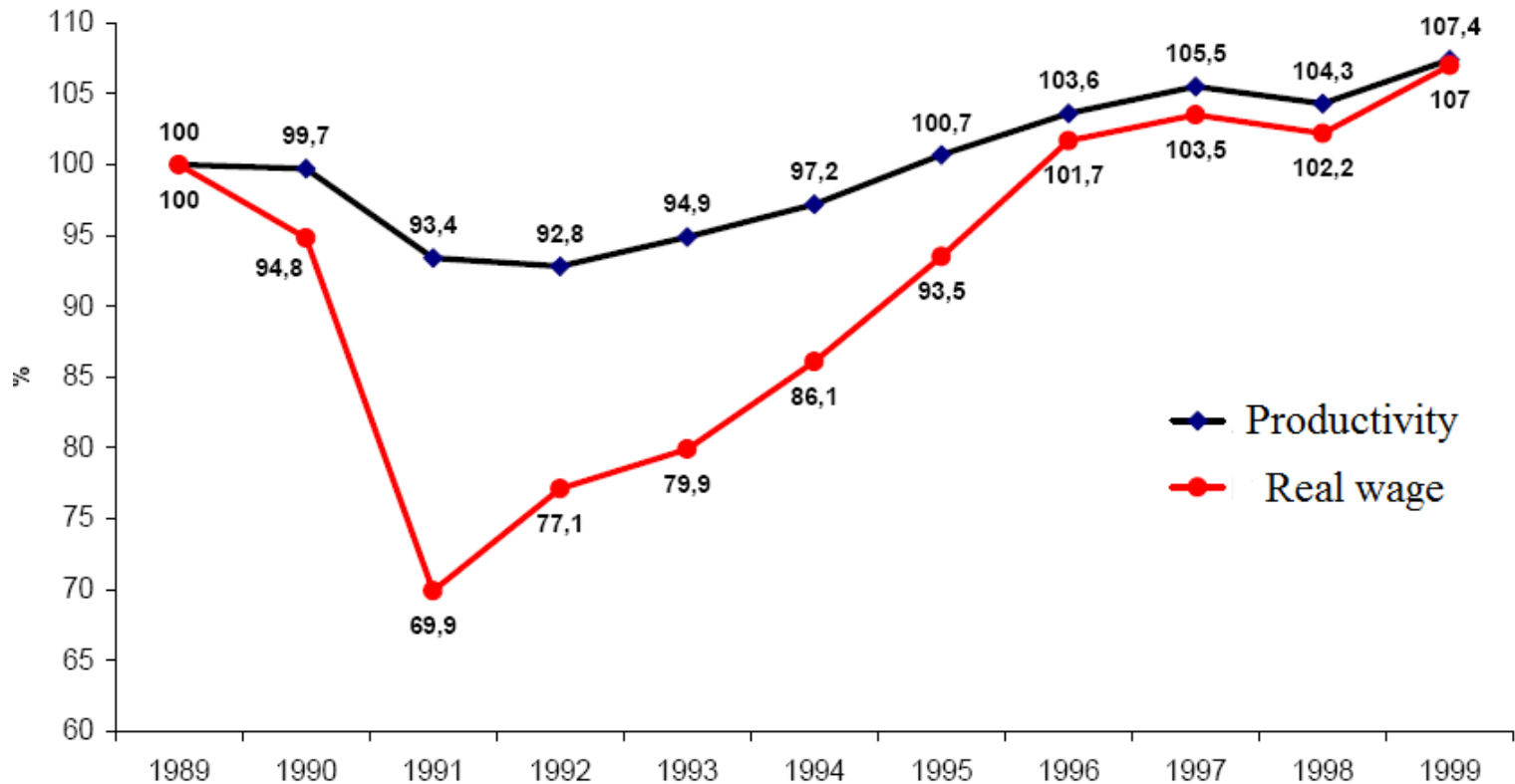
- Initiation of small and later large privatization (voucher booklets, several rounds of large privatization waves (waves were only two!))
  - To 1st January 1993 splitting of Czechoslovakia, establishing of two central banks.
  - At the end February 1993 dividing of Czechoslovak currency and stamping of currency.
  - To 1<sup>st</sup> January 1993 **tax reformation** e.g. establishing of **indirect taxes** -> cutting down the **inflation rate to 20 %**
  - The year 1993 last year of large shocks in the economy and starting of economy recovery.
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# 1994 - 1995

