RYERSON POLYTECHNIC UNIVERSITY
DEPARTMENT OF ECONOMICS
ECN 607: ISSUES IN THE INTERNATIONAL ECONOMY

Globalization and Financial Crises

Origins:

In the years following World War II almost all countries had extensive controls over capital markets. For domestic markets there were detailed regulations governing the banking and financial sectors (e.g. restrictions on mergers and the type of activities banks could undertake). Such regulations were designed to prevent the kind of speculative activity that had occurred in the 1920s and had played a major part in causing the Great Depression of the 1930s. Governments were also allowed and, in fact, encouraged to control capital flows into and out of their countries because it was felt that these could threaten international stability. The IMF charter contained specific provisions to allow this.

The situation changed in the 1970s and 1980s.

(1) The energy crises of that decade resulted in the accumulation of billions of US dollars by the oil exporting countries. These so-called “petrodollars” were deposited in commercial banks in such centers as New York and London so that there was a huge increase in the sums available for international lending.

(2) At the same time an ideological shift in western countries towards an emphasis on free markets led to the lifting of restrictions on financial institutions and international capital flows in the 1970s and 1980s.

(3) The development of new information technology made international financial transactions easier and faster.

The result was an enormous increase in international financial flows, many of them to the LDCs, which were suffering from real declines in international aid flows. Private capital flows to the LDCs increased six-fold between 1990 and 1997. This was the background to the debt crisis in Latin America and Africa in the 1980s and the Mexican peso crisis of 1994-95. In 1997 it was the turn of Asia. On 2 July of that year Thailand devalued its currency (the baht) by 20%. The result was a massive capital flight so that by the end of the year the baht had fallen by 93%. The crisis rapidly spread to other countries in East and Southeast Asia. Indonesia and South Korea were especially hard hit but no country was completely safe.

The Failure of Private Capital Markets:

Some economists see market failures in private capital markets as primarily responsible for the crises. They point to the following problems connected with financial markets:

(1) “Information asymmetry”. Undue haste in opening capital markets to foreign investors contributes to a climate of excessive lending to firms by foreign investors. The evident success of the Latin American economies in the 1970s and the East Asian economies in the 1990s at times when the world economy was generally sluggish led to “irrational exuberance” on the part of those investors. Borrowers possess better understanding of the projects they are engaged in than do lenders but frequently have an

incentive to provide their potential creditors with inaccurate information. In other words, there is an "information asymmetry" which is especially serious when lenders and borrowers are based in different countries. Foreign lending should therefore be undertaken with caution but the haste of lenders often leads them to finance individuals and firms engaged in very speculative activities (e.g. real estate).

(2) In all the crises referred to above an excessively high proportion of the foreign capital was in the form of short-term debt (i.e. bank loans of 1 year or less). This made the recipient countries very vulnerable to nervousness on the part of foreign lenders.

IMF Programs:

The IMF has the responsibility of dealing with international financial crises but has had limited success, in part because its resources are small relative to the volume of transactions involved. Some economists believe that the ineffectiveness of the IMF is also a result of the inadequacy of the adjustment programmed that it imposes on countries needing assistance. These programmed have been criticized on three major grounds:

(1) They invariably include government expenditure cuts, tax increases, and increases in interest rates. Such policies are not only hard on the people of the countries concerned but are often not appropriate as solutions. The problems of Latin American countries in the 1980s were at least partly due to faulty macroeconomic policies but this was not generally the case in Asia, where budgets were balanced, or nearly so. This calls into question the need for tax increases and expenditure cuts. Increases in interest rates have been defended on the grounds that they are needed to prevent capital flight but they might instead increase capital flight since by increasing debt-servicing costs they lead to reduced confidence in the economy.

(2) The IMF has required both Latin American and Asian countries to reduce government intervention in the economy and place greater emphasis on the market. Critics of the Fund argue that such measures are based on the North American market ideology and are not directly related to the financial crises. Even if such reforms are necessary (and not everyone agrees that they are) the middle of a financial crisis is the worst possible time to introduce far-reaching microeconomic reforms. There is also a contradiction in that IMF packages generally require further liberalization of capital controls, while the Fund criticizes LDCs for the inadequacy of their financial regulations. The implication would seem to be that liberalization should be put on hold until such regulations are in place and working effectively.

