International Lending and Financial Crises

Based on Chap 26 of Pugel and Lindert

By

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Introduction

- International capital movement refers to the flow of financial claims between lenders and borrowers. The lenders give the borrowers money to be used now in exchange for IOUs, or ownership shares entitling them to interest and dividends later.
- In the BOP accounts, international capital flows are divided into different categories:
  - by type of lender or investor (private vs. official)
  - by maturity (long term vs. short term)
  - By type of borrower (private or government)

Topics

1. Key categories of foreign investment:
2. A brief history
3. Gains and Losses from International Lending
   - Intertemporal trade:
   - International diversification of risks
- Taxes on International Lending
- International Lending to Developing Countries
  - The surge in International Lending, 1974-1982
  - The debt crisis of 1982
  - The resurgence of Capital Flows in the 1990s
  - The Mexican Crisis, 1994-1995
  - The Asian Crisis, 1997
  - The Russian Crisis, 1998
- Financial Crises: Causes and consequences, and remedies

1. Key Categories of Foreign Investment

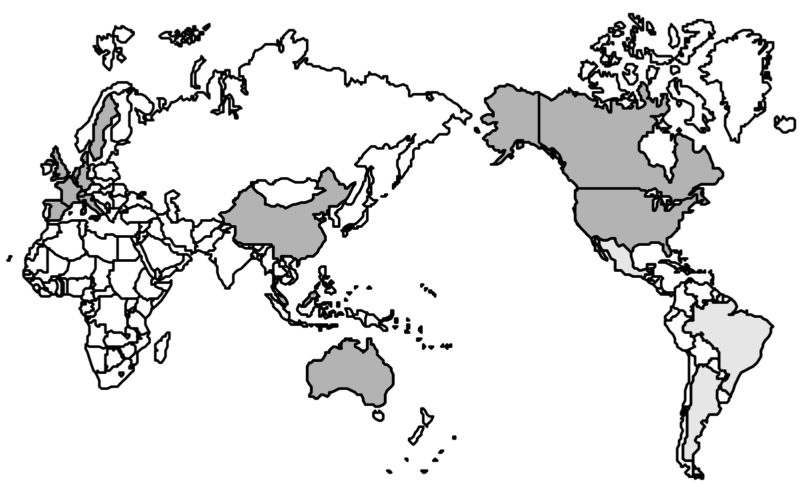
A. Private lending and investing

1. Long term
   a. Direct investment (lending to, or purchasing shares in, a foreign enterprise largely owned and controlled by the investor)
   b. Loans (to a foreign borrower, maturity more than one year, mostly by banks)
   c. Portfolio investment (purchasing stock or bonds with maturity of more than one year, issued by a government or a foreign enterprise not controlled by the investor)
2. Short term (lending to a foreign borrower, or purchasing bonds issued by a government or a foreign enterprise not controlled by the investor,maturing in a year or less)

B. Official lending and investing (by a government or a multilateral institution like the International Monetary Fund or the World Bank mostly lending, both long term and short term)

