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"FINANCIAL CRISIS IN THE GLOBALIZE WORLD"

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ABSTRACT

1. Introduction 1

2. General Overview of the World Economy, Social & Political Situation 2

2.1 Economic Situation After Technological Innovation and Globalization.....................3

2.2 Nature Of Financial Markets and Their Role in The Economy...............................7

- The Money Market 9
- The Capital Market 9

2.3 The Performance of Financial Institutions 10

- Risk and Risk Control 14

3. Banking Crisis 14

3.1 Factors Behind Banking Crisis 15

3.2 The Role of The International Monetary Fund (IMF) 20

3.3 The Case of Argentina 23

- A Better Reform Plan for Argentina 32

4. Conclusion 34

REFERNCES

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ABSTRACT

This paper is talking about Banking Crisis in the developed nations and the reasons behind their occurrence. It considers the impact that they make to a country's overall economic performance. A detailed discussion is provided for the financial markets and the financial institutions and their role in the economy, especially commercial banks, since their performance reflects the overall performance of a nation, and any bank failure might be the beginning of a banking crisis. The crisis, which took place in Argentina, is provided as an example of banking crisis, and the several factors underlying the incident, as well as some policy options for Argentina to overcome the crisis.

1. Introduction

The financial system is a vital component of a modern economy. It is the framework of instruments, markets, and institutions in which exchanges of resources at points in time and over time are accomplished. More specifically, the financial system facilitates payments for goods, services, and productive resources and provides means for the efficient accumulation of saved funds and their allocation into investment uses. The financial system includes such private institutions as commercial banks, savings and loan associations, and insurance companies.

Commercial banks are considered to be the most important sector within the financial system, because of the huge influence they have on the economic performance of a nation, the well being of banks means the well being of the nation, which is the main reason why banks are heavily regulated and supervised. Banks are important economically because they act as intermediaries between the large number of depositors and those who wish to borrow; in this way they encourage savings by providing the means of attracting and collecting funds through the various types of accounts they offer, while at the same time they put such funds to effective use.

Managing a bank in the years ahead promises to be an increasingly more challenging task. A difficult economic environment, a changing regulatory environment, a rapid rate of technological development, an increasingly intensive level of competition, and some worrisome trends in the banking industry all press for a more focused and righteous approach to bank management. Any error or misjudgment of the banking system might lead to disastrous results, such as bankruptcy and at the end cause a severe banking crisis.

Many developed countries have experienced failures in their banking systems, because poor management and weak supervision, and lack of experience, and above all the absence regulative authorities and institutions, which may forbid banks from pursuing harmful tivities such as high risk borrowing, a basic reason for bank failures. However, countries ıst improve their systems to prevent banking crisis from occurrence, by various strategies d policies such as increasing the regulatory laws on banks, reducing taxes to encourage oductive investments in the country, establishing trade arrangements with neighbouring untries, and so on.

General Overview of the World Economy, Social & Political Situation

The burning character and different dimensions of current problems become clearer ıen the so-called "New World Order" under this hegemony of a single power, is evaluated :h in the context of economic crisis since the early 1970's. In terms of standards of living, re was a decline relative to those conditions that applied in the period. 1950-70, the controllable rise of unemployment has been functioning as the main source of the pearance of paramilitary groups, and all the other anti-democratic movements. All of the ns through welfare society, welfare state and democratization processes are being mantled. It should not be a surprise for us, if existing regional conflicts and war get panded.

Given the fact, according to the official figures, there are more than 30 millions people poverty in the US, 34 millions unemployed in the OECD countries and when the annual rking hours in Japan reach 2200 hours, it is clear that, in this process of globalization, lti National Countries (MNC'ies) are the only ones who profit from it. It is those people, o live in the developing countries who suffer most under the conditions of unemployment inflation. The other "bitter" results of globalization are that hundred thousands of people e been dying lack of food, doctors, medicine.

2.1 Economic Situation After Technological Innovation and Globalization

As a word “global” means “to cover whole the world.” From this definition it is possible to create some other concept like “global market”, global enterprises”, global product”, global management”, global culture”, “global policy”, global business” and “global capital”. (Kamil Turan (1994), “Küreselleşen Çağımız ve Çalışma Hayatı”, Kamu-İş Dergisi, Cilt 3, Sayı 3)

In other words, globalism is the coalition of national economy, politics and culture whit the series of multi national progress. As a doctrine of globalization it can affect from one country to another. (James H. Mittelman, the Dynamics of Globalization, London, Lynne Rienner Publishers)

The concept of globalization developing since the 1980s, has accompanied with a series of changes. The end of the cold-war following the collapse of USSR, the acceleration of communication and information technologies through technological improvements and present demand and arrangements caused by increased capital accumulation stimulated the globalization process.

In this period of change, international trade and capital movements are liberalized, spread, accelerated and increased in volume, and new investment alternatives are developed. The world economy and the global capital, growing by advantages of new production techniques and information economy, has reached significant volumes together with black-money additions and unrecorded economy returns Black-money and unrecorded economy, using advantages of liberalization, unrestricted world trade, reduction in customs, lessening of frontier controls add 80-100 billion dollar to the global fiscal system.

This growing capital leads to great waves as a result of entering and existing of the national economies in order to obtain short-term profits and rants. Therefore, another issue that world economies have recognized with globalization is financial-based economic crises caused by sudden attacks and drawbacks of short-term capital movements. When analyzed, it is seen that one crisis occurs every nineteen-month period. Our country was also experienced financial crises in 1994 and 1999 having similar global characteristics which were also affected by financial crises emerged in other countries. (Doç.Dr. Muhammed Akdiş, Pamukkale University, Faculty of Economics and Administrative Sciences, 2001)

Furthermore, the financial sector is increasing its sovereignty in the world. The total market volume of the global financial and monetary transactions has increased from 5 trillion dollars in 1990 to 35 trillion dollars in 1992 and they are expected to reach 83 trillion dollars in the year 2000. Between 1990 and 1994, 50 new markets were opened in the developed countries, while the capital flow towards the developed countries increased 15 folds. The international debt stocks fo the banks increased from 256 billion dollars in 1975, to 4.2 trillion dollars in 1994. At the time when the Asian crises emerged the indebtedness volume of the said region reached 60 trillion dollars.

The financial sector has balanced with other profits, the profit losses incurred from the decreasing domestic and foreign demands, which were the effects of the economic crises. According to 500 Biggest Industrial Enterprises data of the Chamber of Industry of Istanbul, the other profits account for 87.7% of the total net income on the balance sheets by 1998. Besides the stocks are also potential sources of income.

The crisis has significantly affected world output. The IMF's World Economic Outlook forecasts a fall in world growth from 4.1% in 1997 to 2% in 1998. Growth in the newly industrialized Asian economies is expected to be negative, -2.9% in 1998; while GDP growth in the developing world is expected to fall sharply from 5.8% in 1997 to 2.3% in 1998. Latin American countries are expected to grow at only 2 and 2.5%, while those in Africa will grow at around 3.5%. Countries in transition, including Russia, will experience a decline of -0.2 per cent; although those in central and eastern Europe are expected to grow by some 3.4%.

The social cost of the crisis is also significant. For example, according to the World Bank, unemployment in the crisis-hit countries has risen sharply to about 13 million people in Indonesia, 3.5 million in Thailand, and 1.6 million in Korea, for a total of 18 million compared with 5.3 million in 1996. Real wages are also falling sharply, down some 40 to 60 % in Indonesia and about 10% in Thailand. Poverty is also on the rise with, for example, about 17 million more people expected to fall below the poverty line in Indonesia. The decline in global output will also result in a decline in global trade in volumes from 10% in 1997 to 4% in 1998.

