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Renata Przygodzka

CRISES IN LATIN AMERICA

1. Shaping Regional Identity

Latin America (until the nineteenth century known as Iberoamerica), the region now comprising 34 independent states and 12 dependent territories of the United States, Great Britain, France and the Netherlands (*Encyklopedia...*, 2004, p. 194). The area of the region covers approximately one seventh of the total area of land (20,635 thousand. km2) and is inhabited by approximately 495 million inhabitants. Within Latin America there are different sub-regions: Mexico, Central America, Andean countries (Venezuela, Colombia, Ecuador, Peru, Colombia, Chile), the countries of La Plata (Argentina, Uruguay, Paraguay), Brazil and the Caribbean region (Antilles and Guyana) which only recently has been treated as a separate zone belonging to Latin America on the principle of federation (Latin America and the Caribbean).

Although this region is generally very diverse in terms of geography, politics, economy, demography, or culture, but the common heritage of colonial conquests shaped by two countries, namely Spain and Portugal, and reinforced by the influence of Indian and African cultures caused that the "awareness of the Latin American community and universality "is promoted today (*Encyklopedia...*, 2004, pp. 194-195), which is beginning to go beyond the sphere of culture, and also extends to the realm of politics and economy. Evidence of this is the engagement the Latin American countries in solving common problems of debt, trade liberalization, integration processes, etc.

Growing sense of the need for joint action to locate Latin America in international relations and international division of labour appeared on the one hand with the strengthening of its independence, on the other hand – with the experience of becoming deeper and more seriously affected by successive crises facing countries in the region (crisis of dependencies, structural, political and economic crises).

Although most Latin American countries gained independence following the wars of independence in the early nineteenth century, however, almost to the end of World War I, the development of these countries was dependent in nature. It resulted from the specificity of the subordination of the economy to raw material exports and, consequently, the dependence on the situation on international markets. As emphasized by Urszula Żuławska, the export sector was influenced to varying degrees by the economies of individual countries (Żuławska, 2003, pp. 16-17). Neutral impact was due to a lack of connections with the rest of the export sector of the economy. As a result, exports and revenues derived from them did not stimulate economic development (for example, banana plantations in Honduras). From the standpoint of the economy the most adverse impact was from the export sector, which grew at the expense of previous business, at the same time, taking over part of the means of production[1]. In the best situation were the countries where the development of commodity exports contributed to the generation of domestic demand, investment growth, modernization of the economy. Since this type of economy, concerned the largest countries in the region, as a consequence, they developed rapidly. Yet, this does not mean that the development rate was uniform. Like in most market economies and in this case, their growth was exposed to cyclical business fluctuations whose main cause used to be the collapse of international demand for raw materials which, in turn, was accompanied by the economic recession in Europe or the United States[2]. The beginning of the collapse of dependent development in Latin America is ascribable to the outbreak of the Great Depression. Since then, in the countries of the region there were several cases of significant economic instability caused by the debt crisis and currency and banking crises. They were often stimulated by political crises which, by reducing the credibility of the countries in the region, led to the flight of foreign capital and to many problems associated with this phenomenon.

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1 According to U. Żuławska, "such situation had occurred in Bolivia, where tin mining deprived silver mining of workforce, as well as Puerto Rico, where coffee production displaced traditional crops, causing a shortage of supply of food on the market." (Żuławska, 2003, p. 17.)

2 Sometimes outside economic factors political factors contributed to an economic downturn also contributed to political factors. The most spectacular example is Mexico's economic crisis caused by the devastating civil war that took place during the period 1910-1917.

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2. The Great Depression in Latin America

Before the outbreak of the Great Depression the economic situation of most Latin American countries, benefiting from exports of raw materials, was relatively favourable. The high rate of economic growth (e.g. between 1913 and 1929 in Brazil, exceeding the annual average of 4.7% and in Argentina of 3.5%) stimulated by domestic demand, foreign investments and state interventionism funded mainly through revenue bonds sold on foreign capital markets, led to the growth of industrialization and transformation of economic structure. But with the outbreak of the crisis of 1929-1933, the economic basis of growth was destroyed.

