The Global Economy—MALS

Unit 6: The Financial Crisis, the IMF, and the World Bank [revise]

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Unit 6: Financial Crisis, The IMF, and the World Bank

Introduction

In an ideal world nations would harmoniously co-exist in the absence of financial crisis, and fortunate nations would freely offer up their support to improve the economic conditions of those in need. Obviously, however, this is not the case. This unit explains the various types of financial crises nations can experience and looks into the institutions that are responsible for promoting financial stability and encouraging economic development throughout the world.

Part 1: Financial Crisis

> *"If you owe your bank a hundred pounds, you have a problem. But if you owe your bank a million pounds, it has."*
> —John Maynard Keynes
>
> *"If you owe your bank a billion pounds everybody has a problem."*
> —The Economist

Throughout history, and for numerous reasons, most nations have experienced a financial crisis of one sort or another. For instance, following WWI, Germany was forced into crisis by the allies' insistence on war reparation payments which—because the debt was primarily financed through printing money—(1) collapsed the value of the Reich mark, (2) eroded the savings of the of the middle class, and (3) empowered Hitler's Nazi party. As another example, America's heyday of the 1920s came to a devastating end with the sudden and unexpected collapse of the U.S. stock market in late 1929. In a matter of weeks the New York Times index of industrial stocks fell nearly 50%—from a high of 452 to a low of 224. And by the mid 1930s roughly 25% of America's banks had failed. Similarly, a financial crisis struck Thailand in June of 1997 and quickly spread throughout Southeast Asia. Foreign investors sought to "cash out" of the region before the pegged exchange rates—which secured their investments—unraveled under intense speculative attacks. Over ensuing months, the value of Thailand's *baht* and South Korea's *won*, to name but two, depreciated by nearly 50%.

By definition a financial crisis is the result of:

- a banking crisis
- an exchange rate crisis
- some combination of the two

The following paragraphs will explore these factors in more detail.

A banking crisis. A banking crisis occurs when the banking system becomes unable to perform its normal functions and is threatened with **disintermediation**—that is, when it becomes unable to serve as an intermediary between savers, investors, and borrowers. A classic example of a banking crisis occurred during America's Great Depression. The banks—which functioned by lending depositors' funds out to borrowers—became unable to service the depositors because borrowers defaulted. When the banks failed, everyone who lost their money was forced to cut back on consumption. Business had no choice but to respond by laying off workers, thus spreading the recessionary effects. In fact, even governments themselves are susceptible to crises brought on by disintermediation. For example, imagine a government that issues bonds or takes on loans in order stimulate growth through deficit-financed spending. If the spending is unsuccessful, no new income will be created, and the government will face a crisis.

Exchange rate crisis. An exchange rate crisis occurs when a nation cannot maintain the international value of its currency. Under a fixed exchange rate system, crisis entails the

loss of international reserves, which forces either devaluation or an abandonment of the system altogether. Under a flexible exchange rate system, crisis means an uncontrolled, rapid depreciation of the currency. Generally speaking, countries that attempt to peg the value of their currency to another without adequate reserves are most vulnerable to such a crisis. Exchange rate crises become financial crises because they are typically followed by bankruptcies and recession. For example, following the currency depreciations in Southeast Asia, many local banks that had borrowed U.S. dollars in order to finance the loans they made to local businesses failed. The dollars these banks now owed to the international investors increased in value by nearly 50% relative to what they were owed from loans they'd made in their national currencies.

Part 2: Causes of Nation-State Level Crises

Financial crises at the nation state level occur, fundamentally, for two reasons: **(1) macroeconomic imbalances**, such as large budget deficits caused by overly expansionary fiscal policies; and **(2) volatile international financial capital** flows out of the economy.

Macroeconomic imbalances. The "lost decade" of the 1980s was, for many Latin American nations, a period wrought with financial crisis of the macroeconomic imbalance sort. Following WWII many of these nations sought isolationist policies that relied on government expenditure for industrial development—government monopolies operated the airlines, the energy, the mills, the telecommunication, and so on. These policies often resulted in spending that far outpaced the tax revenues collected. In order to finance this spending, the governments resorted to issuing bonds—typically to foreign investors—with the "guarantee" of a pegged exchange rate. As a last resort, bonds were even issued to their own central banks.