'As global economic activity weakens and regional cycles diverge, trade and current account imbalances will increase. For example, the US current account deficit is forecast to double from 1997 to 1999 - from 155 billion dollars to 290 billion dollars- while Japans surplus will increase by 50% -up to 135 billion dollars. Europe's Euro area surplus is expected to remain high, around 110 billion dollars. Developing countries' overall deficit in 1999 is expected to be about 60 billion dollars, but those in Asia are likely to show a surplus of about 40 billion dollars. Economies in transition are likely to show a slightly improved current account position, from a deficit of about 30 billion in 1998 to a deficit of 25 billion in 1999'. (WTO News: 1998 news items, 9 December 1998 - Annual Overview Report)

The economic crisis affected the real wages in 1999, in Turkey; they decreased 29.4% compared with 1993. The wages of the civil servants suffered a remarkable decrease, and the real wages decreased 71.9% compared with 1991. This decrease is the direct result of the government policies targeting to decrease the wages of the civil servants.

One of the effects of the economics crisis is the spread of "flexibility", the employment types, the working hours, the vacations and wages are managed contrary to the benefits of the workers and the capitalist sector imposes law amendments in that direction.

By the end of 1999, the collection from the privatization is 4.1 billion dollars, but the expenses of the privatizations have reached 5.8 billion dollars; apart these crucial public institutions are transferred with a fait-accompli to the hands of the foreign-domestic capital.

The cost of the 6 bank bankruptcies or more precisely the six banks allowed to bankrupt cost to the state 6.6 billion dollars, and while this is condoned without uttering a word, public institutions of great value are privatized at the lowest prices for the pretext to provide "funds for the public deficits".

Although the inflation rate by 1999 was 64.9%, the government of Turkey decided to increase the civil servant and the minimum wages by 25%, which is the predicted inflation rate according to the decision of December 9, 1999 and the IMF agreement.

Table 1. Global Capital Movements (in billion dollars)

	1994	1995	1996	1997	1998	1999
Capital flow-private (net)	155.7	195.3	214.9	123.5	56.7	129.2
Direct Investments (net)	85.3	99.6	120.4	147.2	127.5	118.6
Portfolio Investments (net)	104.4	40.7	80.2	69.9	35.3	41.9
Other investments (net)	(34.0)	55.1	14.2	(93.5)	106.1	(31.3)
Investments-official (net)	(2.1)	23.2	3.2	22.4	53.4	(0.6)
Changes of reserves	(75.4)	121.0	106.2	(37.7)	(31.7)	(67.3)

Source: IMF 1998: 60

2.2 The Nature of Financial Markets & Their Role In The Economy

The financial system is a vital component of a modern economy. It is the framework of instruments, markets, and institutions in which exchanges of resources at points in time and over time are accomplished. More specifically, the financial system facilitates payments for goods, services, and productive resources and provides means for the efficient accumulation of saved funds and their allocation into investment uses. The financial system includes such private institutions as commercial banks, savings and loan associations, and insurance companies. Financial markets include such markets as the stock market, bond market, money market, and mortgage market.

Financial markets are the transmission mechanism between savers-lenders, and borrowers-spenders. Through a wide variety of techniques, instruments, and institutions, financial markets mobilize the savings of millions and channel them into the hands of borrowers-spenders who need more funds then they have hand. Savers-lenders stand to benefit because they earn interest or dividends on their funds. Borrowers-investors stand to gain because they get access to money to carry out investment plans they otherwise could not finance. Without financial markets, savers would have no choice but to hoard their excess money, and borrowers would be unable to realize any investment plans except those they could finance by themselves.

The existence of highly developed, widely accessible, and smoothly functioning financial markets is of crucial importance in transmitting savings into the hands of those desiring to make investment expenditures. Those who can visualize and exploit potentially profitable investment opportunities are frequently not the same people who generate current savings. If the financial transmission mechanism is underdeveloped, inaccessible, or imperfect, the flow of funds from household savings to business investment will be impeded, and the level of economic activity will fall below its potential.

Although all financial markets involve the process of transferring funds from savers to borrowers, the precise role played by different financial markets varies widely. These differences may be characterized by classifying the financial markets. The most common classification is the distinction made between the Money market and the Capital market. This distinction is based on the maturity of the financial assets purchased and sold in the financial market. Short-term financial assets are involved in the money market. Examples are Treasury bills, commercial paper, bankers' acceptances, and other short-maturity financial assets, these types of financial instruments are used by individuals, businesses, and governments primarily to adjust their liquidity. In contrast, longer-term instruments traded in the capital market include such financial claims as corporate bonds and stocks, and mortgages.

- **The Money Market:**

The money market may be defined as providing the means for short-term lending and borrowing, and thus plays a key role in the management of liquidity by business, governmental, and household economic units.

The money market provides a facility in which financial market participants may adjust their liquidity positions. Participants with a temporary liquidity surplus may dispose of their excess fund by purchasing money market instruments. Those with temporary liquidity deficiencies may eliminate them by selling money market instruments held in their portfolios or by borrowing, which is issuing new money market instruments. Therefore the money market is often analyzed as an indicator of the degree of financial pressure in the economy and of the current posture of monetary policy. As such, the money market, like all financial markets, provides important information to market participants. It mirrors the liquidity pressures on financial institutions. In addition, the Federal Reserves injects reserves into the banking system and withdraws reserves through its operations in the money market.

All money market instruments are short-term, and they are characterized by relatively little credit risk. These two features promote substantial price stability to the purchaser. In addition, money market instruments are relatively homogeneous and highly substitutable, with only small differences in risk and return among the major types of money market securities.

These instruments are federal funds (short-term loans between commercial banks), Eurodollar deposits (dollar-denominated deposits at foreign banks), domestic certificates of deposits or Cds (large, business-oriented certificates issued by major commercial banks), bankers acceptance (time drafts drawn on major banks in which the bank has guaranteed payment), and commercial paper (short-term unsecured promissory notes issued by large businesses). (Cooper/ Fraser, 1993, p409)

- **The Capital Market:**

The framework for the borrowing and lending of funds for periods longer than a year is called the capital market; some observers view the capital market as composed of markets for intermediate and long-term funds.

The capital market encompasses a diverse group of securities-bonds, mortgages, and equities issued by economic units. In contrast to the money market, which is very homogeneous in nature, the capital market is quite fragmented. Its securities have considerable differences in credit risk, interest-rate risk, and marketability.

One of the most important sub-components of the capital market is the bond market. The bond market comprises corporate, municipal and US government debt. The volume of new corporate bonds is principally determined by the growth rate of corporate assets, as well as by the relative cost of bonds versus other sources of funds. In the corporate bond market, life insurance companies are the main lenders, followed by pension and retirement funds. State and local government bond are bought primarily for their tax-exempt feature. US government securities are generally bought by a wide variety of purchasers, including the Federal Reserve, commercial banks, and individuals. The same is true of the securities of various government agencies such as the Federal Home Loan Banks; most of these are guaranteed, formally or informally, by the full faith and credit of the federal government.

By far the largest part of the capital market, in terms of dollar value of securities outstanding, is the stock market. About half of all the outstanding stocks are owned by individuals; the rest are held by such institutional investors as pension funds, mutual funds, and insurance companies.

In many of these sectors of the capital market, active trading takes place daily for outstanding issues-especially for stocks and for US government securities, to a lesser extent for corporate and for municipal (state and local) bonds. Trading is facilitated by a variety of institutions, including securities dealers and brokers, with expensive communications facilities, under the regulation of the government.

2.3 The performance Of Financial Institutions

Financial institutions such as banks, insurance companies, and pension funds are called by a special name: financial intermediaries. They dominate the financial scene at home and abroad. It is virtually impossible to spend or save or lend or invest money nowadays without getting involved with some kind of financial intermediary in one way or another.

Financial intermediaries act as agents, transferring funds from ultimate lenders to ultimate borrowers. They borrow from a person to lend another person. What all financial intermediaries have in common is that they acquire funds by issuing their own liabilities to the public (savings deposits, savings and loan shares) and then turn around and use this money to buy primary securities (stocks, bonds) for themselves

Financial institutions are in a better position than individuals to bear and spread the risks of primary security ownership. Because of their large size, intermediaries can diversify their portfolios and minimize the risk involved in holding any one security.

