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
International Financial Relations

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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
Foreign and international actors can have strong influence on a country’s welfare.
International Finance
International Financial Relations

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6. Multinational Corporations
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
International Financial Relations

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## Table 8.1: International Investment Flows, 1973–2007

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<td>Foreign direct</td>
<td>13.4%</td>
<td>13.4%</td>
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<td>82.1%</td>
<td>84.7%</td>
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<td><strong>Advanced</strong></td>
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<td>Foreign direct</td>
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<td>Foreign portfolio</td>
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<td>66.7%</td>
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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

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

loans pay off

loans go bust, bankruptcy

FDIC bailout

FDIC bailout

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

- 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