- The large privatization in proceeding.
  - In October 1995 entrance into OECD as the first post-communistic country.
  - Recovery of economic growth
    - Inflation rate 6 %
    - Unemployment rate 3 %
  - Despite of all economic progress in the financial market were emerged trends that led to banks and currency crisis.
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# Difference - eliminated risk of demand pressure at the beginning of the 1990's



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# Development of banking sector

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# Development of banking sector:

## Main phase

- In 1990 establishing of banking sector.
- Splitting of mono-bank structure to two tier banking system.
- Inherited problems
  - Lower capitalization
  - Bad credits
  - Lack of long-time savings
  - Inexperienced employees
  - Nonexistence of risk management
  - Gaps in law
- Consolidation programme I
  - Cleaning of balance from inherited bad loans
  - It concerned of bad loans in Komerčni banka, Ceska sporitelna, Investicni banka
  - Establishing of Consolidation bank/agency (1991) as a main tool for overdrawng of bad loans.
  - Total costs of Consolidation programme I
    - 100 billion CZK approx. 7 % of 1995 GDP

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# Development of banking sector:

## Main phase

- Entrance of small banks in the banking sector
    - 1990 - 13
    - 1991 - 13
    - 1992 - 17
    - 1993 – 4
    - But banks with unhealthy strategy of development, undercapitalization, fraudulent managers
    - Owners unwilling or were unable to ensure sufficient bank capital
    - Liberal policy of CNB in licensing
  - Consolidation programme II
    - Purpose – to **avoid of cascading failure** in banking sector
      - Problems of small banks could have effect to confidence of banking sector as a whole.
      - From 18 banks 15 entered in KP II, 9 banks withdrawal of banking licence.
      - Total costs of KP II 100 billion of CZK
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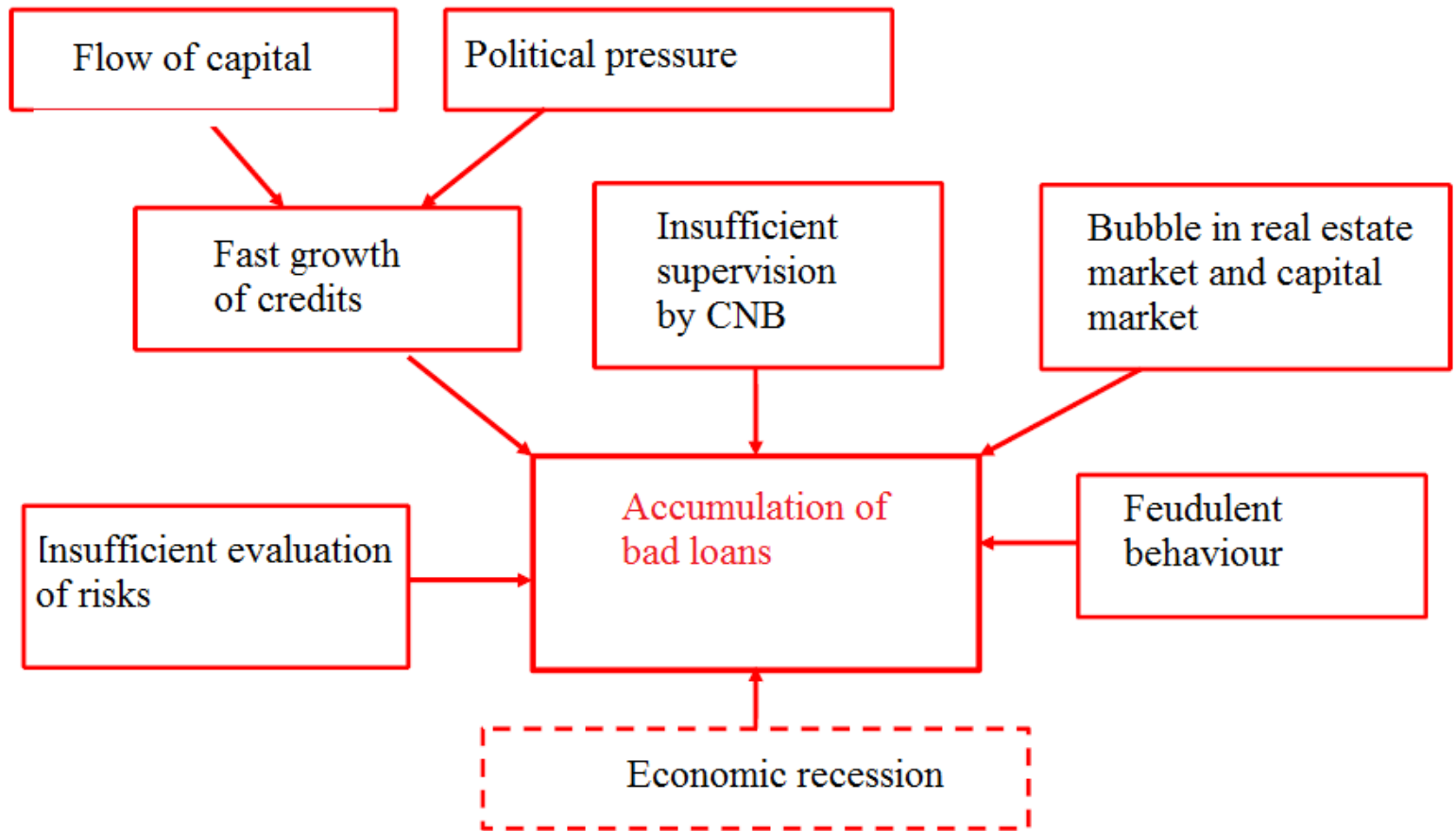
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# Development of banking sector:

