Panic Scenarios

Potential and Nature of a Global Financial Panic

1. The base-line recovery scenario could be derailed by a financial panic. The international financial system now seems more prone to panic than at any time in the past 30 years. The cumulative adverse strains of the prolonged economic slowdown have reached the point where an inordinate number of companies, countries and banks must deal with precarious financial situations. This situation has been made worse by high interest rates and the unsettling burden of the increased short-term debt. On top of the Polish and Argentine debt problems, there has been a spate of sudden failures among financial institutions--Dreyfus Government Securities, Penn Square Bank, Banco Ambrosiano, and Lombard Wall. Finally, the recent Mexican foreign exchange run added a significant new sense of uneasiness since that country owes more than $80 billion.

2. Although the odds of such a panic are now higher than usual, they remain low. The international financial system that evolved since World War II has a proven record of resiliency. That strength arises from the system's flexibility, and the growing common interest of both lenders and borrowers in a smooth functioning system. In addition, bankers and other western financial leaders have worked together effectively, even during emergencies.

3. If there is a panic its impact would likely fall far short of the devastating consequences suffered in the 1930s. Much will depend on the nature of the crisis and the ability of central banks to respond quickly. A situation is certainly conceivable whereby central banks find that they are unable to prevent a panic from starting, but are successful in halting the panic soon thereafter. For example, the sudden impact of some massive triggering event(s) may not give central banks adequate time to sort out the problems of national responsibility for overseas banks thereby making a rescue operation much more difficult if not impossible. Within farily short period of time, however, the central banks could devise a stop gap formula to meet the emergency. Thus the economic consequences of a panic could range widely from a temporary disruption of trade and investment transactions to causing a depression.

4. If there is a panic, it would have the following characteristics:

-- It would spread quickly as a growing number of financial institutions are suspect of having either or both liquidity or solvency problems. Doubts as to the ability of the bank or banks hurt by the initial triggering event to meet its obligations to other banks would greatly increase questions as to the soundness of these other banks.

-- Depositors, banks firms or individuals would seek what they believe to be the soundest placement of their funds: i.e., the most creditworthy banks and government securities. In today's market, that probably would mean a mass flow of funds to the United States. Large quantities of US government securities would probably be bought and many foreign individuals and companies would deposit funds here because this country has the most comprehensive formal deposit insurance scheme and is considered the ultimate safe haven.

-- Banks would retire old loans as soon as they mature and not extend new loans to those companies or countries which do not possess the strongest credit ratings.

-- The international interbank market (i.e., Eurodollar market) would shrink drastically as loan and deposit activity slows.

The Major Dangers

5. Three type of circumstances would most likely cause a panic.

-- Central banks are unable or unwilling to act quickly and in unison to meet an emergency. Among the three possibilities, this one is most important because lender-of-last-resort actions by central banks are the key to arresting a panic caused by the other two.

-- An undercutting of the informal codes of conduct that sustain confidence in the international financial system. For example, the leader of some major debt-laden country could decide to repudiate its loans for whatever reason (political or economic), and this type of action could become commonly accepted.

-- A confluence of a number of major events. Most likely such a situation would involve the near simultaneous inability of several major countries to meet its foreign exchange obligations and some large scale bankruptcies of companies within the industrial world. According to a "Group of Thirty" survey, more than 60 percent of the banks responding believe that under present arrangements, the international banking system would be vulnerable to a chain collapse in a crisis that caused the failure of a major bank or a groups of banks. That percentage is more than 70 percent for European banks and 45 percent for US banks.

The Panic Scenarios

6. Shown below are some currently plausible (although low probability) scenarios that match each of the three above categories.

Central Bank Action

7. A break in the Group of Ten unison in face of a major threat to the international financial system is the least plausible of our three types of dangers, although the most

serious. Such a division would almost certianly require a profound divergence of policies among the governments of the Group of Ten countries, especially the United States, West Germany, France and the UK. Moreover, such deep political splits, in all but the most extreme cases, would sooner or give way to a common desire to avoid a global economic calamity. Until that happens, each country would pursue individual or partially coordinated emergency steps. If these were ineffective in halting a panic, the global economy could be seriously hurt.

8. The scenario presented here involves a deteriorating French economy combined with major political differences between the US and France on East-West issues. During the next few months, the French could face a stagnating economy and rising unemployment as a result of Paris' recent tilt toward restrictive fiscal and monetary policies. Meanwhile, these actions may not have had sufficient time to bring down France's high inflation rate. The Communist party members of the cabinet might resign, not wanting to be stigmatized by the worsening economic conditions. Under those circumstances, the party might call for strikes by the labor unions it controls and other disaffected groups might participate.

9. The Mitterrand Government, under such pressure, might return to its previous emphasis on stimulating economic activity by increasing budgetary outlays and by allowing workers to achieve real increases in wages. Hyper-inflation might result, leading to a capital outflow that drains foreign exchange reserves to the point at which Paris must close its foreign

exchange window. Without any assistance from other central banks, Paris would be unable to restore the franc to full convertibility. French banks and other businesses would thus be unable to repay all their foreign debts as they come due or obtain new loans.