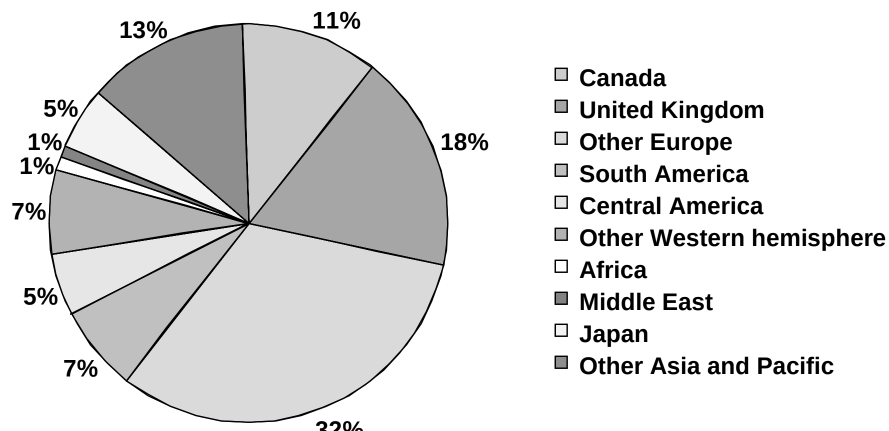
2. Brief History of world capital flows

Top Source and Host Countries for Foreign Direct Investment, 1985–1995



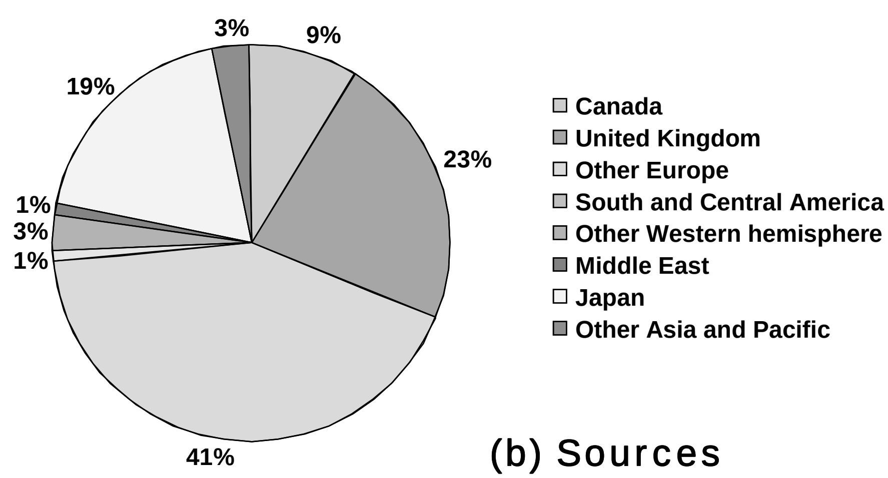
The shaded area represents leading host economies, the darker shaded Areas represent the top twenty source economies for FDI

Destination of US outward FDI



(a) Destinations

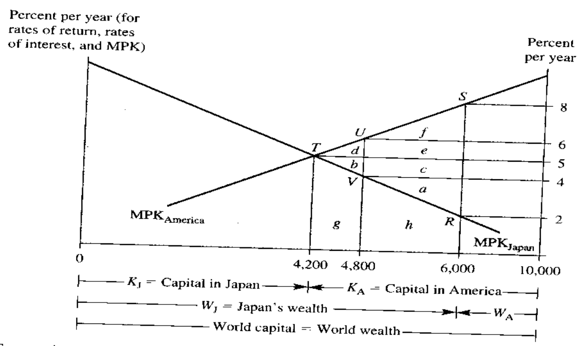
Sources of FDI into the US



(b) Sources

Gains and losses from well-behaved international lending

FIGURE 26.1 *Gains and Losses from Well-Behaved International Lending*



From no international lending (*RS*) to free lending (*T*):

Japan	gains ($a + b + c$)	= 27
America	gains ($d + e + f$)	= 27
World	gains (a through f)	= 54

If Japan imposes a 2 percent per year tax on lending abroad (from *T* to *UV*):

Japan	gains ($e - b$)	= 9
America	loses ($d + e$)	= 15
World	loses ($b + d$)	= 6

If America imposes a 2 percent per year tax on borrowing abroad (from *T* to *UV*):

Japan	loses ($b + c$)	= 15
America	gains ($c - d$)	= 9
World	loses ($b + d$)	= 6

The Surge in International Lending to LDCs 1974-1982

- Reasons: Oil shocks of 1970's led to petrodollar
- Rate of returns in the industrial countries were low.
- LDCs were averse towards FDI because of past bad experiences with it. So private capital flows began.

Crisis of 1982

- August 1982 Mexico declared unable to service its foreign debt.
- Several reasons for it.
- Interest rate in the US was high at that time

Long-term financial capital flow

FIGURE 26.2 *Net Long-Term Financial Flows to Developing Countries, 1980–1998 (billions of U.S. dollars)*

Source and Type	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
Official	35	34	35	35	34	41	45	45	42	42
Loans	22	22	24	24	21	25	28	27	23	23
Grants	13	11	11	10	13	16	17	18	19	20
Private debt	44	53	45	31	27	22	10	10	15	14
Bank loans	30	44	33	23	23	9	2	2	9	6
Bonds	1	1	4	2	0	6	2	1	4	5
Other loans	12	8	8	6	5	8	6	7	3	4
Portfolio equity (stock)	0	0	0	0	0	0	0	0	0	4
Direct foreign investment	4	13	11	9	9	11	10	14	20	23
Total	83	100	91	74	72	73	65	68	76	83

Source and Type	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Official	57	63	54	53	46	53	32	39	48
Loans	28	28	23	25	14	21	3	13	25
Grants	29	35	31	28	32	32	29	26	23
Private debt	16	19	38	49	54	60	100	105	58
Bank loans	3	5	16	3	14	32	44	60	25
Bonds	1	11	11	37	37	27	54	43	30
Other loans	11	3	11	9	4	1	3	3	3
Portfolio equity (stock)	4	8	14	51	35	36	49	30	14
Direct foreign investment	25	34	46	67	89	105	126	163	155
Total	101	123	152	220	224	255	308	338	275

Note: Net inflows of short-term finance have been variable: $20 billion in 1990, rising to $61 billion in 1995, then declining to $5 billion in 1998.
Source: 1980 and 1990–1998: World Bank, *Global Development Finance, 1999;* 1985–1989: World Bank, *World Debt Tables, 1992–93;* 1981–1984: Rachel McCulloch and Peter A. Petri, "Equity Financing of East Asian Development," in Kahler (1998).

To be continued