Competition among financial intermediaries forces interest rates to the lowest level compatible with the intermediaries' evaluation of the risks of security ownership. A high rate of economic growth requires a large volume of real investment. The lower the rate of interest that ultimate borrowers must pay, the greater their expenditures on real investment.

The beneficial effect of intermediation on economic growth can also be seen from the viewpoint of risk bearing. Intermediaries are better able than individuals to bear the risks of lending out capital. As financial intermediaries own a larger portion of the marketable securities outstanding, the subjective risk borne by the economy is lowered, interest rates are reduced, and more real investment takes place. Funds are channelled from ultimate lenders, through intermediaries, to ultimate borrowers more efficiently than if the intermediaries did not exist.

A) Commercial banks: are defined as those financial institutions that offer the widest range of financial services and perform the widest range of financial functions of any business firm in the economy. Commercial banks are the largest financial institutions ranked in terms of asset size. Banks are similar to business firms; The raw material they trade is money, they buy money (take your deposit) and then sell it (make loans or buy securities) to someone else making a profit (interest). The major source of funds for the banks used to be demand deposits (checking accounts), but in the few past decades savings and time deposits have become even more important than demand deposits. With these funds commercial banks buy a wide variety of assets ranging from short-term government securities to long-term business loans and home mortgages.

While many people believe that banks play only a narrow role in the economy-taking deposits and making loans-the modern bank has had to adopt new roles in order to remain competitive and responsive to public needs. Banking's principal roles today are as follows:

Table 1. The many different roles banks play in the economy

The intermediation role	Transforming savings received primarily from households into credit (loans) for business firms and others to make investment in new buildings, equipment, and other capital goods.
The payments role	Carrying out payments for goods and services on behalf of their customers (such as by issuing and clearing checks, wiring funds, and dispensing currency and coin).
The guarantor role	Standing behind their customers to pay off customer debts when those customers are unable to pay (such as by issuing letters of credit).
The agency role	Acting on behalf of customers to manage and protect their property or issue and redeem their securities (usually provided through the bank's trust department).
The policy role	Serving as a conduit for government policy in attempting to regulate the growth of the economy and pursue social goals.

Source: (Rose, 1993, p9)

As Banks work within the financial system to attract funds and make credit available to their customers, they must do so within a climate of extensive Regulation, designed to protect the public interest. Banks are so heavily regulated because of a number of reasons;

First banks are among the leading repositories of the public's savings, many savers lack the financial expertise and depth of information to evaluate the riskiness of a bank. Therefore, regulatory agencies are charged with the responsibility of gathering the information needed to assess the financial condition of banks in order to protect the public against loss.

Banks are also closely watched because of their power to create money in the form of readily` spendable deposits by making loans and investments (extending credit). Moreover, changes in the volume of money creation appear to be closely correlated with economic conditions, especially the creation of jobs and the presence or absence of inflation.

Banks are also regulated because they provide individuals and institutions with loans that support consumption and investment spending. Therefore any discrimination in the granting of credit would represent a significant obstacle to personal well-being and an improved standard of living.

Finally, banks have a long history of involvement with government-federal, state and local. Early in the history of the industry, governments relied upon cheap bank credit and the taxation of banks to finance armies and to supply the funds that they were unwilling to raise through direct taxation of their citizens. More recently, governments have relied upon banks to assist in conducting economic policy, in collecting taxes, and in dispensing government payments. (Rose, 1993, p68-69)

B) Life Insurance Companies: rank third in asset size, they insure people against the financial consequences of death, receiving their funds in the form of periodic payments know as premiums.

C) Pension and Investment funds: are similar to life insurance companies in that they are mainly concerned with the long run rather than the short run. Their inflow of money comes from working people concerned with their retirement years.

D) Mutual Funds: which includes pooling the funds of many people, and investing the total in a wide variety of stocks and bonds, thereby obtaining diversification that individuals acting alone might not be able to achieve.

E) Savings and Loan Associations: have traditionally acquired all their funds through savings deposits, and used them to make home mortgage loans.

F) Sales and Consumer Finance Companies: specialize in lending money for people to buy cars and take vacations and for business firms to finance their inventories. They get their funds by selling their own short-term promissory notes to business firms, as well as by selling their own long-term bonds.

G) Property and Casualty Insurance Companies: insure homeowners against burglary and fire, car owners against theft, etc.

- **Risk and Risk Control**

Unfortunately, the road to profitability involves more than keeping a careful lookout for opportunities to cut expenses and generate revenues. There is also a sizable element of risk that can easily trip up the unsuspecting bank. Risk is an unavoidable part of banking; which involves the day-to-day uncertainties of attracting, lending, and investing money. Eliminating risk is not possible; managing risk is. If not controlled efficiently, risk may cause severe losses to a bank and be a potential threat to the bank's well-being and therefore lead to a banking crisis.

In the banking industry, there are three basic types of risk: **Credit risk** depends on whether individual customers can fulfil their commitments to the bank, while **financial risk** arises when there are changes in interest rates or market prices of currencies and securities, **operational risk** refers to errors which may lead to losses.

1) Credit Risk: arises in lending and in issuing guarantees, there is a risk that issuers will not meet their obligations, if such a situation arises the bank must acquire a new equivalent contract in the market to replace the old one. This may entail a cost for the bank, depending on price trends in the foreign exchange, money and equity markets.
2) Financial Risk: In the bank's operations, various types of financial risk arise. they include: (a) Market Risk which arises during trading sessions, such as exchange rate risk, equity risk, and interest rate risk which arises because of differences in the duration of assets and liabilities. (b) Liquidity risk which arises when the bank's lending has longer maturities than its funding, in such a case the lending must be re-financed once or several times during its life.
3) Operational Risk: A definition of operational risk which is becoming widely accepted is the risk of direct or indirect loss due to inappropriate or inadequate internal routines, human error and erroneous systems or due to external events.

3. Banking Crisis

There is a natural inclination to think of financial crises as rare events. Yet banking crises have become increasingly common – especially in the developing world. over the 1980–96 period at least two-thirds of IMF member countries experienced significant banking sector problems. In many regions, almost every country has experienced at least one serious bout of banking trouble. There are two reasons why banking problems in the emerging economies merit particular attention: first, the serious consequences for the local economies and, secondly, the fallout on other countries as international financial markets have become more integrated. Banking crises in developing countries have been far more severe during the past 15 years than those in industrial countries.

FINANCIAL CRISIS IN THE WORLD

December 1973 : Banking crisis in UK

June 1974 : Herstatt Crise

August 1982 : International Debt Crise

December 1986 : Bond Crise

October 1987 : Crise of Stock Exchange Market

1980s : Saving and debt crise in USA

1970 and 1980 : Crisis in Latin America

1992-93 : Excange Rate crisis in Europe (ERM)

1994-95 : Latin America and, Asia, Brazilia and Russia crises

December 1994 : Mexica Crise

1978 and 1994 : Turkey

February 1997 : Tayland

3.1 Factors behind banking crises

1. Macroeconomic volatility: external and domestic

The very nature of banks makes them vulnerable to large relative price changes and to losses of confidence. Because bankers are presumed to know the creditworthiness of their borrowers better than anyone else, their loans are illiquid and difficult to mark to market. They typically borrow short and lend long. They operate with high leverage (low capital) and on a fractional reserve basis (i.e. hold relatively small amounts of cash). Deposits are redeemable at par, and depositors are assured that they can get immediate access to liquidity – but only if not everyone tries to withdraw funds simultaneously. If volatility sharply alters the relationship between the values of bank assets and liabilities – beyond the ex ante protection provided by bank capital, specific loan loss reserves and reserve requirements against bank deposits – banks can become particularly vulnerable. Volatility in emerging markets derives from several sources – both external and domestic. One external source is the relatively large fluctuations in the terms of trade. When banks' customers suddenly find that the terms of trade have turned sharply against them, their ability to service existing loans is likely to be impaired. Volatility in international interest rates, and the in private capital flows, is another important external factor. Not only do fluctuations in international interest rates affect (either directly or indirectly) the cost of borrowing for emerging markets, but they also alter (at the margin) the relative attractiveness of investing in emerging markets.

