

WESTMINSTER

INTERNATIONAL UNIVERSITY IN TASHKENT

An Accredited Institution of the University of Westminster (UK)

**MODULE**

# **Topics in Macroeconomics**

**WIUT**  
**Teaching Week 11**

**Presenter: Bilol Buzurukov**

## **Seminar 10**

# **The Financial System: Opportunities and Dangers**

## **Mexican Financial Crisis 1994-1995**

# Discussion 1



**1994** – 1 peso = 30 cents  
**1995** – 1 peso = 16 cents



- In January 1<sup>st</sup> 1994, NAFTA was established;
- Mexico became a country on the rise;
- Due to Economic Integration trade barriers were removed;
- Foreign investors were eager to make loans to Mexican economy.

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Mexican political future became under question;  
Investors placed a large risk premium on Mexican assets.

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What do you think?

Why the risk premium did not effect the value of peso at the beginning?

**Fixed Exchange Rate**

Mexican Central Bank had to accept pesos and pay out dollars.

- Mexico's foreign debt was too small to maintain its fixed exchange rate.
- At the same time, the government's budget deficit was too large to be financed by the

Due to these problems, Mexico was not able to pay its debt; Thus Mexican economy was on the edge of default.

Interest Rate

plummeted



How was Mexican government able to recover from 1994-1995  
Financial Crisis?



What were the reasons behind the  
United States and IMF' support of  
Mexico?

- To help its neighbor to the South;
- To prevent the massive illegal migration;
- To prevent the investor pessimism regarding Mexico from spreading to other developing countries.

## **Asian Financial Crisis 1997-1998**



## Symptoms of the Asian Crisis:

- High Interest Rates;
- Falling Assets Value;
- Depreciating Currency.

## As an example of Indonesia:

- Interest Rates rose above 50%;
- Stock Market lost 90% of its value;
- Rupiah fell against dollar by 80%;
- Real GDP fell about 13%.

What sparked the Asian Financial Crisis?

**The problem began in the Asian banking system:**

- Asian nations had been more involved in allocation of financial resources;
- There was partnership between government and the private enterprises.

## What is wrong if the government intervenes in the allocation of financial resources?

- Asian banks extended loans to those with the most political clout rather than to those with the most profitable investment projects;
- International investors lost confidence in the future of these economies;
- Risk premiums for Asian assets rose, causing interest rates to skyrocket and currencies to collapse.

How were Asian countries able to overcome the crisis?



- The IMF and the US tried to restore confidence;
- The IMF made loans to overcome the crisis;



Under what conditions?

- Governments had to reform their banking system;
- Governments had to remove crony capitalism.

## Watch the video!

<https://www.youtube.com/watch?v=nZccen3yMxE>

- 1) How robust was the economy of Argentina in the last 70 years?
- 2) How much loan have IMF issued to Argentina in 2018?
- 3) Was it a wise decision to finance a risky economy?
- 4) Did Argentinian economy experience recovery after the bailout?
- 5) How did the crisis affect the Argentinian stock and exchange markets?
- 6) Does Argentinian economy have proper solution to growing budget deficit?

