Chapter 14
Dealing with Financial Crises—Does the World Need a New International Financial Architecture?

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Fundamental Issues

1. How have recent developments in global capital markets differed across regions?

2. What are some of the problems pervasive to financial markets, and what is a financial crisis?

3. What is the difference between portfolio capital flows and foreign direct investment, and what role did these types of capital flows play in recent financial crises?

4. What are the main activities of the International Monetary Fund and the World Bank?
Fundamental Issues

5. What aspects of IMF and World Bank policymaking have proved controversial in recent years?

6. What changes in the international financial architecture have economists proposed in recent years?
International Capital Flows

• International Financial Architecture
  ➢ The international institutions, governmental and nongovernmental organizations, and policies that govern activity in the international monetary and financial markets.

• Cross-Border Mergers and Acquisitions
  ➢ The combining of firms located in different nations in which one firm absorbs the assets and liabilities of another firm (merger) or purchases the assets and liabilities of another firm (acquisition).
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<tbody>
<tr>
<td><strong>Table 14-1</strong> Geographical Distribution of Foreign Direct Investment, Percent of Total Inflows</td>
<td>1995</td>
<td>1996</td>
<td>1997</td>
<td>1998</td>
<td>1999</td>
<td>2000</td>
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<tr>
<td><strong>Developed Nations</strong></td>
<td></td>
<td></td>
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<tr>
<td>European Union</td>
<td>63.4</td>
<td>58.8</td>
<td>58.9</td>
<td>71.5</td>
<td>77.2</td>
<td>79.1</td>
</tr>
<tr>
<td>Other European Nations</td>
<td>35.1</td>
<td>30.4</td>
<td>27.2</td>
<td>35.7</td>
<td>43.6</td>
<td>48.1</td>
</tr>
<tr>
<td>North America</td>
<td>1.8</td>
<td>1.8</td>
<td>1.9</td>
<td>1.2</td>
<td>1.5</td>
<td>1.7</td>
</tr>
<tr>
<td>Other Developed Nations</td>
<td>5.7</td>
<td>2.8</td>
<td>3.8</td>
<td>2.0</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Developing Nations</strong></td>
<td>32.3</td>
<td>37.7</td>
<td>37.2</td>
<td>25.8</td>
<td>20.7</td>
<td>18.9</td>
</tr>
<tr>
<td><strong>Transitional Nations</strong></td>
<td>4.3</td>
<td>3.5</td>
<td>4.0</td>
<td>2.7</td>
<td>2.2</td>
<td>2.0</td>
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</table>
Figure 14-1  Cross-Border Merger and Acquisition Inflows and Outflows


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Financial Sector

• Financial Sector Development

   The strengthening and growth of a nation’s financial sector institutions, payments systems, and regulatory agencies.
The Importance of the Financial Sector

• Opposing points of view of the contribution of the financial sector to long-run economic development:

  ➢ The financial sector does not play an important role in the long run:
    ✷ Development of real (physical) resources is more crucial to long-run economic performance.

  ➢ The financial sector influences long-run economic performance:
    ✷ It attracts foreign capital and affects private agents’ long-run saving and borrowing decisions, and, therefore, long-run investment strategies.
Capital Misallocations and Their Consequences

• Financial Market Imperfections
  ➢ Asymmetric information can bring about an inefficient distribution of capital through resulting problems of adverse selection, herding behavior, and moral hazard.

• Policy-Created Distortion
  ➢ When a government policy results in a level of output that is different from the economically efficient level of output, causing a less than optimal allocation of an economy’s scarce resources.
Financial Market Imperfections

• Adverse Selection
  ➢ The potential for those who want funds for unworthy projects to be the most likely to want to borrow.

• Herding Behavior
  ➢ Occurs when savers who lack full information base their decisions on the behavior of others who they think are better informed.

• Moral Hazard
  ➢ The potential for a borrower to engage in much riskier behavior after issuing a debt instrument.
Capital Misallocations and Their Consequences (cont’d)

• Financial Instability
  ➢ When a nation’s financial sector is no longer able to allocate funds to the most productive projects.

• Financial Crisis
  ➢ A situation that arises when financial instability becomes so severe that the nation’s financial system is unable to function.
  ➢ Typically involves a banking crisis, a currency crisis, and a foreign debt crisis.
Where Do Financial Intermediaries Fit In?