Real exchange rates are the third member of the external volatility trio. Real exchange rate volatility can cause difficulties for banks either directly (when there is a currency or maturity mismatch between bank liabilities and assets) or indirectly (when exchange rate volatility creates large losses for bank borrowers).

2. Lending booms, asset price collapses and surges in capital inflows

According to one school of thought, banking crises are caused by excessive credit creation and unsound financing during the expansion phase of the business cycle; a crisis is triggered when the bubble bursts. Features of recent experience provide support for this thesis: both bank lending booms and declines in equity prices have often preceded banking crises; those emerging economies that received the largest net private capital inflows have also been those which experienced the most rapid expansion in their commercial banking sectors; and, finally, part of the capital inflow surge during the 1990s might be regarded as a bubble built on over-optimism about the effects of policy reform in host countries.

This argument rests on presumptions that discriminating between good and bad credit risks is harder when the economy is expanding rapidly because many borrowers are at least temporarily very profitable and liquid; that sharp swings in real estate and equity prices intensify these crises because of high loan concentration; and that asset price declines depress the market value of collateral.

3. Increasing bank liabilities with large maturity/currency mismatches

One indicator of financial deepening as economies develop and mature is a rising ratio of broad monetary aggregates to GDP. If the growth of bank liabilities is very rapid relative to both the size of the economy and the stock of international reserves, if bank assets differ significantly from bank liabilities as to liquidity, maturity and currency of denomination, if bank capital and/or loan-loss provisions have not expanded to compensate for the volatility of bank assets, and if the economy is subject to large shocks to confidence (some stemming from external events beyond its control), then one can have a recipe for increased banking system fragility. Several authors have argued that this is just what has happened over the past two decades or so.

4. Inadequate preparation for financial liberalisation

Few question the long-term benefits of financial liberalisation for developing countries. But such reforms inevitably present banks with new risks which, without the proper precautions, can increase the danger of a banking crisis. When interest rates are liberalised, banks may lose the protection they previously enjoyed from a regulated term structure of interest rates which kept short-term rates below long-term rates. More generally, the volatility in interest rates tends to rise, at least during the transition. Rapid rates of credit expansion have often paradoxically coincided with high real interest rates in the wake of financial liberalisation.

Lifting restrictions on bank lending often releases pent-up demand for credit in the liberalised sectors (e.g. real estate, securities activities). Lowering reserve requirements permits banks to accommodate increased loan demand – as does the inflow of foreign capital, often attracted by reforming economies. Yet bank credit managers reared in an earlier controlled financial environment may not have the expertise needed to evaluate new sources of credit and market risk. At the same time, the entry of new competitors (foreign and domestic) may well increase the pressures on banks to engage in riskier activities. Easier access to offshore markets may also allow banks to evade domestic restrictions on riskier activities. Unless the supervisory and regulatory framework is strengthened before the liberalisation of financial markets, bank supervisors may have neither the resources nor the training needed to adequately monitor and evaluate these new activities.

5. Heavy government involvement and loose controls on connected lending

Both factors have played an important role in the generation of banking crises because they allow the political objectives of governments or the personal interests of bank insiders (owners or directors) to intrude on almost all aspects of bank operations, damaging bank profitability and efficiency. While these intrusions are also present in some industrial countries, the frequency and severity of the problem are generally regarded as being greater in developing countries.

Despite increased privatisation, state-owned banks still retain a significant – and sometimes even dominant – share of bank assets in many emerging economies. In some countries with a federal structure, regional or provincial governments also own banks and operate them in pursuit of their particular objectives.

Loan decisions of state-owned banks are much more likely to be subject to explicit or implicit government direction than those of privately owned banks. Most state-owned banks were indeed established to allocate credit to particular sectors of the economy. All too often, however, the creditworthiness of the borrowers does not receive sufficient weight in the credit decision, with the result that loans of state banks can become a vehicle for extending government assistance to ailing industries.

6. Weaknesses in the accounting, disclosure and legal framework

Banks do not operate in a vacuum. To the extent that the institutional structure in which banks carry out their business is weak, their performance will be adversely affected. While there are significant differences across emerging economies, most analysts regard existing accounting systems, disclosure practices and legal frameworks as hindering the operation of market discipline and the exercise of effective banking supervision; these weaknesses also often work to the detriment of bank profitability.

Neither private investors nor bank supervisors will be able to monitor and to discipline errant banks without accurate, current, comprehensive and transparent information on their creditworthiness, as well as on the creditworthiness of their customers. In many countries, the accounting conventions for classifying bank assets as impaired or non-performing are not tight enough to prevent banks from making bad loans look good by lending more money to troubled borrowers. Where loan classification depends only on the payment status – rather than on evaluation of the borrower's creditworthiness and the market value of collateral – it will be easier for bankers and their loan customers to collude in concealing losses by various restructuring, accrual and interest capitalisation devices. If non-performing loans are systematically understated, loan loss provisioning will be inadequate, and the reported measures of bank net income and bank capital will be systematically overstated.

Distinguishing healthy from unhealthy banks is often hindered by the absence of financial statements on the consolidated exposure of banks, by the lack of uniform reporting requirements for banks within a country, by differences in accounting standards across countries, by the lack of published key financial data on individual banks, by the absence of serious penalties for submitting inaccurate reports to supervisors or the public and by the paucity of private credit ratings for banks in the larger emerging economies. For example, the

Basle Committee's recent survey indicated that 20% of countries still do not consolidate financial and prudential information on banks' global operations.

7. Distorted incentives ...

A system of crisis prevention can be expected to operate well only if the main actors face the proper incentives to discourage excessive risk-taking and to take corrective action at an early stage. Bank owners, managers and creditors, as well as bank supervisors, each need to "have something to lose" if they fail to act in a manner consistent with their mandate. As with banking systems in industrial countries, it has frequently been argued that the present incentive structure in banking in the emerging economies is part of the problem.

... for bank owners ...

At least three factors affect the incentives faced by bank owners: bank capital, their share in the costs of any bank restructuring, and the franchise value of the bank. Bank owners (shareholders) will be more likely to appoint good managers and to elect good directors, and so ensure that their agents do not put the bank's solvency in danger, when they have their own funds at risk. Bank capital therefore serves a twofold function: it provides a cushion against unusual losses and it promotes better governance. In a parallel vein, if a bank becomes insolvent, incentives in the future will be affected by who bears the cost of restructuring.

... for managers ...

Ensuring that banks maintain good credit and internal risk management systems is the job of bank managers and directors: poor management has often been singled out as the leading cause of bank failures. Here, too, poor oversight and imprudent behaviour should in principle incur a cost.

In practice, the multiplicity of causes of bank failure – some beyond the control of managers – serves to blur the issue, especially if managers have hard-to-replace experience.

... for bank depositors ...

The potential contribution of bank depositors to market discipline in emerging economies is limited by the quality of accounting systems and by the extent of public disclosure. Some analysts have argued that government bailouts have undermined their incentive to monitor the creditworthiness of banks.

... and for supervisors

Finally, there is the old argument that the political and legal background may encourage bank supervisors to delay the closure of an insolvent bank or the imposition of corrective measures. Given the greater government involvement in banking in emerging economies and the extent of banking or industrial connections, pressures on bank supervisors for regulatory forbearance may well be greater than they are in industrial countries. Not only can closure or restrictions on bank behaviour elicit strong protests from powerful interest groups, but such action can also embroil the supervisor in legal action. Whatever happens, acknowledgement of significant problems at a large bank may subject the supervisor to sharp criticism for not having detected the problem earlier.

8. Exchange rate regimes

The exchange rate regime can affect vulnerability to speculative attack, the way in which the real value of impaired bank assets is adjusted downwards and the ability of the central bank to act as lender of last resort to illiquid but solvent banks.