## Main phase

- Stabilization programme
    - Initial purpose for 13 small banks at the end 6 banks took part in this programme, 5 banks were excepted.
    - Programme were unsuccessful
  - In banking sector existed 4 large state banks
    - Ineffective control, low profitability and competitive advantage
  - About 1996 in banking sector cumulated problems that let to accumulation of bad loans.
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# Anatomy of banking crisis reasons



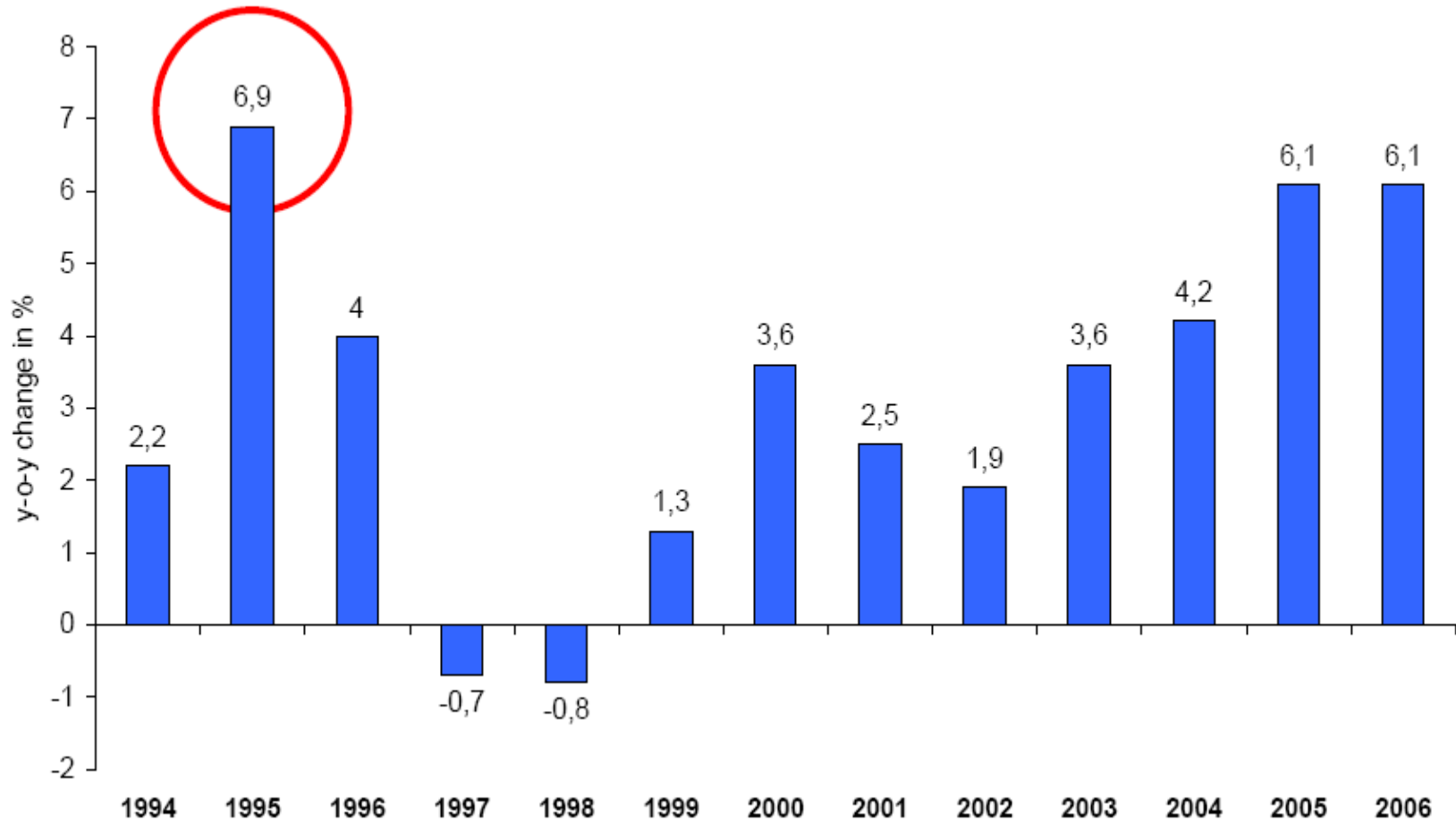


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# Results of accumulation of bad loans

- Banks were vulnerable
  - Wrong working credit channel
  - Fiscal costs to keep banking system alive were high.
  - Banking sector was the most vulnerable place of the Czech transformation
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In 1995 according to GDP growth about 7 % but it was economy overheating



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# Overheating of economy in the half of the 1990's