10. Meanwhile, the United States and French Governments could be at odds over East-West issues. The United States could try to hold up emergency loans to France in the hope of gaining political concessions. Out of nationalist pride, Paris might be unwilling to make even minor modifications in its East-West policy, and this hardening of attitudes might make it more difficult than usual to accept the significant austerity measures that accompany any such loans. Until a way could be found, at least temporarily, to paper over the political differences the international financial system could be significantly damaged.

Codes of Conduct

11. Argentina provides a plausible example of a major debt-laden country that might repudiate its debt within the next year or so. The effectiveness of the current military regime to rule has been undermined by the Falkland Island debacle. There is considerable dissension among its leaders and the regime has little popular support. If the military leaderhsip lacks the ability to take the tough political measures needed to overcome current economic and financial troubles, the economy could deteriorate further leading to unemployment and inflation that is

high even by Argentine standards. As a result of this political-economic chaos, the chances would increase that a strongman could seize power with the support of factions within the military and the Peronist labor groups. The general populace probably would accept the new leaderhsip in the hope of a return to more normal conditions.

12. Based on Argentina's political structure, the new regime's policies could conceivably be based on populists' beliefs including the repudiation of the foreign debt (or more likely a moratorium on debt and interest payments). It would support this move domestically by arguing that the industrial countries are responsible for many of Argentina's economic problems and, anyhow, that group supported the UK during the Falkland Island crisis. In economic terms, the new regime could argue that Argentina normally has a surplus on its trade account and, therefore, would be in good shape if it was not for the enormous debt burden. Further, the leaders might think the country could easily handle foreign transactions on a cash-and-carry basis. They might believe that attempts by foreign creditors to attach their goods could be overcome since many countries want to maintain exports to Argentina. They might also believe, with historical evidence to back them up, that as soon as their economy regained its strength, foreign lenders would provide large amounts of new credits.

13. A number of other countries, especially in Africa, might follow the Argentine lead. Although the additional amount of loans might be relatively small, the post-war precedent

whereby countries promise eventually to meet their debt obligations would no longer stand and confidence in the efficacy of the international financial system could be shattered. The solvency of so many banks might be suspect that the central banks may not be able to step in quickly enough to prevent a panic.

A Confluence of Events

14. Although many combinations of triggering events are possible, a most plausible scenario in the next few months would include the inability of the Mexican government to regain the confidence of foreign bankers. The Mexican situation may not itself cause a panic but might lead to a sharp reduction in commercial bank exposure to other major borrowers, such as Brazil, creating severe foreign exchange problems for that country. The Mexican trigger might also occur at the same time some major US company or bank suddenly declares bankruptcy. The deep involvement of US banks in all these cases would raise questions as to the solvency of many major US banks and again the central banks might find that they were unable to provide assistance fast enough to calm fears and thereby nip the panic in the bud.

15. A crisis atmosphere would most certainly emerge in the international financial markets if the Mexican government seemed unwilling or unable to institute the severe austerity measures needed to restore the confidence of foreign bankers. Mexico is the largest LDC borrower, accounting for 20 percent of the groups' outstanding loans from commercial banks.

16. Such an unfavorable development is certainly conceivable since the most crucial period for restoring banker confidence occurs when a lame duck president is on office. Between now and when he leaves office on December 1, President Lopez-Portillo might not take strong austerity measures because he does not want to be remembered as a leader whose policies created considerable and widespread hardships. Mexico's powerful labor unions could take advantage of the outgoing President's weak position and press vigorously for maintaining the real wages of workers. Widespread demonstrations by workers could take place with radical students joining in. These and other interest groups could play upon the country's fierce nationalism while some others could attack the government for mishandling Mexico's oil wealth. To contain the discontent, Lopez-Portillo might not accept an agreement with the IMF on needed corrective steps, a key requirement in retaining banker confidence and acquiring new financial help.

17. Under these conditions, the peso would likely slide further, sustaining the vicious circle between large currency devaluations and hyper-inflation. Many Mexican companies which borrowed trade and other short-term credits from US banks would find they were unable to make their repayments in dollars at the devalued rate. Banks meanwhile would not roll over short-term credits. The point might be reached where the United States and other industrial countries would find that they were unable to provide sufficient foreign exchange to halt the dollar exodus from Mexico. Mexico would then be forced to reimpose full

foreign exchange controls, creating further uncertainties for its creditors and depositors. In some cases, the financial plight of non-Mexican concerns would become unbearable.

Table 1

Select LDCs: Foreign Debt Service Burden

(as a percent of exports of goods and services)

Interest

	1975	1979	1981	1982*
Argentina	14	12	29	36
Brazil	19	19	38	45
Chile	17	17	31	31
S. Korea	7	7	13	14
Mexico	17	22	26	30
Peru	12	15	19	26
Philippines	6	10	16	19

Principal Repayment (Med/long)

	1975	1979	1981	1982*
Argentina	25	20	32	30
Brazil	21	38	29	33
Chile	27	28	31	28
S. Korea	8	9	7	7
Mexico	17	52	28	21
Peru	35	17	38	34
Philippines	10	9	9	12

Short-term debt

	1975	1979	1981	1982*
Argentina	78	53	89	96
Brazil	20	28	32	38
Chile	56	43	49	57
S. Korea	41	36	40	40
Mexico	44	30	48	75
Peru	59	29	36	35
Philippines	26	27	54	62

*Estimated