# Political Science 12:  IR -- Sixth Lecture, Part 2

# 8 International Financial Relations

# International Financial Relations

1. International Finance

- Cross-Border Investment
- Why Invest and Borrow Abroad?
- Distributional Conflicts
- The Role of the IMF
- Multinational Corporations

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# International Finance

- Cross-border investment can improve welfare in both countries
- Financial interests cooperate
- Financial ties can make societies mutually vulnerable

# International Finance

The Financial Crisis of 2008

- Credit crunch in housing market
- Toxic assets
- Cascade

# International Finance

Foreign and international actors can have strong influence on a country's welfare.

# International Finance

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# Cross-Border Investment

Portfolio: investor has no role in management

- Bonds
- Loans
- Stocks

# Cross-Border Investment

Direct investment: investor maintains control of facilities

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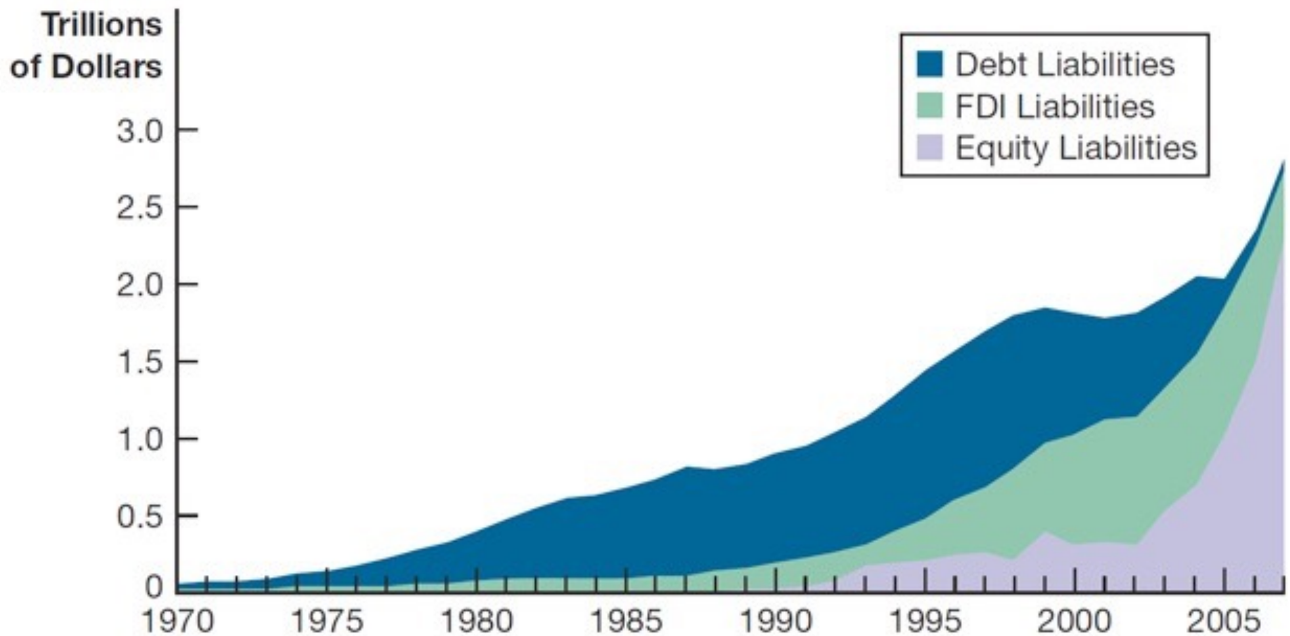
# Why Invest and Borrow Abroad?

Figure 8.1: Foreign Investment in Emerging Markets, 1970–2007




Debt liabilities = gross debt owed by emerging market countries.
FDI liabilities = gross foreign direct investment in emerging market countries
Equity liabilities = gross foreign holdings of equities (stocks) in emerging market countries