(3) The IMF favors private lenders at the expense of its member governments. At least part of the crisis is the result of private sector agents making risky loans but the IMF appears to believe that the burden of adjustment should be borne as much as possible by the debtors. The Fund has made little effort to pressure the western commercial banks into writing off debts but has instead mobilized IMF resources and taxpayer funds in the rich countries to bail out the banks and other private lenders. According to the Fund's critics this is not only inequitable but also creates a "moral hazard" problem by encouraging risky behavior by lenders (who know that if worst comes to worst they will be bailed out).

Critics of the IMF have proposed the following policies:

(1) They agree with the Fund that improvements in financial sector supervision and regulation are desirable but believe that undue haste in liberalization has increased

the dangers inherent in the existing inadequate regulatory institutions. There should therefore be a slower more cautious approach to deregulation than is currently being advocated by the IMF and western governments. In any event stronger financial supervision by itself would not be sufficient to prevent future crises. Even the United States, which has considerable experience in prudential regulation, was rocked by the savings and loans scandals in the 1980s.

(2) There should be less official financing and more bank financing. This would force the lenders to bear a greater proportion of the cost of their actions and in the long run this would encourage greater responsibility on their part. The IMF and G7 governments can launch negotiations to force debt reductions. This occurred in the 1980s as a result of the Latin American debt crisis but it took seven years of considerable hardship in the LDCs before action was taken.

(3) When IMF assistance is provided it should be less conditional. The IMF and the World Bank were originally set up to serve the interests of member countries not those of conservative banking and business interests.

Capital Account Liberalization:

When the IMF was founded Article VI of its charter allowed restrictions on capital transactions but insisted on current account convertibility. The current account of the balance of payments includes transactions related to trade in goods and services and current account convertibility was intended to promote a multilateral trading system in which currencies employed in international trade would be freely convertible into each other. This did not, however, apply to transactions involving capital markets since these were regarded as less efficient than goods markets in a number of ways, including the following:

(1) They are more prone to market failure due to asymmetric information between borrowers and lenders.

(2) Market failures may arise due to mismatches between short-term liabilities and long-term assets.

(3) They are prone to irrational herd behavior.

In the years immediately following World War II it was generally believed that the above characteristics of capital markets had contributed to the financial collapse of the 1930s and controls over capital markets were accepted as necessary. With the new emphasis on unrestricted markets in the 1980s, however, came pressure from western governments and multilateral agencies for the removal of restrictions on international financial flows. A series of international financial crises since then (e.g. the Debt Crisis, the Mexican Peso Crisis, the Asian Crisis) have caused some analysts to believe that some restrictions and controls over capital transactions are necessary.

The problem then becomes one of how to reduce the volatility of international financial flows without eliminating them. It is not desirable to eliminate all capital flows since long-term foreign investment clearly helps development by supplementing domestic savings and facilitating the transfer of technology between countries. The problem is with short-term flows.

The development of new communications technology has led to a widely held belief that it is now impossible for governments to control international movements of

capital. This is certainly not literally true since governments could bring such flows to a halt by suspending currency convertibility but this would be an extreme step. There may, however, be other courses of action that could slow down capital flows without eliminating them. Two possible approaches would be the adoption of the `Tobin Tax' or a system of reserve requirements.

The Tobin Tax:

In the 1970s James Tobin proposed a small tax of 0.1% ($1000 for every $1 million sold) on all foreign exchange transactions. This would be a trivial amount for long-term investors but for speculators flipping currencies weekly or daily the `Tobin Tax' could amount to an annual imposition of between 10% and 50%. Tobin's proposal has been criticized on the grounds of feasibility - US $ 1.3 trillion changes hands daily on foreign exchange markets - but the North-South Institute argues that the tax would be technically feasible. The problem is that if a country imposed it unilaterally it would be in danger of being ostracized by international investors. For this reason the tax would only be practically feasible if the G7 powers all agreed to it, which is unlikely at the present.

Reserve Requirements:

In 1991 Chile introduced central bank "reserve requirements" on all foreign borrowing. 20% (now 10%) of all loans with a maturity of up to one year would have to be deposited at the central bank. Since reserves deposited at the central bank pay no interest this amounts to a tax on all foreign borrowing and investment. In 1993 Colombia introduced a similar measure but with the reserve requirements modified according to the maturity of the debt (i.e. the proportion of a loan having to be deposited at the central bank was much higher for short-term than for long-term loans). These reserve requirement systems seem to have worked well since total inflows of capital into Chile and Colombia were apparently not reduced but average loan maturities were lengthened. As a result Chile and Colombia managed to avoid the financial volatility that afflicted other Latin American countries during the Mexican peso crisis of 1995.