A poor track record on inflation and the lack of any obvious alternative to the exchange rate as a nominal anchor led many emerging economies to adopt exchange-rate-based stabilisation plans in the 1970s and 1980s. These plans were often successful in cutting inflation but were also accompanied by significant real exchange rate appreciation. In some cases, heavy market pressure forced a return to greater exchange rate flexibility, often entailing massive devaluation. Fixed exchange rate regimes have also been criticised for increasing the fragility of the banking system to external adverse shocks.

3.2 The Role of the International Money Fund (IMF)

The International Monetary Fund is a specialized agency of the United Nations system set up by treaty in 1945 to help promote the health of the world economy. Headquartered in Washington, D.C., it is governed by its almost global membership of 184 countries. The IMF is the central institution of the international monetary system—the system of international payments and exchange rates among national currencies that enables business to take place between countries. It aims to **prevent crises** in the system by encouraging countries to adopt sound economic policies; it is also—as its name suggests—a fund that can be tapped by members needing temporary financing to address balance of payments problems. The IMF works for global prosperity by promoting the balanced expansion of world trade, stability of exchange rates, avoidance of competitive devaluations, and orderly correction of balance of payments problems

The IMF's Purposes: The purposes of the International Monetary Fund are:

To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

I. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

II. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

III. To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

IV. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards.

V. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

To serve these purposes, the IMF:

- Monitors economic and financial developments and policies, in member countries and at the global level, and gives policy advice to its members based on its more than fifty years of experience.
- Lends to member countries with balance of payments problems, not just to provide temporary financing but to support adjustment and reform policies aimed at correcting the underlying problems.
- Provides the governments and central banks of its member countries with technical assistance and training in its areas of expertise.

As the only international agency whose mandated activities involve active dialogue with virtually every country on economic policies, the IMF is the principal forum for discussing not only national economic policies in a global context, but also issues important to the stability of the international monetary and financial system. These include countries' choice of exchange rate arrangements, the avoidance of destabilizing international capital flows, and the design of internationally recognized standards and codes for policies and institutions.

- **Strengthening Financial Sectors**

A major reason why a country may be vulnerable to economic crisis is weakness in its financial system, with institutions that are illiquid or insolvent, or liable to become so as a result of adverse developments. To make the system more robust, banks and other financial institutions may need to improve their internal controls, including their assessment and management of risk. The authorities may also need to bring their supervision and regulation of the financial sector up to international standards.

The IMF and the World Bank in 1999 began joint assessments of member countries, financial sectors to help identify actual and potential weaknesses. IMF and World Bank teams, generally with the assistance of experts from central banks and financial regulatory agencies, have been assessing the strength of financial systems in a number of member countries. These assessments are presented to the country as a guide to the measure needed. IMF staff is also working with national governments and other international institutions to:

- Strengthen the legal, regulatory, and supervisory frameworks for banks.
- Review minimum capital requirements for banks and financial institutions.
- Develop a core set of international accounting standards.
- Finalize a set of core principles for good corporate governance.
- Avoid exchange rate regimes that are vulnerable to attack.
- Ensure a freer flow of timely financial data to markets.

Similarly the IMF has been working with the Basel Committee on banking supervision to improve regulatory standards.

3.3 The Case of Argentina

It Is agreed that the key factor underlying recent financial crises is not a failure of capitalism but an "absence of capitalism." Argentina provides a cogent example; the lack of economic freedom-- the necessary environment for capitalism to work effectively--resulted in continual economic decline and, ultimately, the financial crisis that erupted in November 2000.

Poor economic policies and political instability contributed to Argentina's decline from its noteworthy position as the world's 10th wealthiest nation in 1913 to the world's 36th wealthiest in 1998. Argentina is the only wealthy country to experience so great a reversal in recent history, despite the involvement of the International Monetary Fund (IMF). Indeed, the IMF's loans and guidance have aggravated, not alleviated, Argentina's problems. After more than nine bailouts and extensions of IMF loans since 1983, Argentina is once again on the verge of a financial crisis, with fewer prospects for stimulating effective economic growth in the future.

Argentina should **reform** its economy in a manner that increases economic freedom. To help countries like Argentina reduce the severity and frequency of financial crises in the future, they should promote **reforms** in the lending practices and advice of the IMF and other international financial institutions so that their efforts will result in open economies and less reliance on loans from international financial institutions.

Argentina's Story: Economic Policies Matter

Argentina has come a long way since its military government yielded to democracy in 1983. President Raúl Alfonsín successfully consolidated the government; brought issues like human rights back to the public debate; and made the case for trade liberalization, deregulation, and privatization. To Argentina's detriment, however, Alfonsín lacked the leadership skills necessary to carry out the economic reforms he sought. For example, the government proposed Plan Austral in 1984, with the support of the IMF, to impose fiscal discipline and control skyrocketing inflation of 627 percent that year.

These targets, however, were not met; inflation rose to 672 percent in 1985, and government expenditures increased from 11 percent of gross domestic product (GDP) in 1984 to 18 percent in 1985. A subsequent IMF-sponsored program, Plan Primav was only marginally more successful, with government expenditures falling from 16 percent of GDP in

1986 to 11 percent in 1988 and inflation falling briefly to 90 percent in 1986 before rising to 343 percent in 1988.

The failure of the Argentine government to respond effectively to its economic problems contributed to an erosion of investor confidence, massive capital flight, devaluation of the peso, and hyperinflation of 3,080 percent in 1989 and 2,314 percent in 1990. Alfonsín resigned five months before the end of his term in 1989 and yielded power to Carlos Menem. Menem surprised the country by announcing major plans to open the economy. The reforms he initiated during his first administration (outlined below) gave an immediate boost to the economy and ushered in a period of prosperity with the promise of change.

Menem's second term, however, met with disappointment; the economy's decline exposed the limited nature of the reforms and the government's failure to open the market completely. Now Argentina faces a deep recession, and prospects of economic improvement are dubious.