# Great Depression 1930's



# Discussion 12

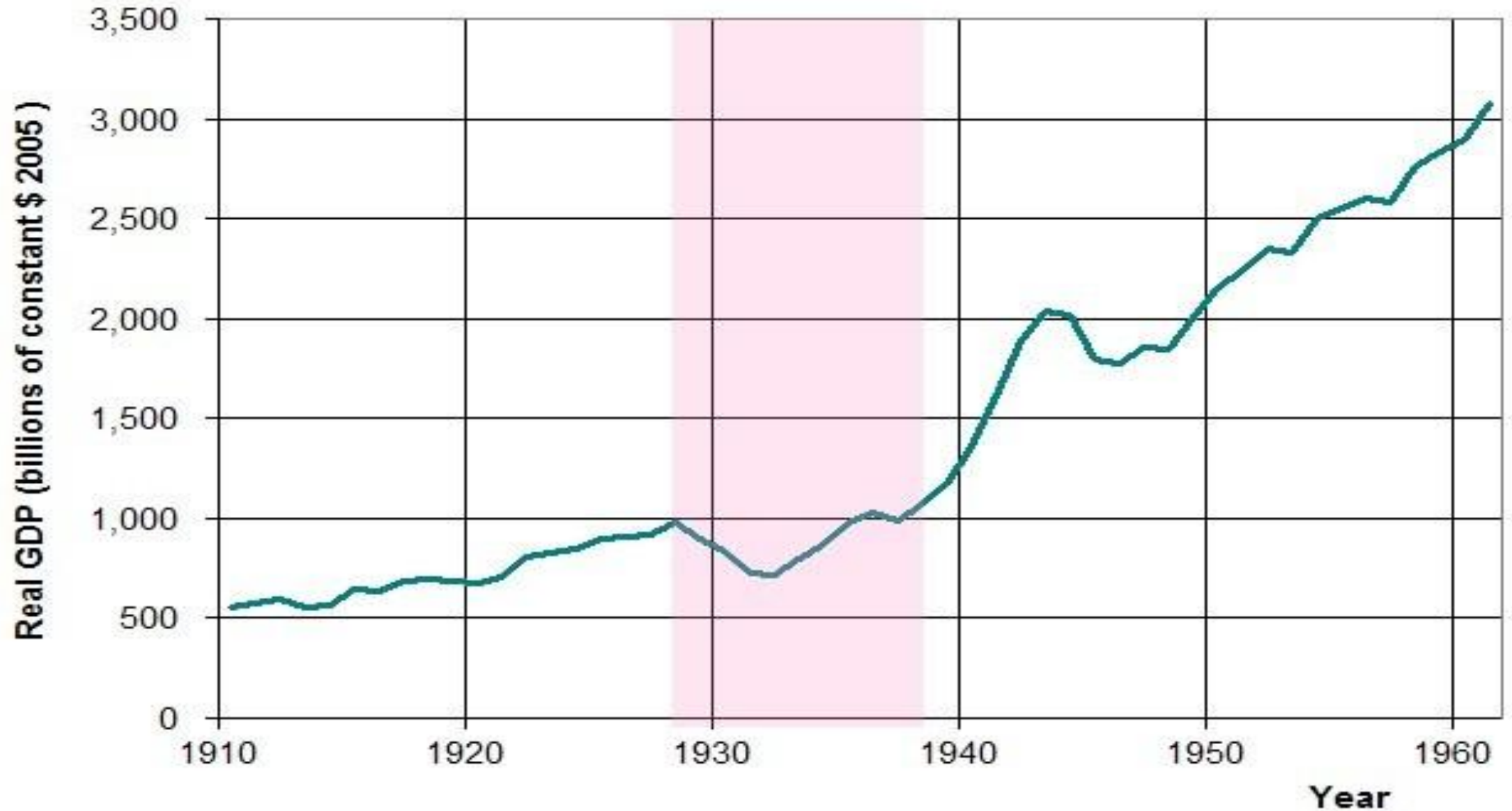
- The Great depression was the longest, deepest, and most widespread depression of the 20th century.
- The Great Depression started in the United States after a **major fall in stock prices** that began around September 4, 1929, and became worldwide news with the **stock market crash** of October 29, 1929 (known as **Black Tuesday**).

- 1929 – 1932, worldwide GDP fell by an estimated 15%.
- 2008 – 2009, worldwide GDP fell by an estimated 1%.