As a result of the economic collapse of most of the countries buying raw materials exported by Latin America, the volume of exports from this region decreased significantly and there was a decline in prices of exported commodities. The value of trade in South America in 1933 accounted for only 31% of turnover from 1928. Prices of major export goods in the region, namely raw materials and agricultural commodities were running at an unfavourably low level. Their lowest level was recorded in 1933.

Industrialization, the road Latin America entered at the turn of the 19th and 20th centuries was, however, subordinated to a narrow specialization, namely the production of raw materials for export, caused the region's heavy dependence on the international economic situation. Its collapse led to a strong decline in industrial production which between 1929 and 1933 decreased by as much as 52% compared to 1928.

The need to supplement domestic production with import, strengthened further by worsening export revenues, led to a currency crisis. The currencies of countries in Latin America which exported raw materials were the first to collapse. Already in November 1929 the Argentinian peso and the Brazilian milreis were depreciated. Later that same year, the convertibility into gold was formally suspended in Uruguay and Argentina. Decline in value of Uruguay currency in 1931 was 57%, in Argentina 39%, while in Brazil 48% in relation to parity. In March 1930, Bolivia's boliviano and Venezuelan currency began to lose their value (Ciepielewski, and others., 1977, p. 389). Some countries within the framework of stabilization action, decided to introduce a system of multiple exchange rates[3]. For example, in March 1933 Chile introduced three exchange rates, two exchange rates a year later were introduced in Argentina, Brazil, Uruguay, Bolivia, Colombia and Costa Rica (Morawski, 2003, p. 119). Usually, it was accompanied by the use of protectionist policy (exception was

[3] The system of many exchange rates allowed maintainance of convertibility (as opposed to countries that moved in the direction of autarky and total non-convertibility), but it differentiated its principles depending on the interests of different economic sectors. Its disadvantage was the blurring of real results and the ability to compete in these sectors.

Peru). Those actions resulted in later years in significantly reduced imports and accelerated development of anti-import production. This resulted in a significant increase in share of the processing industry in the GDP. Industrialization, however, was superficial, because the "substitution did not mean reducing the value of imports, but only a change in its composition: less industrial consumer goods, more means of production" (Stemplowski, 1983, p. 119).

The crisis highlighted the significant socio-economic disparities that occurred in most countries of Latin America. On this fertile ground fell, on the one hand, communist and socialist parties slogans, on the other hand – those formulated by fascist groups who, under the banner of the nationalist and popular movement supported large land and industrial properties. Already at the beginning of the crisis there were large-scale upheavals and revolutions. In 1932, in Chile there socialist republic was proclaimed, for a short time, and in 1933 it was announced in Cuba.

Undoubtedly, the Great Depression in Latin America, like in other countries, increased the role of the state in the economy. The institutional system was expanded, enterprises based on foreign capital were nationalized, radical agricultural reforms were introduced, the range of adjustment was increased. Those actions were reinforced by the ideology of populism.

After the Second World War, the economic primacy of the United States, Europe recovering from the devastation of war, created in the Latin American countries a new challenge, i.e. foreign competition. In the post-war economic policies of the region a kind of duality of development can be distinguished: some of the countries deepened the processes of industrialization while protecting the internal market (Argentina, Brazil, Chile, Colombia, Mexico, Paraguay), others – returned to the export-oriented strategy[4]. However, a common feature of the post-war development of almost all Latin American countries was steadily increasing share of the public sector[5] as a result of direct intervention and an increase in the use of indirect instruments of intervention. The implementation of public tasks required significant financial resources. Their acquisition on the internal market was generally limited because of shallowness[6] and willingness to avoid the crowding out-effect. Hence, special importance was put on foreign financing and with it, debt became increasingly a problem.

4 According to U. Żuławska "These two varieties of Latin American economic system are often referred to as (...) inward development and outward development." (Żuławska, 2003, p. 26).

5 The literature refers to three main methods of public sector expansion: nationalization, public investment, the acquisition of bankrupt businesses.

6 U. Żuławska informs after Bulier-Thomas that while in the 60s the region's public debt needed 10 years to triple, in the 70s it reached the same result within 5 years (Żuławska, 2003, p. 39).

