International Financial Crisis Essay, Research Paper

Financial Instability The soaring volume of international finance and increased interdependence in recent decades has increased concerns about volatility and threats of a financial crisis. This has led many to investigate and analyze the origins, transmission, effects and policies aimed to impede financial instability. This paper argues that financial liberalization and speculationare the most reflective explanations for instability in financial markets andthat financial instability is likely to be transmitted globally with farreaching implications on real sector performance. I conclude the paper with theargument that a global transaction tax would be the most effective policy tocurb financial instability and that other proposed policies, such as targetzones and the creation of a supranational institution, are either unfeasible or unattainable.INSTABILITY IN FINANCIAL MARKETS In this section I examine four interpretations of how financialinstability arises. The first interpretation deals with speculation and thesubsequent bandwagoning in financial markets. The second is a politicalinterpretation dealing with the declining status of a hegemonic anchor of thefinancial system. The question of whether regulation causes or mitigatesfinancial instability is raised by the third interpretation; while the fourthview deals with the trigger point phenomena. To fully comprehend these interpretations we must first understand anddifferentiate between a currency and contagion crisis. A currency crisisrefers to a situation is which a loss of confidence in a country’s currencyprovokes capital flight. Conversely, a contagion crisis refers to a loss ofconfidence in the assets denominated in a particular currency and the subsequentglobal transmission of this shock. One of the more paramount readings of financial instability pertains tospeculation. Speculation is exhibited in a situation where a governmentmonetary or fiscal policy (or action) leads investors to believe that thecurrency of that particular nation will either appreciate or depreciate in termsrelative to those of other countries. Closely associated with these speculativeattacks is what is coined the bandwagon effect. Say for example, that acountry’s central bank decides to undertake an expansionary monetary policy. Aneoclassical interpretation tells us that this will lower the domestic interestrates, thus lowering the rate of return in the foreign exchange market andbringing about a currency depreciation. As investors foresee this happeningthey will likely pull out before the perceived depreciation. Efforts to getout would accelerate the loss of reserves, provoking an earlier collapse,speculators would therefore try to get out still earlier, and so on (Krugman,1991:93). This herding or bandwagon effect naturally cause wild swings inexchange rates and volatility in markets. Another argument for the evolution of financial market instability isclosely related to hegemonic stability theory. This political explanationpredicts a circumstance (i.e. a decline of a hegemon’s status) in which a lossof confidence in a particular countries currency may lead to capital flightaway from that currency. This flight in turn not only depreciates the currencyof the former hegemon but more importantly undermines its role as theinternational financial anchor and is said to ultimately lead to instability. The trigger point phenomena may also be used as an instrument to explainfinancial instability. Similar to the speculative cycles described above, thisrefers to a situation where a group of investors commits to buy or sell acurrency when that currency reaches a certain price level. If that particularcurrency were to rise or fall to that specified level, whether by real orspeculative reasons, the precommited investors buy or sell that currency orassets. This results in a cascade effect that, like speculative cycles,increases or decreases the value of the currency to remarkably higher or lowerlevels. Country after country has deregulated its financial markets and institutions. The neoclassical interpretation asserts that regulation is thought to create incentives for risk taking and hence instability. It is said to bring about what are called moral hazards. Proponents of deregulation argue thatwhen people are insured, they are more apt to take greater risks with their investments in financial markets. The riskier the investment activity, the more volatile the markets tend to be. A closer look suggests that perhaps only two of these explanations arevalid when thinking about the origins of financial instability. The triggerpoint explanation seems to be a misreading of the origins of instability. It isunlikely that a large number of investors would have the incentive oroperational ability in order to simultaneously coordinate the buying or sellingof a currency or assets denominated in that currency. If even there is suchunlikely coordination, the existence of even a very large group of investorswith trigger points need not create a crisis if other investors know they arethere (Krugman, 1991:96). The theory of hegemonic stability also overlooks a number of factorsthat can provide useful insights in explaining the emergence of financialinstability. Historical precedence supports this assertion. For instance,Britains role as international economic manager was very minor in the stabilityexperienced under the gold standard. The success of the standard can beattributed to endogenous factors such as the self adjusting market mechanism andthe informal discipline maintained by its rules. The destabilization of thegold standard can be attributed to the extreme domestic economic and financialpressures brought on nation states by World War I, and not solely on theindustrial and economic demise of Britain. A valid explanation for the origins of financial instability are thespeculative attacks brought on by investors. Although similar in function totrigger points, these speculative cycles cannot be mitigated simply by purerecognition. Rather than acting on the value of the currency itself,speculators act on occurrences or policies that will alter the value of thecurrency. Instability arises from the fact that these speculative cycles inducecapital flight and therefore a change in the value of that particular currency,whether or not the