• Financial Intermediaries
  - Institutions that channel funds from savers to those who ultimately make capital investments.
    - Funnel savings to borrowers with minimum inefficiencies.
    - Make it possible for many people to pool their funds together.
    - May also reduce the degree of information asymmetries.
    - Provide a means for savers to pool risks.
**Capital Flows and International Financial Crises**

- **Portfolio Investment**
  - A highly liquid investment approach that involves the acquisition of foreign financial assets that results in less than a 10 percent ownership share in the entity.

- **Foreign Direct Investment (FDI)**
  - A long-term (illiquid) investment strategy in which the source of funds establishes financial control, making FDI a stabilizing influence on a nation’s economy.
Financial Crises and Multilateral Policymaking

• The International Monetary Fund (IMF)
  A multinational organization that promotes international monetary cooperation, exchange arrangements, and economic growth and that provides temporary financial assistance to nations experiencing balance-of-payments difficulties.

• Growth in IMF Membership
  The number of member nations in the International Monetary Fund is now about six times larger than it was when the organization was founded.
Figure 14-2  Growth in IMF Membership

Source: International Monetary Fund.
IMF Funding

• Quota Subscription
  ➢ The pool of funds deposited by IMF member nations that IMF managers can use for loans to member nations experiencing financial difficulties.

• Special Drawing Right
  ➢ A composite currency of the International Monetary Fund in which the value is based on a weighted average of the currencies of five member nations.

• Conditionality
  ➢ The limitations on the range of allowable actions of a government that is a recipient of IMF loans.
Figure 14-3  IMF Quota Subscriptions

Source: International Monetary Fund.
<table>
<thead>
<tr>
<th><strong>Regular IMF Facilities</strong></th>
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<tbody>
<tr>
<td>Stand-by Arrangements (SBA)</td>
<td>Intended to assist in situations requiring temporary or cyclical adjustments. Arrangements are typically for 12 to 18 months and are phased in on a quarterly basis, with releases of funds contingent on meeting performance criteria and periodic program reviews.</td>
</tr>
<tr>
<td>External Fund Facility (EFF)</td>
<td>Designed to provide assistance for adjustment to problems arising from structural macroeconomic problems for periods up to three years.</td>
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<tr>
<th><strong>Concessional Assistance</strong></th>
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<tr>
<td>Poverty Reduction and Growth Facility (PRGF)</td>
<td>Provides financial assistance for supporting long-term structural programs intended to foster increased economic growth via 10-year loans.</td>
</tr>
<tr>
<td>Heavily Indebted Poor Countries (HIPC) Initiative</td>
<td>Provides financial assistance to countries experiencing difficulties in repaying large bilateral and multilateral external debts.</td>
</tr>
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**Source:** International Monetary Fund.
### Other Financing Facilities

<table>
<thead>
<tr>
<th>Facility</th>
<th>Description</th>
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<tbody>
<tr>
<td>Compensatory Financing Facility (CFF)</td>
<td>Intended to assist members experiencing difficulties arising from temporary export declines or increased expenses in importing foodstuffs.</td>
</tr>
<tr>
<td>Supplemental Reserve Facility (SRF)</td>
<td>Designed to assist members experiencing sudden and disruptive adjustment problems arising from a loss of market confidence.</td>
</tr>
<tr>
<td>Contingent Credit Lines (CCL)</td>
<td>Designed to assist members affected by contagion effects of financial crises originating elsewhere.</td>
</tr>
</tbody>
</table>

**Source:** International Monetary Fund.
The World Bank

• A key supranational institution that provides support to nations experiencing financial problems.
  ➢ Created during the 1944 Bretton Woods conference to provide assistance to countries in the post-World War II rebuilding period.
  ➢ In the 1960s it broadened its scope to encompass making loans for specific projects to about 100 developing nations with an aim toward reducing poverty and improving living standards.
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<th><strong>Table 14-3</strong></th>
<th><strong>World Bank Institutions</strong></th>
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<tr>
<td><strong>International Development Association</strong></td>
<td>On behalf of 161 member countries, specializes in funding loans aimed toward poverty reduction in developing nations.</td>
</tr>
<tr>
<td><strong>International Bank for Reconstruction and Development</strong></td>
<td>On behalf of 182 member nations, provides loans and other forms of development assistance to middle-income countries and the more creditworthy developing nations.</td>
</tr>
<tr>
<td><strong>International Finance Corporation</strong></td>
<td>On behalf of 174 member nations, promotes private-sector investment in developing countries by committing its own funds, brokering loans from private sources, and offering advice to private firms.</td>
</tr>
<tr>
<td><strong>Multinational Investment Guarantee Agency</strong></td>
<td>On behalf of 153 member countries, promotes foreign direct investment in developing nations by offering political risk insurance to lenders and investors.</td>
</tr>
<tr>
<td><strong>International Center for Settlement of Investment Disputes</strong></td>
<td>On behalf of 132 member nations, provides conciliation and arbitration facilities for settling investment disputes arising between foreign investors and developing countries.</td>
</tr>
</tbody>
</table>

**Source:** World Bank.
Ex Ante versus Ex Post Conditionality at the IMF

• Ex Ante Conditionality
  ➢ The imposition of IMF lending conditions before the IMF grants the loan.