3. Latin American debt crisis

Latin American debt, growing in the 70s of the 20th century, was the result of the impact of several negative factors. One of them was undoubtedly the world economic recession triggered initially by the collapse of the Bretton Woods system, and made worse by two successive "oil shocks". A decrease in aggregate demand in the industrialized countries on goods exported by Latin America deepened its balance of payment deficit on the one hand, on the other hand – the possibility of financing for development through the swift flowing stream of loans from banks with a substantial surplus of funds collected through the so-called petrodollars, consistently increased the level of indebtedness. While still in 1970 the Latin American debt did not exceed 21 billion USD, in 1980 it increased by more than elevenfold, to the amount of U.S. $ 230 billion, and later during the next two years it reached the level of almost 315 billion dollars.

Not all Latin American countries were indebted to the same degree. Typically, higher indebtedness related to countries pursuing the path of industrialization (Argentina, Brazil, Chile, Mexico). At the opposite extreme were Paraguay, Nicaragua, Honduras, El Salvador, the Caribbean countries. An important indicator illustrating the problem of debt is the level of debt in real terms, but individual ability to service it is shown by the level of debt in relation to the value of annual exports. In Chile, this ratio reached almost 300%!

Initially, very favourable credit terms deteriorated at the end of the 70s. When in 1979 the U.S. Federal Reserve introduced a severe anti-inflationary policy and with it substantially increased the dollar interest rates, in Latin American countries there was an immediate spectacular growth of interest paid on previous credits[7]. In addition, the problem was intensified by a sudden appreciation of the dollar on the currency market which greatly increased the real value of debt expressed in dollars. Also the prices of raw and basic materials plummeted, worsening the terms of trade of Latin American economies (Krugmann, Obstfeld, 2007, pp. 482-483.)

Top debt crisis dates back to 1982 when Mexico announced that its Central Bank exhausted its foreign reserves and could no longer meet the obligations of its foreign debt service. Fearing similar reactions of other central banks of Latin America's creditors, the banks of the industrialized countries (mainly affiliated to the so-called

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[7] This problem is often referred to as the so-called "original sin" and was formulated by Barry Eichengreen and Ricardo Hausman. It consists in the impossibility of developing countries to borrow capital in their own currencies. Devaluation of the currencies meant a kind of an automatic increase in debt expressed in foreign currencies. Such a currency functioning untill the 80s as monopolistic international money was the U.S. Dollar (USD), and a change in its exchange rate or interest rates immediately affected the financial situation of developing countries (Eichengreen, Hausmann, 1999, pp. 329-368).

London Club – private institutions and the Paris Club – public) sought to reduce their risk by cutting off new loans and demanding repayment of earlier loans. As a result, it turned out that Latin American countries were unable to meet their obligations, and suddenly were on the brink of total insolvency (Skodlarski, Matera, 2004, p. 277).

The problem of debt was accompanied by the collapse of economic activity, galloping inflation, high unemployment, collapse of public finances, the deterioration of living standards of citizens. The enormous costs that were incurred to stabilize the economies of Latin America over the next ten years allow of specifying them as "lost decade".

The IMF, World Bank and the governments of developed countries worrying about the general collapse of the entire world of finance, joined forces to take actions in favour of a partial reduction of debt. It is commonly believed that the crisis did not end until 1989 when the banks decided to reduce 12% of Mexico's debt and next of Costa Rica, Venezuela, Uruguay. In 1992 also Brasil and Argentina reached an agreement with their creditors. Consequently, the share of Latin America in the overall debt of the world decreased to 31%.

A common condition laid down for debtors was the need to implement economic and institutional reforms. But they did not have a voluntary character resulting from needs and circumstances of individual countries, and were subordinated to the development vision "set by the creditors. Today, the "vision" is called Washington consensus.

In practice, this meant: measures taken to stabilize inflation, the need to reduce the state's role in the economy, improving public finances, liberalizing trade, improving competitiveness of the economy by, inter alia, reduction of regulation of labour markets and products, improving the efficiency of financial markets, widespread privatization, etc. These reforms assumed somewhat different forms in different countries in Latin America, some contributing to substantial progress. They had come to grips with the phenomenon of hyperinflation, duties were reduced unilaterally, $150 bn were obtained by virtue of the privatization of state enterprises. The result was a decent level of GDP growth and a belief in the need for further reforms and their sense (Gugała, 2006, p. 162). Unfortunately, they had not spared the country from further economic instability.

