

Managing risk to the international economic system

Chapter 5

Little review of risk

- The possibility of an unforeseen development that influences our welfare
- In games of chance, where the outcome is uncertain before the dice are rolled, but the nature of the outcomes is understood and the relative probability is known
- Dealing with risk in social system = trying to influence the probabilities

Current international economy

- In the period of rapid change, driven by technology (ex. improvements in transportation and communication), that integrate the world market, and reduce the natural protection of regional or national markets
- Developing countries, such as Korea & Brazil, are not merely basis for doing business abroad, but also becoming important international business & political actors, asking for fundamental changes in the international economic system. This creates uncertainties about the durability of the existing 'rules of the game'

Various adverse development

- Disturbance – an unfortunate event
- Crisis – a disturbance that threatens more serious consequences and the possibility of breakdown
- Collapse – event which causes us to change in some fundamental way
- Catastrophe – a breakdown from which recovery is difficult, prolonged, and very painful

What is international economic system?

- A framework in which firms and nations undertake international transactions
- It comprises formal rules, informal conventions, and the accepted practices that govern international economic transactions, along with institutional arrangements for policing the rules, resolving disputes, and changing the rules in the face of altered circumstances

Resilience of the system

- Some participants in the international economic system can be in crisis or go bankrupt, and leave other participants.
- Is the system resilient and able to absorb disturbances, crises, and breakdowns among its participants without generating a system wide crisis ?

Some questions:

- What types of disturbances are most likely to unsettle the system?
- What mechanisms we have to prevent a crisis for the system?
- What mechanisms we have to mitigate the effects of a crisis and prevent a breakdown?
- What improvements are possible to prevent system wide crises and to mitigate the effects?

Current threats to international economic system

- Four possible sources of crisis: Foreign exchange crisis, banking crisis, oil crisis, and trade wars
- The most serious threat: erosion of the international rules and conventions under the pressure of various national economic crises

Foreign exchange crisis

- The crisis arises when there is a rush to change the holdings of one currency to another (conversions to another currency)
- Banks experience such difficulty → floating exchange rate among major currencies lead to a depreciation of the currency
 - Countries with rapid appreciating currencies will find imports more competitive
- Central banks can brake the movement in exchange rates, by intervening directly in the market (as counter-speculators)

Foreign exchange crisis

- The extent of intervention is limited by the country's foreign exchange reserves & its capacity to borrow abroad, including credit line with other central banks
- Central banks can brake the movement in exchange rates, by intervening directly in the market (as counter-speculators)
- One factor that cause devaluation → the large amount of external indebtedness denominated in foreign currency
 - Devaluation increases the local-currency cost of servicing the debts
 - It causes nongovernmental debtor to be forced into bankruptcy

Banking crisis

- Interbank transactions in international level are dominated by bank lending → a bank insolvency can create illiquidity & insolvency in the banking community
- Insolvent bank:
 - Reduce the assets of other banks
 - Influence other banks by reducing confidence in them, lead depositors to withdraw their funds
- Precipitating events:
 - Withdrawal of funds by major depositors
 - Default by major debtors
 - Losses in operations due to management's bad judgment, bad luck, or malfeasance

Banking crisis

- Large withdrawals create a problem:
 - But, the bank can borrow funds in the interbank market to cover the withdrawals
 - Become serious if the bank has lost access to the interbank market
 - If the banks have diversified their international lending, default then becomes less likely to happen. It is a major problem if several substantial events occurred at the same time (common cause), such as large increases in oil prices or major world recession

Oil crisis

- Modern economies are extremely dependent on petroleum
 - By 1977, 53% of petroleum for non-Communist world originated in the Persian Gulf, Libya, Algeria
 - A cutoff or substantial fraction of this oil have devastating effects on the economies & political systems of the Western world
 - A price increase based on those fears become a major disturbance to Western economies

Trade wars

- Countries protect their economies from import competition for several reasons:
 - To encourage ‘infant industries’ with the prospect of development
 - To improve their international payments position
 - To protect employment in particular sectors that are experiencing import competition
 - To grant favors to particular firms or individuals who have supported the government in power
 - To retaliate against similar actions by trading partners

Trade wars

- Call for import protection is more strident & favorably received during times when:
 - Economic growth is sluggish
 - Unemployment is high
 - International payments are in deficit
- Prospect of trade wars is enhanced by an oil crisis
 - Arise also from the efforts of countries to maintain tight monetary & fiscal policies in order to combat inflation

Large sources of uncertainty

- Oil disruption
 - How governments of consuming nations respond to an oil disruption (usually by economic contraction, by introducing price & allocation controls)
 - Whether they will survive from such a disruption politically
- The changing role of developing countries
 - Developing countries are being victimized by the industrialized nations, but, some of them have done extraordinary well
 - Others have been positioning themselves to grow faster through changes in their own economic policies & can be expected to do well

Large sources of uncertainty

- How industrialized countries will respond
 - Some will maintain open markets for products of developing countries, while others resist to admitting them into the circle of decision making on changes in the international rules as the developing countries are able and willing to take on the obligations of full membership
- Large & growing disparity of circumstances and views among developing countries
 - Bloc voting in the international political arena (such as G-8) provide advantages in terms of cohesiveness. But, will the 'moderates' or the 'radicals' come to dominate the group?
 - How much difference will that actually make?

Reference

- Managing risks to the international economic system, in Herring, R. J. (2002) Managing Internatinal Risk, Cambridge University Press