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**EDITORIAL: FINANCIAL CRISES-CAUSES,  
CONSEQUENCES AND REMEDIES**

by

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by Irma Adelman

Since 1980, three quarters of the IMF's member countries, developed and developing alike, have been hit by financial crises. The global economy has thus become quite unstable. Although the origins of these crises differed, they share common features: They are preceded by a lengthy period of large foreign capital inflows (FCI) supporting: sizable current account deficits; increases in investment and economic growth; and significant appreciations of the country's currency. The FCI permit running extensive budget deficits and cheap-money policies. The economy booms but at the cost of increased inflation. Inevitably, the currency appreciation decreases the country's competitiveness and widens the current account deficit further. At some point, foreign lenders get worried about the sustainability of the twin deficits and, fearing a devaluation, curtail lending and start withdrawing capital. This triggers a sharp devaluation. Futile currency stabilization efforts which reduce foreign reserves to perilously low levels. This accelerates capital flight and leads to precipitous declines in exchange rates. A severe domestic credit crunch ensues as banks and corporations scramble to repay foreign debts with much more expensive dollars. They sell off domestic assets, to generate liquidity, and stock and real estate markets crash. Eventually, the country is forced to approach the IMF. Loan conditions usually entail: closing insolvent banks, reducing the budget deficit, raising domestic interest rates, and curtailing wages and social spending. The human, social and political costs escalate. Nevertheless, eventually, the country's international credibility is restored and the crisis is transformed into a severe and prolonged recession.

Why are financial crises frequent now while absent before 1973? Largely because, in 1973, when the supply of dollars became woefully inadequate for world trade, the global financial system was changed drastically. Flexible exchange rates replaced fixed ones; and, under US and IMF pressure, open capital markets replaced closed short-term capital markets and regulated foreign investment flows.

These changes provided the environment enabling financial crises by robbing countries of their economic autonomy. Governments become unable to employ their traditional policy instruments (interest rates, government expenditures, and exchange rates) unilaterally: Raising interest rates above world markets triggers a large FCI, setting the stage for a financial crisis; fixing them below world markets, triggers a large foreign capital outflow, generating the crisis. Similarly, setting exchange rates above equilibrium levels leads to a current account deficit (stage I); fixing them below equilibrium stimulates capital flight and investment abroad, producing the crisis. Finally, running a budget deficit to stimulating growth or providing social programs more generous than the international norm causes capital outflows. Flexible exchange rates amplify the effects of these international capital flows, by allowing speculation on foreign exchange markets that are excessively large (\$1.5 trillion of daily transactions, \$600 billion speculative); excessively liquid; excessively volatile; imperfectly informed; and subject to herd psychology.

The resulting loss of economic autonomy afflicts both developed and developing nations, but has more severe consequences for developing ones: for, if their capital markets are open and unregulated, their governments cannot stimulate further

development. All countries are left with responsibilities without instruments. It is therefore hardly surprising that periodically governments ignore the international constraints on their economic freedom and trigger a financial crisis. So far, the United States has enjoyed both economic autonomy and immunity from crisis because dollars are the sole global asset. But, it is about to lose that immunity once the Euro joins the dollar.

What must be done? One, we must negotiate with the EU to precommit to a stable Euro-dollar exchange rate. Two, we must discontinue pressuring developing countries from regulating or taxing portfolio investment and foreign borrowing. Three, we must require greater financial transparency: in OECD banks, disclosure of lending to hedge funds and foreign exposure; and, in LDC banks, better and more timely reporting and governance.