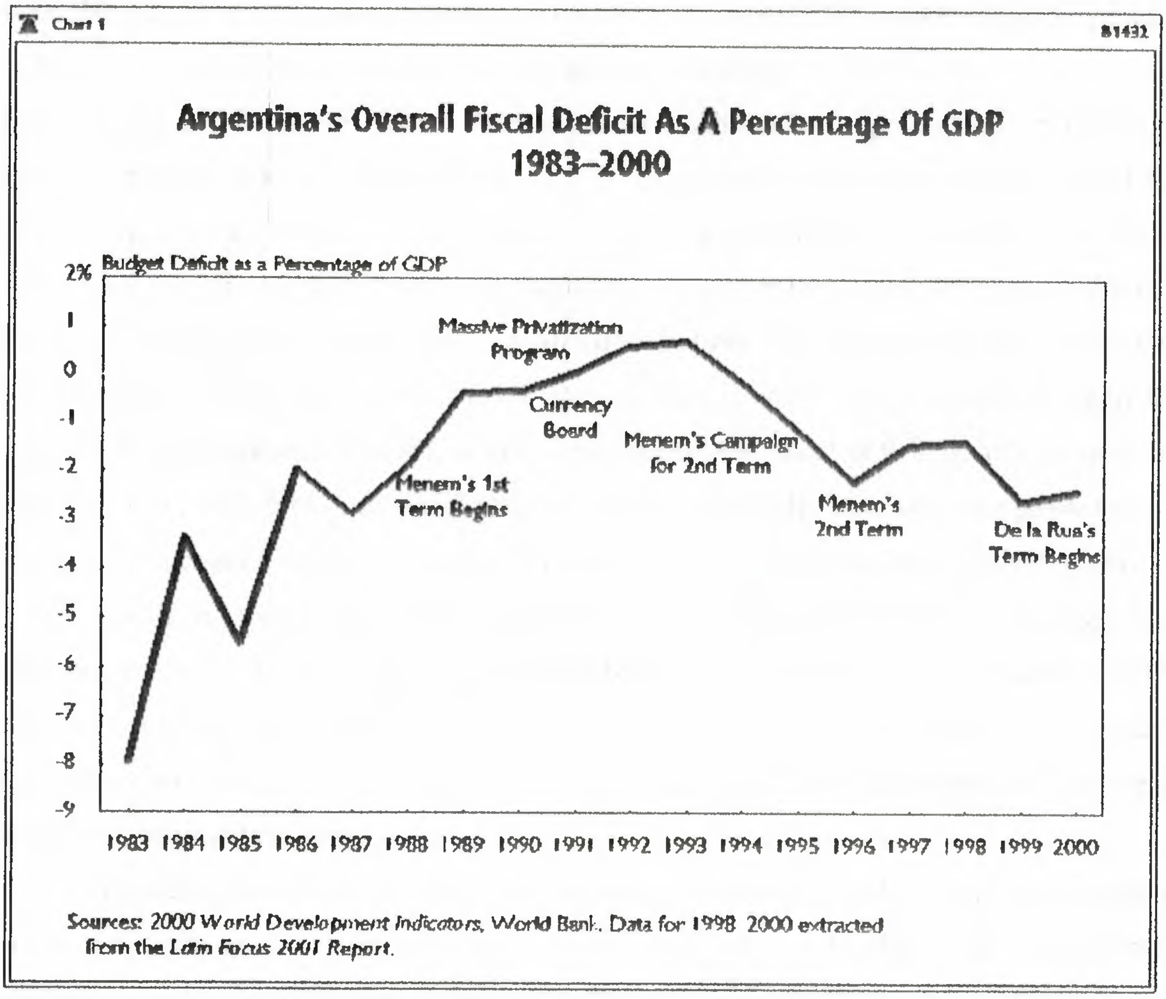
Early Reforms

(1) During his first term as president, Menem instituted several serious reforms. Specifically, his government Established a *currency board*. In 1991, the Argentine Congress passed the Convertibility Law, making "the peso fully convertible with the dollar at a fixed nominal exchange rate, with the domestic monetary base fully backed by the foreign exchange reserves of the Central Bank." In essence, a currency board system restricts the government's ability to issue notes and coins without a full backup of foreign reserves. Domestic notes and coins are fully convertible into the reserve currency at the fixed rate. Under this law, the government's liabilities could not be financed by printing money. This reform helped to arrest the hyperinflation problem immediately.

(2) *Aggressively privatized state enterprises.* Between 1990 and 1994, the Menem government privatized the airlines, gas transportation and distribution, passenger and cargo railways, power generation and distribution, telecommunications, the postal service, and the water and sewage systems. It also sold oil and gas extraction facilities, coal mines, petrochemical plants, steel mills, and most public banks. This reduced government consumption through unproductive government industries that were operating at a loss, as well as inefficiency, by transferring state industries to the more productive private sector.

(3) *Deregulated the economy* Menem's administration liberalized the foreign investment code, eliminated price and exchange rate controls, and removed export taxes and import quotas. Deregulation reduced the cost of doing business and spurred investment, which resulted in greater economic output.

Chart. 1 Argentina's Overall Fiscal Deficit As A % of GDP



Source: 2000 World Development Indicators, World Bank, extracted from the Latin Focus 2001 report.

These reforms immediately rewarded President Menem and the people of Argentina with lower inflation, renewed investor confidence, economic expansion, and higher standards of living. Argentina achieved 7.9 percent annual GDP growth from 1991 to 1994--the world's 10th largest rate during that period. Gross fixed investment rose by more than 120 percent.

The percentage of families living under the poverty line fell from 38 percent in 1989 to 13 percent in 1994. Unfortunately, however, the growth was not sustainable.

Incomplete Reforms

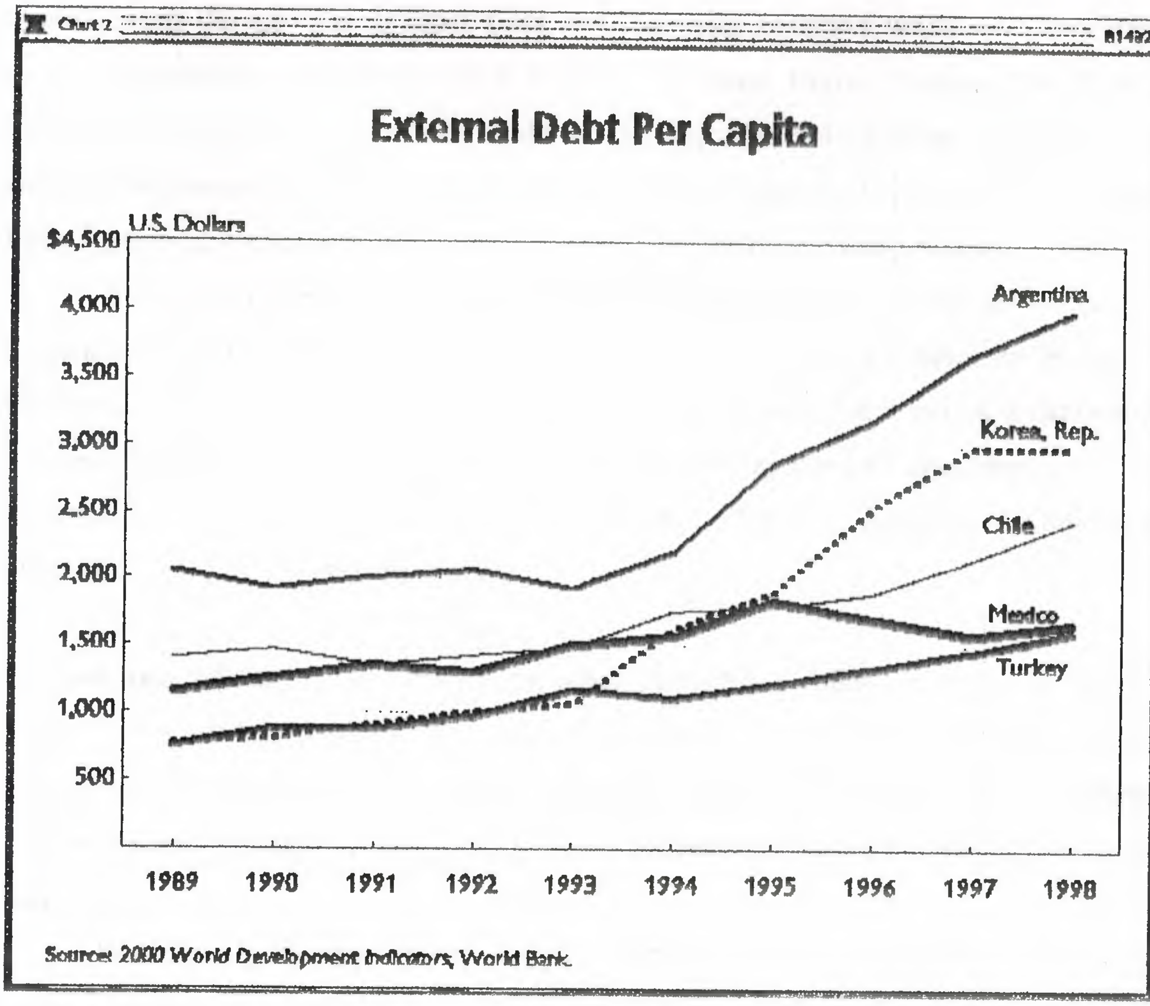
Even though Menem's reforms initially spurred economic growth, the government's failure to commit fully to economic liberalization contributed to Argentina's economic decline over the past five years and a recession that is now in its 33rd month. Specific problems reflecting the lack of economic freedom include the following:

Increasingly burdensome debt. Government expenditures as a percentage of GDP grew from 9.4 percent in 1989 to 21 percent in 2000. At the same time, GDP growth slowed from 7.9 percent between 1991 and 1994 to negative or negligible growth since mid-1998. Lack of economic growth, combined with an expansion in government expenditures, generated a fiscal deficit that grew from 0.15 percent of GDP in 1994 to 2.4 percent in 2000. (See Chart 1) To achieve fiscal balance without distorting the economy, the government could have lowered its expenditures. Instead, it chose to finance the fiscal deficit by raising taxes and incurring additional debt in financial markets and with the IMF. Raising taxes proved to be a bad tactic; it generated more tax evasion and suffocated an already hobbled private sector.