These policies, coupled with the inherent inefficiency of state-run industry, were a recipe for disaster. By requiring the central banks to purchase their bonds, the governments were essentially printing money. This led to massive inflation—often over 1000% per year—and (as you will recall from Unit 5) put tremendous pressure on their currencies to depreciate. Knowing these governments could not pay their debts, and fearing total financial ruin, foreign investors and financial capital quickly headed for the door. In the end, the inefficiencies of these state-run economies and their resulting macroeconomic imbalances lead to nearly a decade of negative economic growth and declining living standards in Latin America.

For an audio clip on the need for debt relief in developing nations, listen to this NRP interview below. John Ydstie talks with Nancy Birdsall, head of the Center for Global Development in Washington D.C., about the progress that has been made in relieving the debts of the world's poorest countries. (4:30) Birdsall is co-author of *Delivering on Debt Relief: From IMF Gold to a New Aid Architecture*. The book is published by Institute for International Economics, April, 2002.

AUDIO CLIP: NPR Audio: Debt Relief (4/18/2002).
http://discover.npr.org/features/feature.jhtml?wfId=1141922

Crises caused by macroeconomic policies can be cured, and on paper the solution is quite simple, but the consequences can be painful and are often politically difficult. These steps include:

- cutting the deficit
- raising the interest rates
- letting the currency float

Deficit financing. Although macroeconomic imbalances can lead to crisis, one should not take the above example to imply deficit financing is always bad. For example, during

the Great Depression, the U.S. deficit-financed spending put people back to work through "New Deal" projects—leading to increased consumption, private sector hiring, economic recovery, and new tax receipts that could pay back the initial debt. Thus, deficit financing is not inherently bad or good, but ultimately depends on whether enough new growth is created so that the old debt can be comfortably absorbed—a debate often raised when contemplating the current state of the U.S. economy.

VIDEO: Is Borrowing and Debt Owed to Foreigners a Good Thing or a Bad Thing?

Volatile international financial flows. Volatile international financial flows, as described above in the case of South East Asia, are another common cause of crises that have been the subject of much debate in recent years. These crises are due in large part to recent advances in technology coupled with increased openness in financial markets, which now make it possible to shift enormous amounts of money from one market to another almost instantaneously. While many argue in favour of the efficiencies of such technology, others claim that the gains are far outweighed by the volatility caused by these freedoms.

Today, investors move billions of dollars in and out of markets across the globe on a daily basis in response to the slightest change in information about interest rates, exchange rates, and other macroeconomic conditions. A problem created by this free flow of money and information is a kind of "herd" mentality, where small adjustments in economic conditions can result in massive destabilizing financial flows. The example of the crisis in Southeast Asia is a perfect case in point. The crisis began in a few nations that investors feared had growing macroeconomic imbalances—caused by growing trade deficits and politically corrupt "crony" capitalism—and quickly spread throughout the region, adversely affecting many nations without the same fundamental weaknesses.

VIDEO: Explanation of Asian Financial Crisis

Regulatory control. The destabilizing potential of large-scale capital that flows out of nations has called into question the need for some sort of regulatory control. Proponents of such legislation argue that placing restrictions—such as a transaction tax—on the cross-border flow of capital would cause investors to more carefully consider information, helping to minimize destabilizing "knee-jerk" reactions. On the other hand, economic theory clearly holds information and unfettered access as key to market efficiency.

Source: http://web.singnet.com.sg/~mielbox/welcome13.html

Part 3: The International Monetary Fund (IMF)

Prior to WI, foreign exchange markets were relatively uneventful. Currency values were defined in accordance with the Gold Standard, which guaranteed (as discussed in Unit 5) fixed exchange rates between the participating nations. After the war, however, the system collapsed as countries began printing money to pay for the war and tried to stimulate their economies by devaluing their currencies in an attempt to sell more exports. Increased uncertainty over exchange rates and the newly erected protectionist policies brought the global economy to a standstill.

The Bretton Woods conference. Towards the end of WWII, the Bretton Woods conference convened, hoping to establish, among other things, a new international monetary system. The "Bretton Woods" system that emerged was a modified variation of the previous Gold Standard. The value of the U.S. dollar was fixed in terms of gold, and all other currencies were assigned exchange values in terms of U.S. dollars—effectively linking them to gold as well. The U.S. agreed to maintain the value of the dollar at $35 per ounce of gold, and the other nations agreed to maintain the value of their currencies within one percent of their assigned values through central bank intervention in the foreign exchange markets. According to the agreement, countries could only alter their official exchange rates with the consent of a newly created institution, the International Monetary Fund, or IMF, whose primary purpose was to promote stability within the system.