# Why Invest and Borrow Abroad?

- Benefits from investing outside one’s country
- Costs of investing abroad

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# Distributional Conflicts

Table 8.1: International Investment Flows, 1973–2007

| | 1973–1977 | 1978–1982 | 1983–1987 | 1988–1992 | 1993–1997 | 1998–2002 | 2003–2007 |
|---|---|---|---|---|---|---|---|
| All Countries in sample (billions of U.S. dollars) | 989 | 2,034 | 4,170 | 5,048 | 9,410 | 12,715 | 51,238 |
| Foreign direct investment | 13.4% | 13.4% | 12.8% | 17.9% | 15.3% | 24.5% | 15.2% |
| Foreign portfolio investment | 86.6% | 86.7% | 87.1% | 82.1% | 84.7% | 75.5% | 84.8% |
| Advanced Economies (billions of U.S. dollars) | 772 | 1,617 | 3,817 | 4,577 | 8,084 | 12,043 | 46,555 |
| Foreign direct investment | 13.4% | 13.8% | 13.2% | 16.3% | 12.4% | 21.8% | 13.1% |
| Foreign portfolio investment | 86.7% | 86.3% | 86.8% | 83.7% | 87.6% | 78.2% | 86.9% |
| Developing Countries and Emerging Markets (billions of U.S. dollars) | 216 | 417 | 353 | 471 | 1,326 | 672 | 4,683 |
| Foreign direct investment | 13.8% | 11.7% | 8.9% | 34.1% | 33.3% | 73.8% | 35.8% |
| Foreign portfolio investment | 86.0% | 88.3% | 91.1% | 65.9% | 66.7% | 26.2% | 64.2% |

# Distributional Conflicts

Across borders

- Terms of the investment
- Loans
- Obsolescing bargain

# Distributional Conflicts

Within a borrowing country

- Foreign capital may be fickle
- Foreign capital inflows may benefit some more than others

# Distributional Conflicts

Within a borrowing country

- Government borrowing:

  Who should sacrifice?

# Distributional Conflicts

# Distributional Conflicts

Within a borrowing country

- Moral hazard

# Distributional Conflicts

Moral hazard

- Federal Deposit Insurance Corporation (FDIC)
- Created in 1933 (very early in FDR’s administration)

# New Financial Instruments

- Innovation in financial sector in the last thirty years
- Hedge funds and investment banks created new products
- Unregulated, no safeguards, no insurance

# Moral Hazard: Insurance

The S&L crisis (late 1980s)

A bank knows that it is insolvent

declare bankruptcy → FDIC bailout

make a bunch of very risky loans that will be lucrative if they pay off (such as buying lottery tickets)

loans go bust, bankruptcy → FDIC bailout

loans pay off → live the high life!

# Moral Hazards and Solutions

- Insurance: someone else pays if you get in trouble
- Moral hazard: insurance reduces incentives to act responsibly
- Solution to moral hazard: regulation and monitoring

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- The Role of the IMF
- Multinational Corporations

# The Role of the IMF

- The International Monetary Fund
- Cooperation through an institution
- Serves same function as Britain in the nineteenth century

# The Role of the IMF

The IMF created the recognition that monetary and financial markets are prone to socially disastrous failure.

# The Role of the IMF

The IMF turned from monetary insurance to financial power in the mid 1970s.

# The Role of the IMF

Lately, Ireland, Greece, and Portugal all have needed to borrow from the IMF.

# The Role of the IMF

Voting share adjustments October 2010

G-20 agrees to give over 6% voting share to “dynamic developing countries”

# The Role of the IMF

Benefits

- Provides information
- Can facilitate agreement that otherwise would be difficult

# The Role of the IMF

Criticism of the IMF

- Financial standards and information
- Negligible impact on *preventing* crises

# The Role of the IMF

Criticism of the IMF

- Negotiations nondemocratic
- IMF forces noneconomic policy concessions

# The Role of the IMF

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# Multinational Corporations

Foreign direct investment (FDI)

- Greenfield
- Mergers and acquisitions
- Joint ventures

# Multinational Corporations

FDI: Why and where?

- Market access
- Natural resources

# Multinational Corporations

FDI: Why and where?

- Minimize factor costs
- Permissive tax
- Regulatory environment

# Multinational Corporations

# Multinational Corporations

Nearly 75% of FDI flows among wealthy countries.

# Multinational Corporations

Why do countries seek FDI?

- Less risky than loans
- Creates jobs

# Multinational Corporations

Spillover effects

# Multinational Corporations

- International institutions and FDI
- Unlike trade, FDI is not deeply regulated at the international level

# Political Science 12: International Relations