For the past seven years, the Argentine government has imposed an increasingly heavy debt burden on the people. Total Argentine public debt increased from 34 percent of GDP in 1991 to about 52 percent in 1999 and currently accounts for 23 percent of all emerging market debt. High debt increases the cost of borrowing from capital markets because it increases the perception of investment risk.

Sustaining this level of debt will soon be impossible. Unless Argentina generates strong economic growth soon, it will not be able to service its debt without additional external bilateral or multilateral support, debt forgiveness or debt restructuring by creditors, or some combination of the two.

Chart 2. External Debt Per Capita



Source: 2000 World Development Indicators, World Bank.

Uncertainty over the monetary system. Argentina adopted the Convertibility Law to address its chronic problems with high inflation. Some have blamed Argentina's economic problems on the high value of the peso that is tied to a strong U.S. dollar; in fact, however, Argentina's problems derive primarily from its failure to implement economic reforms that would open its markets and bring economic stability to the country.

Excessive regulation. Privatization should be the means to create a competitive environment in which producers are motivated to improve their products while consumers benefit from more choices and lower prices. In Argentina, however, most privatization did not foster such competition; it simply transferred monopolies from the public to the private sector.

Barriers to free trade. Argentina began reducing its tariffs in the 1980s. The major trade policy of the 1990s was to participate in setting up the Common Market of the Southern Cone (known as Mercosur) in 1991. Mercosur prohibits trade barriers between member nations on approximately 85 percent of tariff lines and maintains common tariffs and trade barriers against non-members. The bloc--which includes Argentina, Brazil, Uruguay, and Paraguay--has significantly altered Argentina's trade relationships. Before Mercosur, Argentina's trade with Brazil averaged approximately 11 percent of its total trade. A year after the preferential trade agreement was signed, Brazil had become Argentina's top trading partner.

If Argentina wanted to open its markets to trade, Mercosur was not the trade strategy to follow. Its high common external tariff (CET) of 14 percent inhibits trade with non-members. The adoption of the CET reduced the government's discretion on trade policy and crippled the ability of consumers to choose from among the best and cheapest products available in the world, while also removing incentives for local producers to innovate and improve in order to remain competitive.

A weak rule of law. There was a time when Argentina's judicial system was strong and robustly protected property rights. Argentina then was also the world's 10th wealthiest country, with foreign investment driving economic growth. For the first time, Argentina had violated its own constitution, setting a precedent for the weakness in the rule of law that exists today.

Weakness in the rule of law, coupled with a large bureaucracy, also has fostered a culture of corruption. Corruption affects the highest public officials down to ordinary Argentines who must navigate through the extensive red tape. The severity of this problem is evident in the fact that 82 percent of people living in Argentina do not trust the effectiveness of the judicial system and therefore do not use it. This distrust has disastrous implications for the country's ability to generate sustained economic growth. A weak, non-transparent judicial system raises the cost of doing business and undermines an important engine of growth: local and foreign investment. By increasing risk, a weak rule of law undermines the confidence of citizens and foreign investors alike in undertaking commercial activities, saving, and making long-term investments. Risk increases because the ability to seek compensation or justice for illegal actions is hindered in a judicial system that is unreliable or subject to political manipulation

These many problems indicate the clear lack of economic freedom that has contributed to Argentina's inability to spur economic growth. This policy of economic protectionism has resulted in recession, a dramatic rise in crime, a high level of unemployment, and a reduction in living standards.

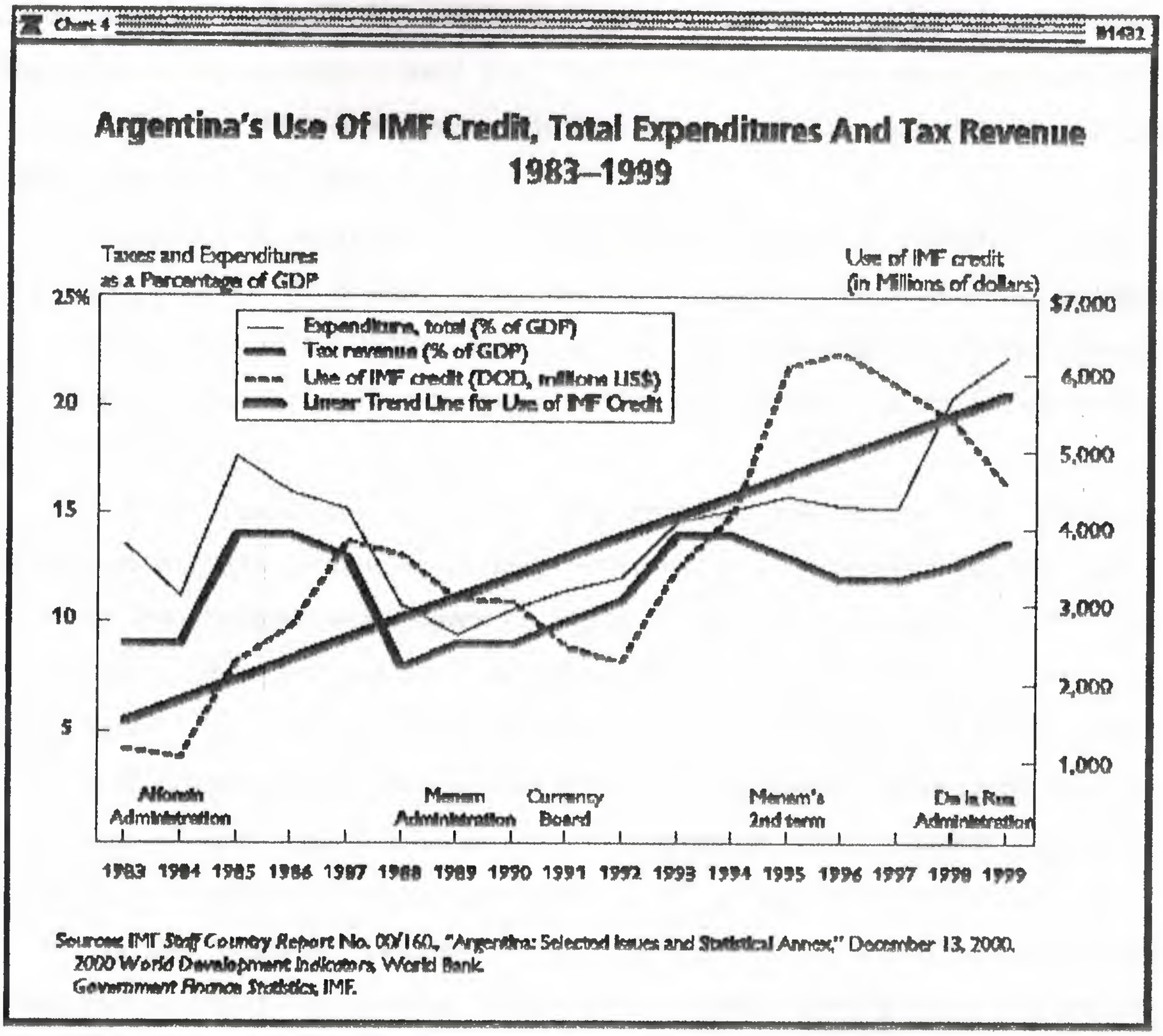
The IMF's Role in Argentina's Crisis

The International Monetary Fund shares the blame for Argentina's current malaise. The history of IMF lending to Argentina since 1983 shows nearly continuous funding accompanied by policy recommendations. While some of these recommendations would have helped to liberalize the economy, most of them hindered economic growth, and the reliability of IMF loans encouraged moral hazard. After almost two decades of misguided recommendations and nearly continuous funding, the IMF's involvement in Argentina actually strengthened the power of political vested interests at the expense of economic growth. Consider the following facts:

- Since 1983, the IMF has extended to Argentina seven Stand-By Arrangements, two Extended Fund Facility agreements, and two renegotiations of its loans. The total amount lent to Argentina through these arrangements was SDR 24,117 million, or nearly $30.6 billion in U.S. dollars
- IMF loan agreements with Argentina have been in place during all of the 18 years since 1983, except 1986-1987 and 1988-1989. The loans were available without interruption, whether the country was facing a crisis or not.
- In each program, the IMF prescribed policies that retarded economic stability and long-term growth. Each IMF arrangement, for example, required Argentina to balance its fiscal budget by raising taxes, which in turn deterred economic activity and encouraged tax evasion, thereby aggravating the fiscal imbalance that the recommendation was intended to address.
- Argentina regularly failed to implement the reforms demanded by the IMF in return for credit arrangements. In each IMF arrangement, for instance, Argentina was required to cut government expenditures to help balance the budget. Since 1989, however, expenditures have grown from 9.5 percent to 22.3 percent of GDP. Only with massive inflows from privatization was the government able to run a fiscal surplus. After most state industries had been privatized, the fiscal deficit returned.