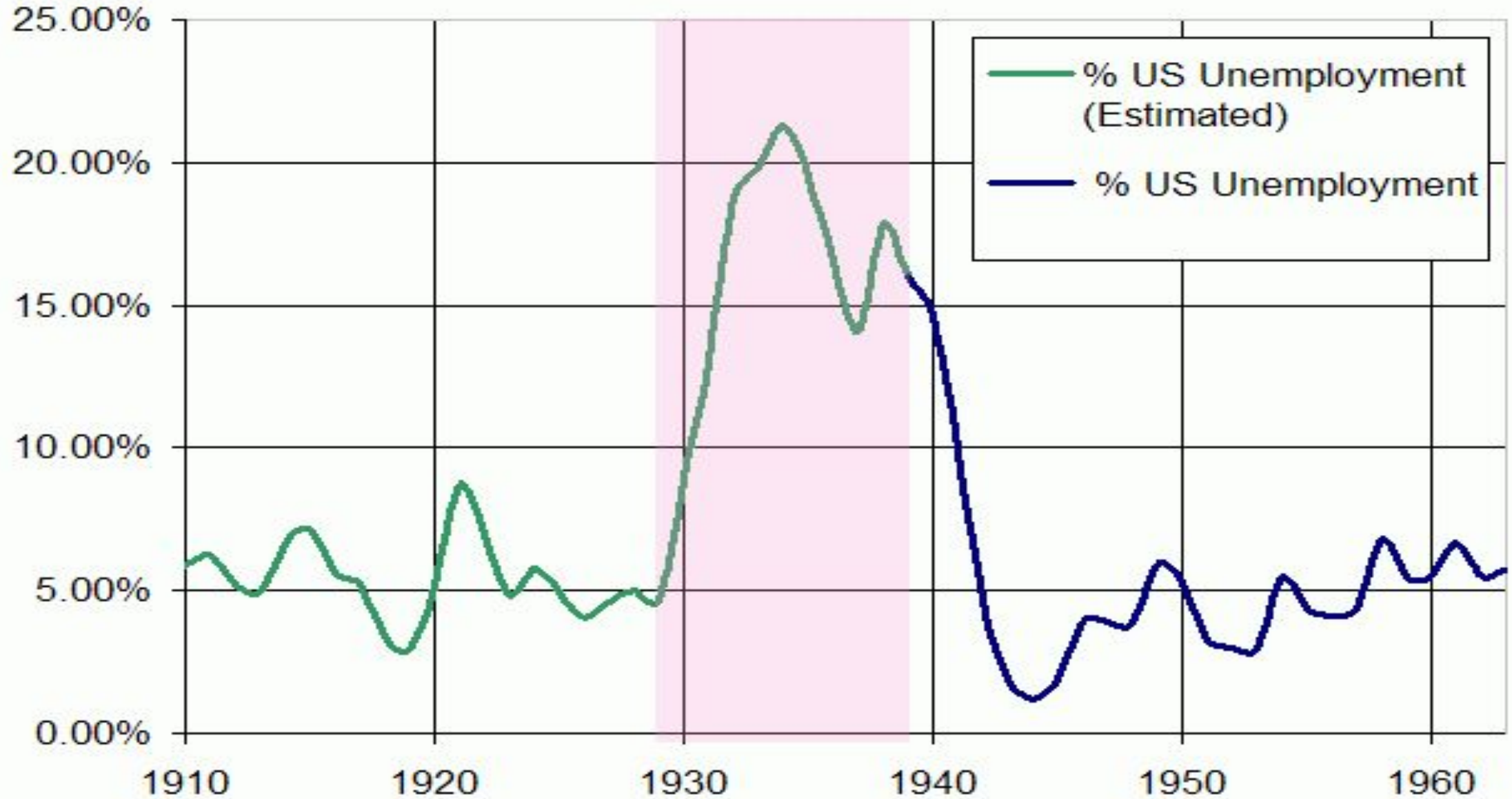
The Great Depression had devastating effects in countries both rich and poor.