4. Financial crises in Latin America

The specificity of the crises that occurred in Latin American countries in the 90s was primarily their financial character. Since the direct causes of breakdowns were different, hence, we can identify very specific currency and banking crises. Naturally, this division can be debatable because the phenomena from the sphere of finance are usually closely linked, as noted Barry Eichengreen and Richard Portes (1987, pp. 34-35). Not everywhere, however, a currency crisis would entail a banking crisis.

4.1. Currency Crises

The essence of a currency crisis is a sudden loss of confidence of international financial markets in the rate stability of a given currency raising expectation of an imminent and close moment of its devaluation (Żywiecka, 2002, p. 11). Among Latin American countries which had experienced such a crisis were, *inter alia*, Mexico, Argentina, and Brazil.

Mexico

It is commonly believed that the beginning of a currency crisis in Mexico falls on 20 December 1994, when the new government due to a decrease in the level of foreign reserves (from 29 billion USD at the beginning of 1994 to $ 10 billion at the end of that year) increased the threshold for the rate fluctuation of the peso by 15%, which was essentially equivalent to the 15% devaluation of the peso (Małecki et al., 2001, p. 42). This led to a sudden reduction in the credibility of Mexico on the international financial market and the cumulative outflow of capital (the value of reserves at the end of 1994 amounted to only 6.3 billion USD). Government's decision to release the rate of the peso led to further depreciation of 70%. In that situation, Mexico could borrow only at penal interest rates and, as in 1982 – appeared in danger of insolvency. The country avoided that threat only by a loan of 50 billion dollars orchestrated by the U.S. Treasury Department and the International Monetary Fund[8].

The currency crisis also caused repercussions in the real sphere. First of all, inflation, which dropped from 159% in 1987 to only 7% in 1994, rose sharply after the depreciation of the peso. Domestic production also decreased by more than 6% of, and unemployment more than doubled as a result of drastic budget cuts, very high interest rates and the overall banking crisis (Krugmann, Obstfeld, 2007, pp. 487-488). However, the recession lasted less than a year. Up to 1996, together with subsequent floating of the peso, inflation fell, and there was a general economic recovery.

The major causes of the currency crises in Mexico include: "overheated economic situation, admission to the boom and widespread use of foreign credit by economic subjects, and at the same time with consent to a real appreciation of national currency and not counteracting the high negative balance for the current account" (Żuławska, 2003 p. 151). Generally, it can be stated that the problem of this country had been

[8] The U.S. involvement in the financial aid granted to Mexico was due to Mexico's membership since 1994 of the North American Free Trade Area (NAFTA) and the fear of deepening and enlargement of the effects of the financial collapse.

low levels of domestic savings with, at the same time, the wrong structure of foreign capital (domination of portfolio investment). In a sense, the passivity of the authorities was the effect of the presidential election – a political cause (Małecki and others, 2001, p. 47).

While the Mexican crisis of 1994-1995 was managed effectively and quickly, however, it caused serious problems in other Latin American countries, known as the "tequila effect" ("contagion of markets"). The largest of its effects were felt in Argentina.

Argentina

In 1991, the authorities in Argentina, struggling with hyperinflation and attempting to recover public trust in the financial system, introduced a state monetary board system[9], thus depriving the Central Bank of the ability to conduct an autonomous monetary policy. Indeed, high inflation was eliminated thanks to that operation, however, Argentina's economy became vulnerable to external shocks. The first one was just the currency crisis in 1995 caused by the currency crisis in Mexico, and the second was due to the devaluation of the Brazilian Real[10].

The sharp outflow of capital from Argentina in 1995 with a value of over $ 5 billion, or about 30% of the total foreign exchange reserves was a consequence of investors' concern that the currency board system used in Argentina could break down and devaluation of the peso would take place. They were also afraid of difficult access to external sources of finance by the authorities of Argentina, a growing trade deficit, the difficulties of financing the budget deficit and the solvency of banks in Argentina. In addition, 1995 was the year of presidential elections, and therefore of a lack of political stability.

Inhibition of the negative consequences of capital outflow occurred through the vigorous action of the Central Bank of Argentina (BCRA), which gave banks refinancing loans, prompted the state bank to grant loans to private banks. The government increased the discipline of public finances making the IMF give Argentina substantial financial assistance, which headed off a threat of insolvency (Małecki et al., 2001, p. 59).