Despite ample evidence of such failure to meet IMF reform demands, the IMF continued to lend Argentina funds--and in increasing amounts.

Chart 3. Argentina's Use of IMF Credit, Total Expenditures & Tax Revenue



Source: 2000 World Development Indicators, IMF Staff Country Report, Dec.13, 2000.

IMF lending in Argentina has been both self-defeating and a failure on its own terms. The most recent IMF package is a case in point. Once again, the Argentine government had tried to end the recession by increasing taxes. The efforts proved fruitless and increased skepticism among investors as to the de la Rúa government's commitment to reform and its ability to implement reforms and restore growth. This skepticism, combined with doubts about Argentina's ability to meet its upcoming debt payments, precipitated the financial crisis in November and December 2000. The IMF negotiated a $39.7 billion credit line in December 2000 (made available in January 2001) that, while it stabilized the immediate crisis, has neither resolved the problems leading to the crisis nor spurred an economic turnaround. Even though the IMF demanded that Argentina adopt labor and social security reform, promote competition in the monopolized telecommunication and energy sectors, and expand social assistance, the primary condition for this recent arrangement is once again that the government reduce the fiscal deficit by increasing tax revenues and lowering expenditures. The deficit target was again relaxed. For 2000, the target had been relaxed from $4.3 billion to $5.3 billion; or 2001, it was relaxed to $6.7 billion, and the target date for a balanced budget was extended to 2005.

Except for the misguided demand that Argentina increase tax revenues, as well as its contradictory advice to increase social assistance programs while reducing government expenditures, most of the IMF's reform demands are reasonable. In any case, based on Argentina's track record, its government is unlikely to implement the reforms established in its last agreement.

Domestic resistance to reform is strong. Proposals to cut expenditures, for example, forced two Ministers of Economy to resign within weeks of one another. Minister José Luis Machinea lost credibility and resigned on March 2, 2001, when it became obvious that the $39.7 billion IMF bailout had failed to restore economic growth. His replacement, Ricardo López Murphy, has also resigned. He proposed spending cuts of $2 billion in 2001 and $2.5 billion in 2002 to enable Argentina to meet the IMF's fiscal targets, but his proposal led to the resignation of three cabinet officials and six government officials, mainly Frepaso party members, and to widespread strikes and protests by unions and student groups.

The IMF policy of continuous lending to Argentina regardless of the risk of crisis or compliance with IMF reform demands has had two negative consequences: The predictable IMF assistance signaled to the markets that investment risk would be mitigated by IMF bailouts, thereby increasing moral hazard and encouraging reckless investment decisions. In addition, Argentina has had no incentive to reform its economy because the IMF would provide funds regardless of reform. These two consequences created a downward spiral leading to a third, and worse, potential consequence: If the IMF takes a stand and stops lending to Argentina because it does not reform or cannot restructure its debt, the country will have another crisis and likely will default on its debt. This could be desirable if it were to spur Argentina to undertake the reforms necessary for ensuring long-term economic stability and growth, but it would also spur capital flight from Argentina and could constrain lending to other emerging markets around the world.

- **A Better Reform Plan for Argentina**

The solution to the economic crisis in Argentina lies in domestic political action. Economists agree that the \$39.7 billion credit line extended by the IMF to Argentina in January 2001 to halt the recent crisis will provide only a limited respite of perhaps six months to one year. Argentina's debt of \$124 billion is more than 350 percent of its export base, and almost two-thirds of foreign exchange receipts are consumed to service the debt. Unless economic growth resumes, Argentina's debt obligations and external financing needs, estimated to be as much as \$50 billion this year, will quickly exhaust the IMF credit line.

Some proposed solutions for Argentina. Argentina must take immediate action to increase its level of economic freedom. Liberalizing its economy would reassure international investors and set Argentina on the path toward long-term growth and stability. Specifically, Argentina is advised to:

1. **Adopt the U.S. dollar as its official currency.** Speculation about the sustainability of the currency board has helped to increase interest rate premiums on Argentine debt beyond the normal spread between peso and dollar debt. In these circumstances, the best way to address the interest rate premium resulting from currency risk would be for Argentina to adopt the U.S. dollar as its own currency. This would eliminate the risk stemming from the peso-dollar exchange rate and lead to lower interest rates on the country's debt, which is what happened in El Salvador and Panama after they adopted the dollar.
2. **Reduce spending and taxes.** To spur economic growth, Argentina needs to bolster productive behavior by lowering taxes to increase the incentive to work, save, and invest. To lower taxes without creating an economic disaster, it also needs to slash government expenditures.
3. **Foster further deregulation.** President de la Rúa succeeded in getting a labor reform bill passed by the Senate and the lower house. Argentina should build on this progress by scaling back regulations governing, for example, the ability of employers to lay off employees. The government also needs to scale back the wages and numbers of public-sector employees, since high public-sector wage rates make it difficult to adjust private wage rates. This is particularly true in the provinces, where many public sector workers do not contribute to production and are merely a drain on public resources.

4. **Encourage free trade.** Argentina should expand its export markets and diversify its export base by signing agreements with other nations that are receptive to unrestricted trade. Considering the linking of the peso and the dollar, a free trade agreement between the United States and Argentina would be particularly beneficial by providing greater stability to Argentine exporters. The United States is Argentina's second largest trading partner, and reducing trade barriers would enhance that relationship to the benefit of both countries. Argentina will need to open its market in order to facilitate trade talks with the United States. If necessary, it should withdraw from Mercosur as an exclusive trade area; if it wishes to remain a political ally of Mercosur as Chile has done, it could do so.
5. **Strengthen the rule of law.** The vulnerability of the judiciary to bribery and political influence has undermined public confidence to the extent that ordinary Argentines do not use the legal system and businesses restrain their investments. The Argentine government must punish corruption more aggressively, insulate the judiciary from political pressure through whistle-blower protections, and increase standards for those employed in law enforcement.

4. CONCLUSION

WHAT CAN BE DONE FOR PROTECTION

Our world is in a rapid globalization process in the new millennium. In the last century we saw financial crises repeated every 19 months. Globalization is affecting financial markets deeply. Due to the floating character of capital, this affects it at every little crisis.

The globalization in the world gives great opportunities to financial institutions and increases the importance of such institutions. Financial institutions play an important role in national economies. This is the reason why financial markets and financial institutions need to be protected from all kinds of crisis.

And for this reason, institutions such as the IMF and World Bank which give direction to the global money and capital markets need to be restructured primarily. As in the words of the world famous speculator and businessman George Soros, 'In the globalized era the control of the international capital movement is a serious problem and IMF is quite inefficient in this.'

Soros believes that IMF should be turned into a real international central bank in order to prevent international crisis, as well as helping the countries in crisis with its own money emissions. Apart from this, gaining stability for exchange markets is also increasingly important.

We believe that the following measures will also help in the prevention of financial crises:

- The foundation of an international early warning system
- Raising of IMF quotas
- The easing of getting credit with IMF guarantees
- Creation of a structure for IMF, independent of the US Treasury
- Raising the struggle against corruption
- Expansion of financial sector reforms

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