- Personal income, tax revenue, profits and **prices dropped**;
- International trade plunged by more than **50%**;
- Unemployment rate in the U.S. rose to **25%**;
- Unemployment rate in some other countries rose as high as **33%**;
- Farming communities and rural areas suffered as crop prices fell by about **60%**;
- Beginning in the mid-1930s, a **severe drought** ravaged the agricultural heartland of the U.S.

# U.S.A. Real GDP



# U.S.A. Unemployment Rate



## **Great Recession 2008-2009**

## How did everything start?

- Federal Reserve lowered interest rates to historically low levels in the aftermath of 2001 recession;
- Low interest rates helped the economy, but made it less expensive to get a mortgage and buy home;
- As a result housing prices skyrocketed.

- Mortgage market made it easier for subprime borrowers;
- Securitization developed, as well.

## What is MORTGAGE?

- It is a form of debt created to finance investment in real estate;
- A debt is secured by the property, so if the property owner does not meet payment obligations, the creditor can seize the property.

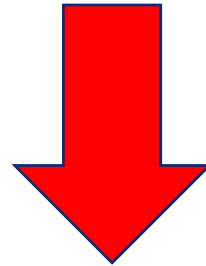
### Types of Mortgage

**Prime Mortgages** - offered to borrowers who satisfy traditional lending standards.

**Alt-A mortgages** - typically satisfy some but not all the criteria for prime mortgages.

**Subprime mortgages** - offered to borrowers who do not qualify for prime loans.

**What was the reason behind encouraging high-risk lending by the government?**

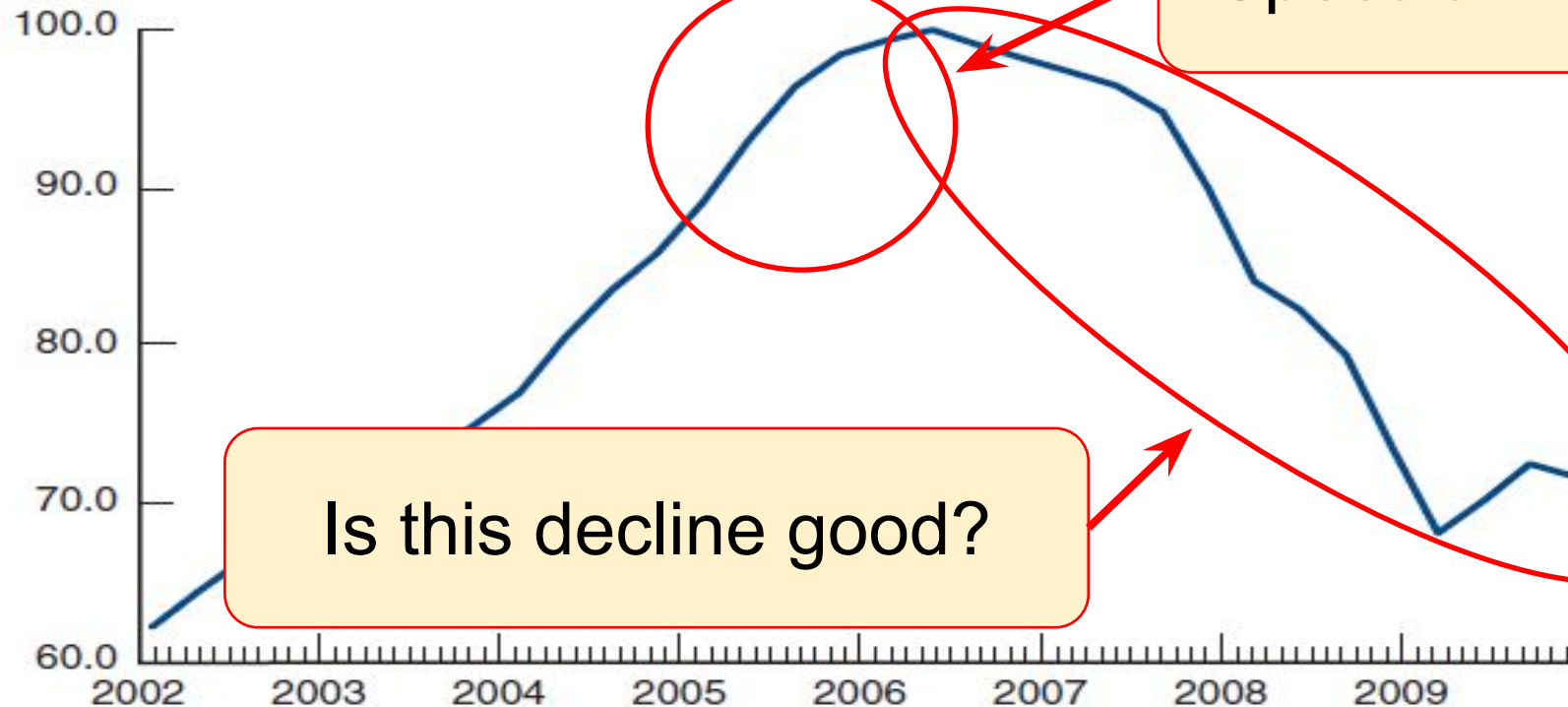


**Make homeownership more attainable for low-income families.**



The Financial Crisis started due to this decline?

Housing  
(Case-Shiller Index,  
2006, Q2 = 100)



Speculative Bubble

Is this decline good?

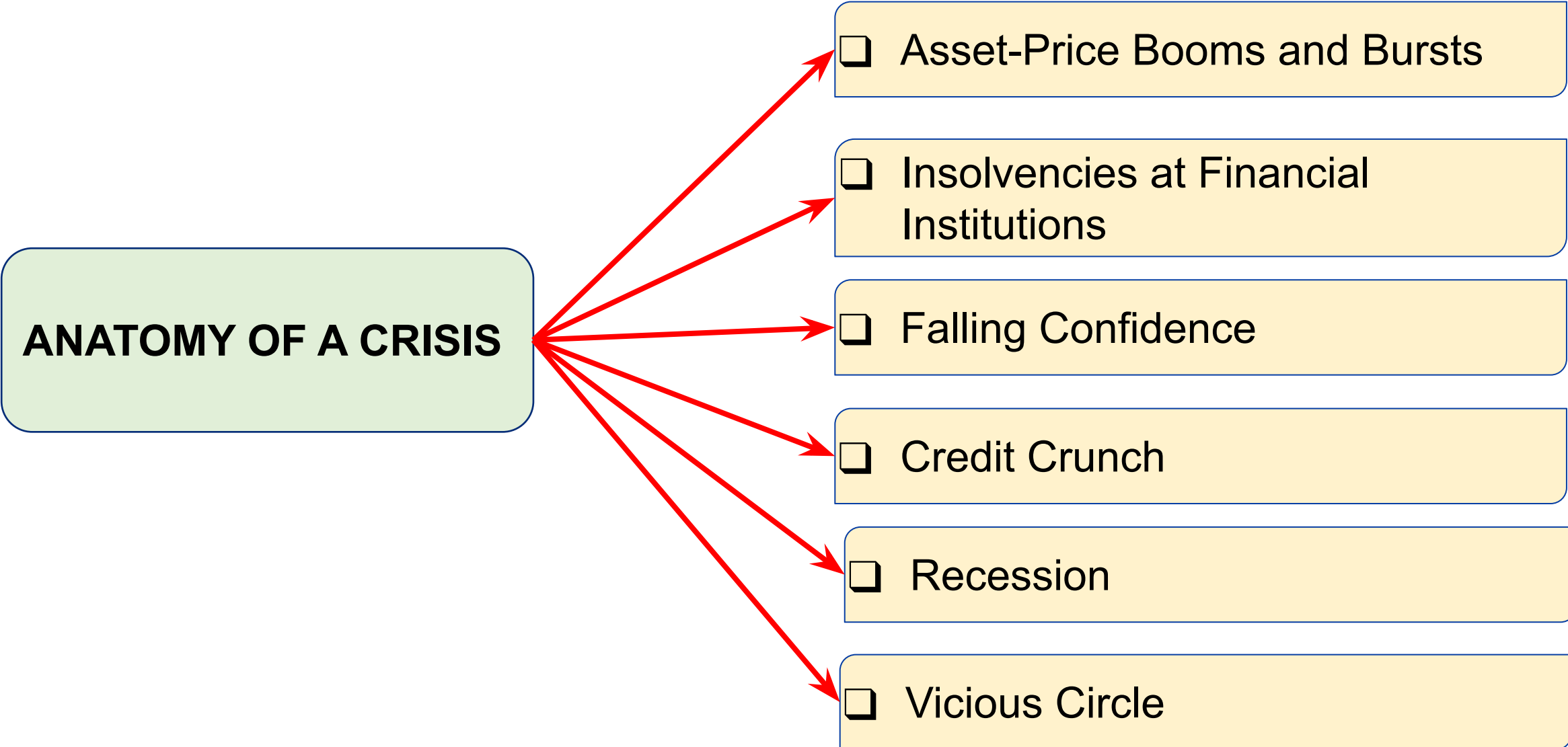
- When housing prices declined, the homeowners were *underwater*;
- The homeowners owed more on their mortgages than their homes were worth;
- The homeowners stopped paying their loans;