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9 Monetary Board is the simplest form of the fixed exchange rate system. Currently, this role is played by central banks that are acting in a very limited lending opportunities for refinancing. The main mechanism for the functioning of the currency board is based on two assumptions: 1) increasing the monetary base of the domestic circulation of money may be the result of only the purchase of foreign currencies by the central bank, 2) Central Bank undertakes to buy and sell foreign currencies using a rigid conversion rate which cannot be changed (Małecki et al., 2001, p. 50). In the case of Argentina, the peso exchange rate was based on the U.S. Dollar parity and the monetary authorities were obliged to defend the exchange rate regardless of the associated costs and capital flight.

10 Both currency crises were also accompanied by a banking crisis, which is characterized in the next section of the article.

Another currency crisis hit Argentina in the late 90s, and the main culprit of that crisis became the devalued Brazilian real which led to a significant reduction in the competitiveness of Argentina's exports (Brazil was Argentina's main trading partner – in 1999, exports to that country accounted for almost 60% of the total value of Argentine exports.) Reducing the volume of exports (along with several other economic and political factors) led to deep economic recession, and investors feared the merits of maintaining the currency board. Along with an increased risk they were expecting a higher premium, which led to an increase in debt levels. Despite the reforms undertaken by successive governments, both in the public finances and the currency board, investors' anxiety increased steadily and at the end of 2001 there was a massive flight of foreign capital (Radzikowski, 2004, pp. 120-121). In the same way people behaved in Argentine where they withdrew their savings from banks. Because all expected payments in dollars at rigidly defined rate, soon the accumulated reserves were insufficient, the authorities announced Argentina's insolvency and the peso was devalued by 30%. The general situation in which Argentina was then is often referred to as the biggest bankruptcy in world history.

Brazil

In the 80s Brazil, like Argentina experienced galloping inflation, but the stabilization policy was carried out in the country in a much less systematic way. In 1994, a new currency was introduced – the real, linked to the dollar. In 1995, Brazil defended the exchange rate through high interest rates, bankruptcies of banks, and later as a result of a significant appreciation it changed to a constant exchange rate with creeping up stiffening (Krugmann, Obstfeld, 2007, p. 485). Although inflation dropped from 2,669% in 1994 to below 10% in 1997, the paceof growth was not too high.

Although the anti inflation action was accompanied by numerous reforms in the financial sector, privatization of inefficient state enterprises, elimination of import barriers, their progress was slower than in the case of Argentina. The budget deficit remained high. Nevertheless, in 1998 Brazil received a record amount of foreign direct investment amounting to USD 32 bn.

As a result of a currency crisis in Russia and the general similarities to the situation (high level of internal debt) in the same year, there was a wave of capital outflow, especially short-term. The intervention of the Central Bank maintained the exchange rate of real, but reserves diminished significantly. In order to reduce further capital flight, Brazilian monetary authorities raised interest rates by 50%. It was only a loan from the IMF in the amount of U.S. $ 42 billion that calmed the situation down and led to an increase in investors' confidence. Experts stressed at that time that there was still another danger of speculative attack due to the revaluation of Real and high budget deficits.

Prediction proved correct. In January 1999, Brazil devalued the real by 8%, and then approved its liquidity. The Real quickly lost value of more than 40% against the dollar. In this situation, they feared a return of inflation. However, reforms implemented in previous years, immunized the Brazilian economy to the effects of the so-called after-devaluation shock. The competitive ability of Brazilian exports improved significantly. The high rate of unemployment was not conducive to the growth of aggregate demand, so there was no inflation increase (Małecki et al., 2001, pp. 166-168). There was also no collapse of the financial sector because Brazil's major financial institutions avoided loans denominated in dollars.

4.2. Bank crises

The concept of banking crisis usually means a loss of security in the banking sector, which may refer to either the number of bankruptcies and shares of banks in the market (Ostałecka, 2009, p. 46). A factor that initiates a banking crisis is usually the insolvency of one or more major banks or run (panic) of depositors in one or more large banks which are seen as insolvent and unable to pay deposits. Sometimes, the source of the banking crisis could be a currency crisis. An attempt to protect a currency against devaluation results in generally in reduced foreign exchange reserves, which causes the reduction in money supply and credit, causing a threat to the solvency of banks. Sometimes, there are attemts to limit the flight of capital by raising interest rates which, in turn, translates into insolvency of borrowers and threatens the stability of banks. This combination of the two crises is referred to as twin crises (Ostałecka, 2009, p. 49). They are the economic crises that hit Argentina.

