

Simon Johnson: One Page Summary

### **15.015, class #6: Modern Financial Crises**

It helps to differentiate clearly between three types of economic crises. (This is not an exhaustive list; there are many ways to seriously mess up an economy.)

First, there is a large budget deficit and investors become concerned about “debt sustainability,” i.e., whether there will be some kind of default or other reduction in payments below what was promised. Interest rates tend to increase, which puts further pressure on the budget. This is Greece 2010, Portugal 2010-11, and perhaps now Italy.

In terms of the ISLM framework, responding with fiscal austerity (lower government spending or higher taxes or both) will shift the IS curve down and to the left – lowering output and lowering interest rates. In the BBNN framework, this will reduce domestic demand (C+I+G), so the economy will move to the left (presumably below the NN curve, so unemployment is increasing.)

Second, there is a current account deficit, which was previously financed by net capital inflows (i.e., more capital coming in than going out). Now capital wants to leave, tending to depreciate the exchange rate. If there is a fixed exchange rate regime, the central bank will sell its foreign exchange reserves and buy local currency. Eventually the central bank will run out of reserves and the currency will depreciate (or devalue, meaning that it moves to a new pegged value.) This happened to Thailand in 1997.

It is possible to have a current account deficit without a budget deficit and vice versa. But the two often occur together. Think in terms of the flow of savings.

If the current account is balanced, net capital flows are zero (aside from any change to official reserves). So any budget deficit is financed by borrowing domestically (meaning investment is less than domestic savings.)

If the budget is balanced, then a current account deficit (and associated net capital inflows, assuming the exchange rate is stable) means that foreign savings are financing domestic investment being higher than savings.

If there is a budget deficit, this may be financed by savings coming in from abroad – implying that the current account has a deficit (as this is the counterpart to a net capital inflow).

In this context, it is a great disadvantage to borrow in a foreign currency, rather than in your own currency. When your currency depreciates – for example, as part of the process that reduces a current account deficit – the real value of foreign debts, measured in local currency, goes up. This can cause financial distress and bankruptcies.

Third, the banking system may contract sharply – often known as a “financial crisis” (be careful, this term is sometimes used in a generic way for any kind of crisis). In principle, a banking crisis could occur without a budget crisis or a current account crisis. In practice, banking crises are often triggered by sharp currency depreciations or by a fall in the value of government debt (as this is one of the main assets that banks hold).

Banks have “informational capital” about their customers; bank failure generally destroys valuable information about who is and is not a good credit risk. A decline in the price of collateral (e.g., real estate) can also contribute to the “financial decelerator.”

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