- The banks responded to the defaults by taking the houses away in foreclosure procedure;
- The banks started to sell the taken-houses;
- This phenomena further decreases the housing prices. Why?

## How was the US government able to unfold the financial crisis problem?

- In September 2007, Fed cut its target for the federal funds rate from 5.25 % to about zero;
- In October 2008, Congress appropriated \$700 billion for the Treasury to use to rescue the financial system;
  - The funds were used for equity injections into banks;
  - The banks used funds for making loans;
  - The government became a part owner of the banks (at least temporarily).

## ANATOMY OF A CRISIS



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graph LR; A[ANATOMY OF A CRISIS] --> B[Asset-Price Booms and Bursts]; A --> C[Insolvencies at Financial Institutions]; A --> D[Falling Confidence]; A --> E[Credit Crunch]; A --> F[Recession]; A --> G[Vicious Circle];
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Asset-Price Booms and Bursts

Insolvencies at Financial Institutions

Falling Confidence

Credit Crunch

Recession

Vicious Circle

# Practice Exercise 1

Consider an economy characterized by  $C = cY$ , with  $c = 0.5$ ,  $T = 0$ ,  $G = 500$ ,  $NX = 250$  and  $I = \bar{I} - bi$ , with  $\bar{I} = 1000$  and  $b = 5,000$ . Note that investment depends on the interest rate.