Argentina

The relatively short-lived 1995 currency crisis triggered recession in the Argentine economy and a banking crisis. The main reason for this was a lack of automatic access to external sources to supplement foreign exchange reserves which, in terms of outflow of capital, was translated into a liquidity crisis in the banking system. It resulted in a reduction in the number of banks in operation (out of 205 financial institutions 51 ceased operations), and the value of the liquidated bank deposits amounted to 958 million pesos, of which depositors recovered 50% of their investment (Ostałecka, 2009, p. 81). Restoring confidence in the banking system required numerous operations. Banking supervision was strengthened, prudential regulations tightened, deposit guarantee system was restored and steps were taken within the scope of privatization of local banks.

Banking and currency crisis of 1995, although relatively quickly resolved, however, led to recession. The increase in interest rates reduced banks' lending activity, investments decreased (by 13.1%), and with them – the level of production fell (by

6.7%), while unemployment rose to 15.9%. A year later, after a clear decline in GDP induced by the "tequila effect", the economy accelerated, and in 1997 reached the growth level of 8.1%.

That trend, however, was not sustained and in 1998, due to the Asian and Russian crises, the domestic product of Argentina began to fall. More and more limited investors' confidence in emerging economies led to restrictions on access to capital on international financial markets and an increase of its cost. At that time, Argentina's plight was deepened by the growing public debt and the devaluation of the Brazilian Real. As a result, in 2001 the GDP growth rate reached 10%, investment fell by 43% compared to 1998, the budget deficit reached 6% of GDP and total debt – 140 billion dollars (Iwanicz-Drozdowska, 2002, p. 338).

The first wave of banking panic occurred in March 2001 causing a reduction in deposits by 3.1 billion pesos. Another wave was in August that year when more than $ 3.5 billion flew out from the banking system. It was estimated that within 2001 a capital flight reached 17 billion USD. This caused a radical move by the government involving the introduction of restrictions on the freedom of making bank payments (up to 1000 pesos per month), the introduction of ban on loans in pesos, the imposition of foreign exchange restrictions on travellers and the restrictions on transfer of capital. These decisions resulted in a loss of confidence in the government and cutting off financial support from the IMF funds.

Generally, it is estimated that the crisis of 2001 is one of the worst in Argentine history. It caused huge financial and businesses losses, and making them up is a big challenge for this country.

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Over the past century, Latin America was beset by numerous economic and financial crises. While the economic collapse of pre-World War II resulted from specific dependence on exports of raw materials and international economic trends for countries in the region, in the second half of the twentieth century, the crises were associated primarily with the substantial dependence of Latin America on the international finance. Often, in the absence of internal sources of financing industrialization and state intervention, many countries were looking for external sources. Global recession of the 70s led most of these countries into the trap of debt and the enormous costs of stabilizing their economies.

Although the implemented reforms helped to enhance the credibility of Latin America and the renewed inflow of capital, but not everywhere had a comprehensive character, and provided full stability. An example of such a country may be Argentina, in which despite the introduction of the currency board, the crisis occurred twice with the accompanying banking crisis, leading to deep recession and the country's insolvency. It is believed that the reasons for that difficulty was a lack of consistency in the implementation of ongoing reforms (especially in the area of fiscal policy and labour market) and the destructive activities of populist movements (Radzikowski, 2004, pp. 123-124).

One of the biggest weaknesses of Latin American countries is their political instability and with it a lack of long-term vision that would allow to choose a specific path of development. This is confirmed by even the fact that, despite the democratization of most countries of the region and deep economic reforms, there is not universal agreement among the Latin American societies that democracy is the best possible system. According to a report by the United Nations Development Programme (UNDP) from 2004, "54.7% of the population of Latin America would accept an authoritarian government if it effectively solved basic social problems of the region" (Gawrycki, 2006, p. 16). This means, unfortunately, the announcement of further instability, if only people are dissatisfied with the socio-economic policy of teams in power, which in turn, significantly affects the overall assessment of the reliability of these countries.

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