• Ex Post Conditionality
  ➢ The imposition of IMF lending conditions after a loan has already been granted.
Figure 14-4  The Distribution of World Bank Lending

Economic Imbalances and International Financial Crises—Traditional View

• Economic Imbalances
  ➢ An inconsistency between the value of the exchange rate corresponding to a nation’s economic fundamentals and an officially targeted exchange rate value can engender a financial crisis.

• Economic Fundamentals
  ➢ Basic factors determining a nation’s current exchange rate, such as the country’s current and likely future economic policies and performance.
Economic Imbalances and International Financial Crises—Traditional View

- Speculative Attack
  
  A concerted effort by financial-market speculators to profit from anticipations of a depletion of official foreign exchange reserves via sales of assets denominated in the nation’s currency intended to induce abandonment of an exchange rate target that will yield them profits in derivative markets.
Economic Imbalances and International Financial Crises—Alternative Views

• Self-Fulfilling Expectations and Contagion Effects
  - A relatively widespread perception by traders that a nation’s policymakers face relatively high internal costs, perhaps because of resulting political difficulties, from maintaining the official exchange rate.
  - A speculative attack takes place because of expectations that it will be successful, but not necessarily because of underlying problems with economic fundamentals.
Economic Imbalances and International Financial Crises—Alternative Views

• **Structural Moral Hazard Problems**
  - Crisis situations that are brought on by flaws within the structure of a nation’s financial system.
  - Crisis conditions exist when governmental policies for government-directed credit to less credit worthy borrowers generate actual losses and widespread failures.
Crisis Prediction and Early Warning Systems

• Financial Crisis Indicator
  ➢ An economic variable that normally moves in a specific direction and by a certain relative amount in advance of a financial crisis, thereby helping to predict a coming crisis.

• Early Warning System
  ➢ A mechanism that multinational institutions might use to track financial crisis indicators to determine that a crisis is on the horizon, thereby permitting a rapid response to head off the crisis.
Figure 14-5a  The Emerging Market Bond Index (EMBI) Spread and Private Capital Flows During the 1990s

Source: International Monetary Fund.
Figure 14-5b

The Emerging Market Bond Index (EMBI) Spread and Private Capital Flows During the 1990s

Source: International Monetary Fund.
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Redesigning the International Financial Architecture

• Proposals
  - Stricter and more measurable conditions for receiving loans from the IMF and World Bank.
  - More public information about the internal operations and lending policies of the IMF and World Bank.
  - New management structures for the IMF and World Bank
  - Adding and/or replacing multinational institutions with new institutions that would operate differently or aim to achieve different objectives.
## Table 14-4a
A Sampling of Proposals to Restructure the International Financial Architecture

<table>
<thead>
<tr>
<th>National Proposals</th>
<th>Private Proposals</th>
</tr>
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<tbody>
<tr>
<td>Canada Proposal for Emergency Standstill Clause</td>
<td>Calomiris-Meltzer Proposals for Strict International Lending Rules</td>
</tr>
<tr>
<td>France Proposal for an IMF Council Composed of National Finance Ministers</td>
<td>Garten’s Proposal for a Global Central Bank</td>
</tr>
<tr>
<td>United Kingdom Proposal for a Standing Committee for Global Financial Regulation</td>
<td>Soros’s Proposal for an International Investor Insurance Agency</td>
</tr>
</tbody>
</table>
### Table 14-4b

**A Sampling of Proposals to Restructure the International Financial Architecture (cont’d)**

<table>
<thead>
<tr>
<th>International Proposals</th>
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<tbody>
<tr>
<td>IMF Proposal for Internal Reforms</td>
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<tr>
<th>G-7 Proposals for a Larger Role for Private-Sector Lenders</th>
</tr>
</thead>
<tbody>
<tr>
<td>G-22 Proposals for Greater Accountability, Stronger Financial Systems, and Crisis Containment</td>
</tr>
</tbody>
</table>

**Source:** Barry Eichengreen, *Toward a New International Financial Architecture.*

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