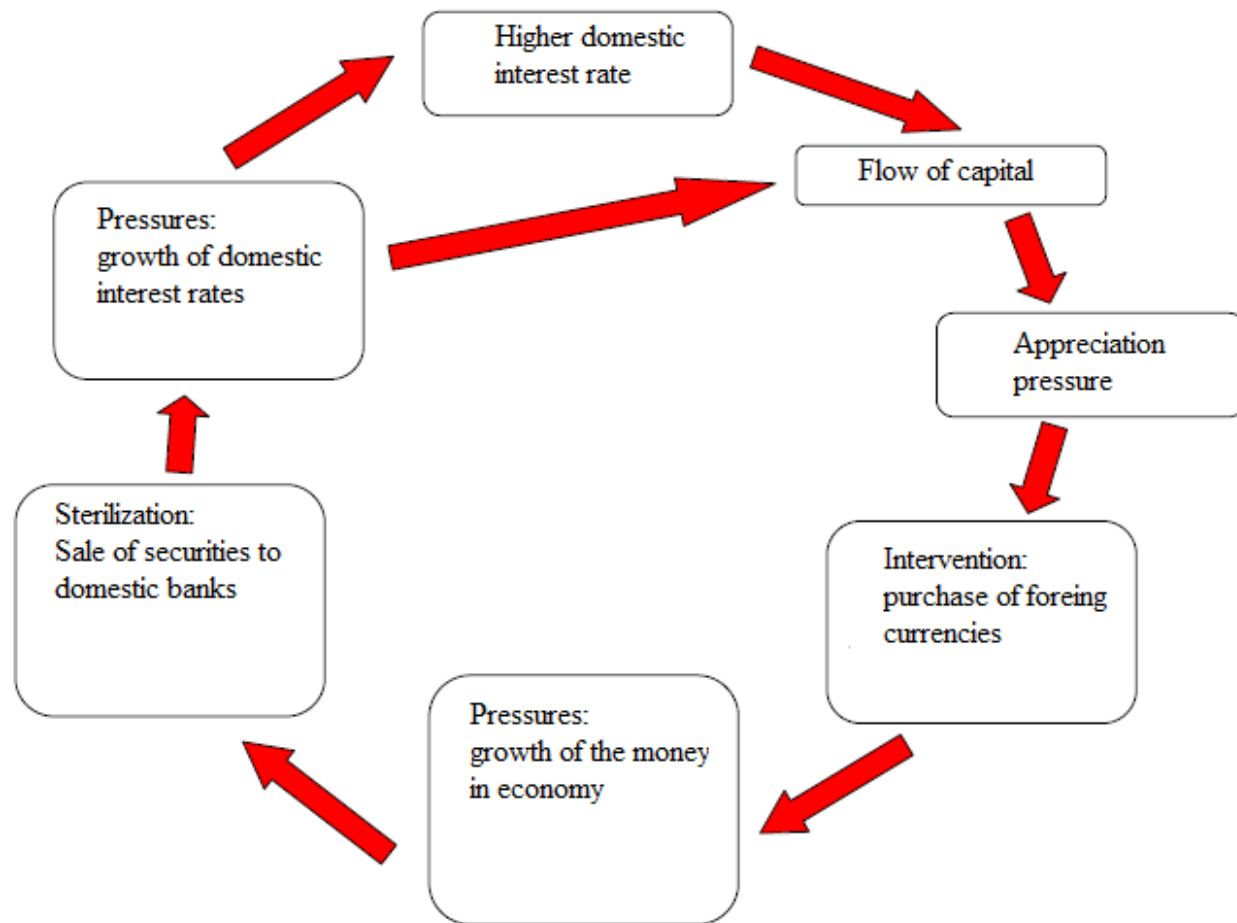
- **Fast growing demand**
    - Fast growth of wages but slow growth of productivity
    - Fast growth of private and public investments (building of infrastructure)
    - Fast growth of credits
    - Fast flow of capital
  - **Inelastic supply**
    - Infirm markets
    - Functionless law framework
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# Monetary framework

- Fixed currency exchange rate from 1991
    - Several baskets
      - Originally to 5 currencies
      - Later only to USD and DEM
  - Liberalization of capital account
  - Establishing of Impossible Trinity –parallel existence of
    - Free flow of capital
    - Fixed currency exchange rate
    - Independent monetary policy
  - Liberalization of capital account destroyed coherence of monetary framework.
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# Vicious cycle of monetary policy



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# Routing to CZK attack

- Fluctuation belt of CZK expanded from  $\pm 5$  p.p. to  $\pm 7.5$  p.p. at the end of 1996
  - Growth of repo rate from 11.3 to 12,4 (in 2009 1,75 %)
  - Growth of obligatory minimal reserves from 8,5 % to 12,5 %.
  - First attempt to stabilize Czech economy. Not successful.
  - In May 1997 after several days of fluctuation belt protection loss about 3 billion USD.
  - Leaving of fixed currency exchange rate
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# Transformation – what was successful

- Stabilization of the Czech economy in the first phases
  - Splitting of Czechoslovakia and splitting of currency
  - Offers of wide range of privatization methods and transit of assets to private hands
  - Openness of the economy, establishing of competitive environment
  - Attractive of Czech economy
  - All transitive economies were more and less successful in some party of transformational process.
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# What could be better

- Fast privatization of large banks (slow privatization was expensive)
  - Problems with Impossible Trinity – long time in fixed currency exchange rate and overheating of economy
  - Wrong law framework
  - Unfinished privatization (CEZ, CD, CSA)
  - Worse regulation of capital market
  - Low elasticity of labour market
  - No reform of pension, medical care, education system
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The End

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