Emerge of IMF. By the early 1970s, however, the fixed exchange rate system of Bretton Woods had become unmanageable due to the constraints it placed on the U.S.'s ability to grow its money supply, which (as you will recall from Unit 5) was necessary to sustain global economic growth. In 1973 the Bretton Woods system was officially disbanded and countries began to allow their currencies to freely float. As such, the role of the IMF was forced to change too. Today, the IMF monitors the exchange-rate policies of member nations. It collects information on the state of the nation's economy and recommends changes when a nation engages in practices that could undermine future international debt payments and stability. If a member nation cannot meet its international obligations, then, ultimately, the IMF serves as its lender of "last resort."

Source: http://web.singnet.com.sg/~mielbox/welcome13.html

How the IMF works. IMF member nations, which account for most of the world's GDP, contribute an annual payment, called a "quota subscription," which provides the IMF with the funds necessary to make emergency loans to member nations experiencing financial difficulty. Each member nation can withdraw 25% of the quota that it paid in the form of gold or a convertible currency. Larger sums can be borrowed from the IMF if the country provides an acceptable plan for eliminating the problems that brought on the crisis. These reform plans generally include:

- a reduction in government spending
- a more stringent monetary policy
- the privatization of inefficient public enterprises
- related "market-oriented" reforms

The decisions the IMF makes are based on "voting rights," which are allocated on the basis of the size of the quota subscription. The U.S. has the largest quota subscription, followed by many other large developed nations. This bias in voting rights is a common criticism of the IMF. Critics claim the IMF is largely a puppet controlled by wealthy nations and large corporations, whose interests don't easily coincide with the developing world.

CAPTION: Some see the IMF as a Trojan horse. Source: http://www.narmada.org/a16-dc/snaps/imf.trojan.horse.jpg

Debate about the usefulness of the IMF. During more recent years, crises in Latin America and Southeast Asia have resulted in substantial debate over the usefulness of the IMF. Supporters of the IMF argue that its actions prevented these problems from becoming more severe. Critics, on the other hand, argue that the availability of these "bailout" funds create a moral hazard, encouraging those in power to take huge risks, often burdening the layperson who can least afford it.

Critics also argue that the stringent reforms demanded by the IMF—and the wealthy western nations which dominate its decision making—as a condition for loans is tantamount to an infringement of national autonomy. And nations, when faced with the prospect of such restrictions, will hesitate to accept IMF loans, causing fixable problems to become full blown crises. To fully appreciate the magnitude of the disagreement surrounding the IMF, consider the following quotes and click on the links to read the paper and speech from which they are taken:

> *The legitimate political institutions of the country should determine the nation's economic structure and the nature of its institutions. A nation's desperate need for short-term financial help does not give the IMF the*

moral right to substitute its technical judgments for the outcomes of the nation's political process.

—Martin Feldstein, Professor of Economics, Harvard University, and President of the National Bureau of Economic Research

Refocusing the IMF: http://www.nber.org/feldstein/fa0398.html

There in neither point nor excuse for the international community to provide financial assistance to a country unless that country takes measures to prevent future such crises.

—Stanley Fischer, Professor of Economics, MIT, and First Managing Director of the IMF

The IMF and the Asian Crisis:
http://www.imf.org/external/np/speeches/1998/032098.HTM

VIDEO LECTURE: Value of IMF stepping in to avert global crisis and IMF conditionality requirements

WEBLINK: For additional information on the IMF and the IMF's response to its critics visit:

What is the IMF and Common Criticisms of the IMF

WEBLINK: To read additional debates by leading economists on the pros and cons of the IMF, visit this article by the Hoover Institution:

Abolish the IMF?

VIDEO CLIPS: For some short video clips produced by the IMF watch:
user: mals620
password: year0405

IMF introductory video

IMF origins video

IMF lending video

IMF oversight video

IMF role in S. Korea video

Part 4: The World Bank

The International Bank for Reconstruction and Development was founded at the Bretton Woods conference in 1944 alongside the IMF. Its mission, originally, was to assist in the reconstruction of nations ravaged by the horrors of WWII. By 1948, however, it had become clear that the capital requirements for reconstruction exceeded the financial capabilities of the IBRD. In response—and over fears of a growing Soviet threat—the U.S. initiated the Marshal Aid Plan for Western Europe.