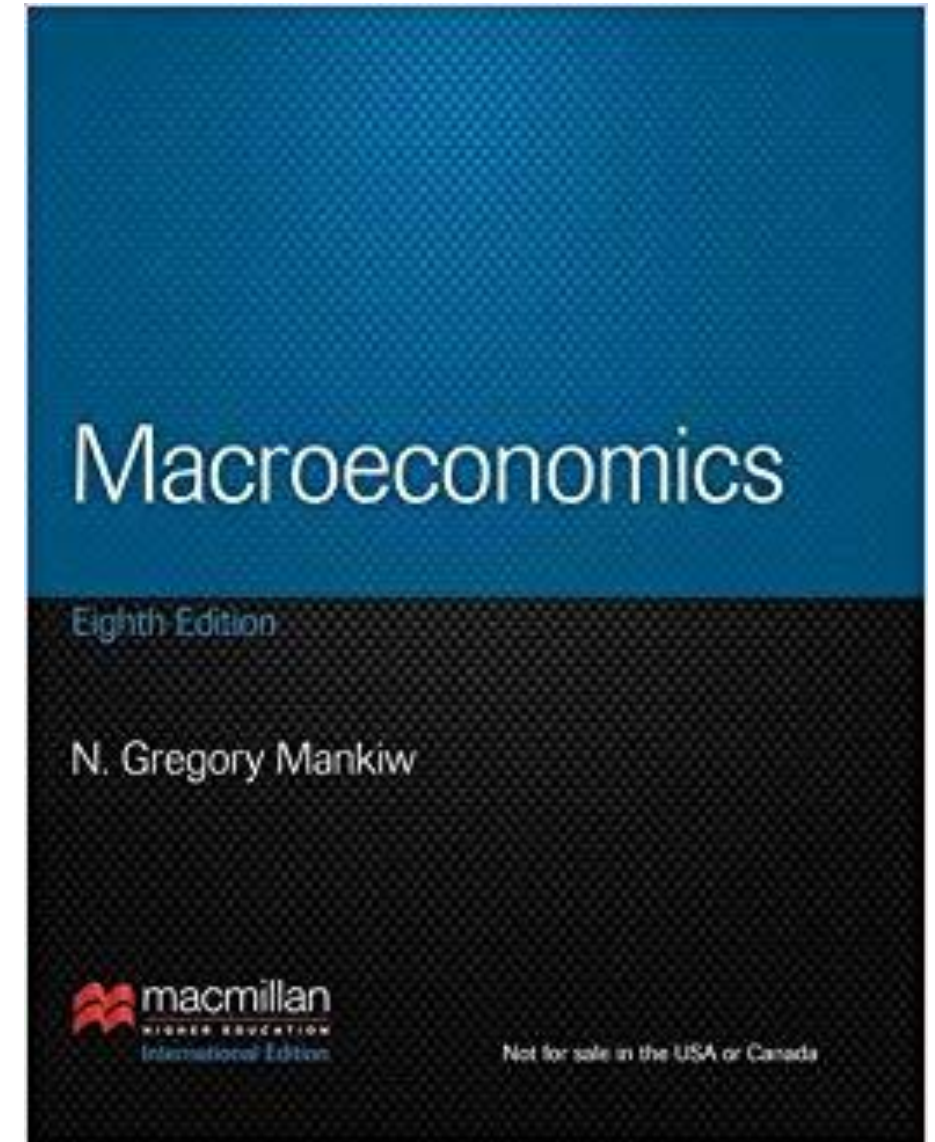
- 1) Assume that, due to the increasingly pessimistic expectations of investors, autonomous investment decreases from 1000 to 500. The interest rate and all other exogenous variables stay constant. Calculate the resulting change in income.
- 2) At the same time the interest rate decreases from 0.06 to 0.03. Calculate the effect on equilibrium income.

# Practice Exercise 2

Consider the economy of Practice Exercise 1, except that consumption now depends on disposable income:  $C = c(Y - T)$ . The government increases expenditure from 500 to 1000. This additional expenditure is financed partly by taxes, which account for 50% of government revenue, and partly by issuing bonds. This sudden appearance of huge quantities of government bonds on the capital market drives up interest rates from 0.03 to 0.05. ( $\Delta \bar{I} = 0$ )

- 1) What is the effect of all these changes on equilibrium income?
- 2) Would it have been better to finance the expenditure entirely by taxes (then  $\Delta G = \Delta T = 500$  and  $\Delta i = 0$ )?

- 1) Mankiw, G. (2013).  
Macroeconomics. 8<sup>th</sup> edition.  
Houndmills: Palgrave  
Macmillan. Pages: 567-587;  
373-374; 374-375; 346-347.
- 2) [https://en.wikipedia.org/wiki/Great\\_Depression](https://en.wikipedia.org/wiki/Great_Depression)
- 3) Seminar Video link:  
<https://www.youtube.com/watch?v=4OVUdIJQp2A>



*Thank  
you*