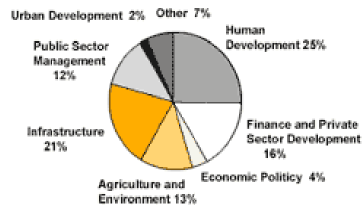
Today the IBRD is one of five sub-groups that make up the World Bank Group. Its current mission is to lend money and provide aid for specific development projects, such as schools, roads, and other infrastructural improvements, to Third-World nations. The other groups that make up the World Bank include the:

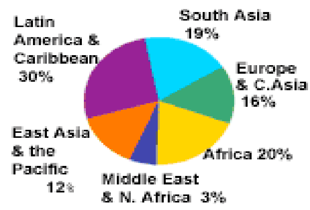
- International Development Association
- International Finance Corporation
- Multilateral Investment Guarantee Agency
- International Center for Settlement of Investment Disputes

Together, these groups work towards achieving the World Bank's primary mission of **reducing poverty** through the following means:

- investing in people, particularly through basic health and education
- focusing on social development, inclusion, governance, and institution-building as key elements of poverty reduction
- strengthening the ability of the governments to deliver quality services, efficiently and transparently
- protecting the environment
- supporting and encouraging private business development
- promoting reforms to create a stable macroeconomic environment, conducive to investment and long-term planning

The World Bank Group currently has 184 member nations and employs over 10,000 people—80% of whom are located at the World Bank's headquarters in Washington, D.C. Funding for the World Bank projects comes from donor nation contributions and sales of debt securities in private markets. In 2003, the World Bank Group made loans and credits in excess of 18 billion dollars.





CAPTION: The World Bank's lending by section and region for fiscal year 2001.

CAPTION: The World Bank's primary mission is to reduce poverty in Third-World nations. Source: www.adelantesi.com/Archive/ Dec02/poverty_esp.htm.

WEBLINK: To learn more about the function and projects of the World Bank please visit:

About Us: the World Bank Group.

For an audio clip of a speech by James Wolfensohn, President of the World Bank, listen to this NPR clip below. A former investment banker, Wolfensohn is the World Bank's ninth president. In this clip, he discusses economies in the developing world, including Iraq, which has the world's second largest oil reserves but is $120 billion in debt.

AUDIO CLIP: James Wolfensohn, World Bank President, National Press Club Luncheon Speaker—Oct. 29, 2003.
http://www.npr.org/programs/npc/2003/031029jwolfensohn.html

Weblinks

During your reading of UNIT 6, Parts 1–3, the following weblinks were presented. Read them now if you have not already done so.

NPR audio clip on debt relief
http://discover.npr.org/features/feature.jhtml?wfId=1141922

Refocusing the IMF
Martin Feldstein

The IMF and the Asian Crisis
Stanley Fischer

What is the IMF

Common Criticisms of the IMF

Abolish the IMF?

About Us: the World Bank Group

James Wolfensohn audio clip
http://www.npr.org/programs/npc/2003/031029jwolfensohn.html

Readings

Purchased books:

Globalization and its Discontents by Joseph Stiglitz, Norton Press, 2002. Continue reading.

Chapter 10, *The Choice: A Fable of Free Trade and Protectionism* by Russell Roberts, Prentice Hall, 2001.

From *Real World Globalization,* 8th Ed., edited by the Dollars and Sense Collective, 2004, read the following chapters:

Chapter 1, Article 3, "Learning from the Southeast Asian Crisis."
This was chapter was assigned as part of the reading for Unit 3, but you may want to re-read it in preparation for Discussion Question #1

Chapter 4, Article 18, "The IMF and the World Bank's Cosmetic Makeover."

Chapter 4, Article 19, "Economic Debacle in Argentina: The IMF Strikes Again." (Purchased book)

Assignments

DISCUSSION FORUM: Remember to go to the Discussion Forum in Blackboard to answer the question for this unit.

Discussion Question #1

Some economists are fearful that America's budget and trade deficits have the potential to destabilize the value of the US dollar and burden future generations, while others argue that these deficits result in stimulatory consumption and investment spending, and will ultimately increase America's standard of living. What are your thoughts?

Discussion Question #2

Do you believe controls should be put in place to limit the flows of financial capital in international markets?

Discussion Question #3

Have America and the other dominant nations within the IMF and World Bank overstepped their bounds in their attempt to promote the "Washington Consensus"?

SHORT PAPER

PAPER TITLE: The IMF: (a) More Good than Bad, or (b) More Bad than Good? Choose either (a) or (b) and write short paper critically justifying your position.