decisions of these investors are based on market fundamentals. Futures, options, swaps and other financial instruments havegiven investors and speculators an unheard of capacity to leverage financialmarkets. The greater the leverage, the greater the instability (McCallum,1995:12). If we examine the deregulatory process closely, it becomes clear thatthere is a perverse relationship between deregulation and financial stability.Say for example, investors suffer from a profit squeeze. This causes theinvestors to lobby politicians for deregulation. The resulting wave ofderegulation fosters instability and wide swings in exchange rates which in turncause loan defaults and subsequent banking crisis. The resulting financialinstability thus begs calls regulation, likely placing the investors in theoriginal position with an unsolved problem. We can see that the dialectic ofthe regulatory process undermines anticipated stability and will eventually leadto financial instability and collapse. In this environment, there arises callsfor new forms of financial regulation. These policies and proposals are ofcritical importance and will therefore be discussed later in the paper.THE TRANSMISSION AND EFFECTS OF FINANCIAL INSTABILITY There are three contending albeit interrelated views on how financialinstability may be transmitted globally. These include equity markets,multiplier effects and monetary reverberations. Say for example, a movement of stock prices generates a recession in onecountry. This is turn leads to a reduce in imports from abroad. The loweraggregate demand for foreign imports will generate a contraction in othercountry’s output markets. The resulting contraction in the foreign countrieswill then induce a contraction in the originating country. As seen, themultiplier effect begins to take place that in turn leads to a global recession. If an asset crash leads to a monetary crises, the money crisis could betransmitted worldwide. The Mundell-Flemming model assumes that under a fixed exchange rate system, such as that under the gold standard, a worldwide monetary contraction will result from a contraction in any one particular country because a monetary contraction in one country, which raises interest rates in that country, must be matched by an equal rise in rates elsewhere (Krugman, 1991:103). However, under a flexible exchange rate system, such as the one in operation today, the model predicts that monetary shocks will be transmitted perversely, that is, a monetary contraction in one country will produceexpansion elsewhere. Herring and Litan (1995) advance this argument byconcluding that the transmission of crisis creates a systemic risk. Thisview states that continuous losses in financial markets has adverse effects onthe real economy because significant losses can occur if there is a significantdisruption in the payments system or the mechanism through which transactionsfor goods, services, and assets are cleared (Herring and Litan, 1995:51) . While it may be accepted that financial crises can be transmittedglobally, there is debate on its ramifications on the real sector of the economy. Krugman (1991:97) states that a currency depreciation will produce animprovement in competitiveness that will increase net exports and thus have anexpansionary effect on the domestic economy. He also asserts that policyresponses may help to curb real sectors effects. When currencies depreciate,government officials and central bankers raise interest rates to discouragecapital flight. The recessionary effects of tight monetary and fiscal policies,it is argued, dilute the inflationary repercussions of the currency crisis.Citing historical evidence of the US stock market crash, Kapstein (1996:6) goesso far as to say that the real economy is shockproof from transmission offinancial instability and even in the face of financial crisis continues tofunction normally. The assumption that swings in financial markets do not influence realsector performance is inattentive to many factors. Advocates of this view usewhat is percieved as relatively small repercussions felt worldwide after the USstock market crash in 1929 where in general the slump was mild (Krugman1991:91). The empirical data of the slump underscores this argument. BetweenDecember 1929 and December 1932, for example, Germany experienced a 30.% percentstock market decline, France 38.5 percent and Canada 37.5% (Kindleberger, 1973).If we keep in mind that the percentage swing in the US stock during that sameperiod was 37.3 percent, we see that the slump was only slightly milder but byno means mild. The real sector ramifications were just as remarkable.Germany saw a 58 percent decline in industrial production, France 74 percent andCanada 68 percent, all comparably higher declines than in the United States(Yeager, 1976). It is obvious that financial crises do have global spillover effects andconsequences on real sector performance. However, recognition of these adverseeffects does not solve the problem. In the next section I present contendingpolicies and proposals designed to curb international financial instability andits repugnant ramifications.CONTENDING VIEWS AND POLICY PROPOSALS Three main policies have been introduced to curb internationalfinancial instability. A global transaction tax, which is a tax on short termfinancial investments, a target zone approach, where nations exchange rateswould be allowed to fluctuate within a specific band and a supranational orregional institution aimed at coordinating global financial reform. Proposed by economists and Nobel Laureate James Tobin in 1978, a globaltransaction tax (STT) would act to throw some sand in the well greased wheelsof the global financial markets. The STT is predicted to slow the short termfinancial excursions into other currencies, yet at the same time it would have alighter impact on trade and long-term investments with higher percentage yields.Speculators, now carrying the burden of a tax woul therefore have less leverage with which to exploit exchange volatility while long-term investmentwould be encouraged. Another benefit of the tax is that it would reducewasted financial resources and increase government revenues. While proponents of the STT say the policy will reduce wasted financialresources, others argue that there would be an adjustment problem because of thefact that goods and the price of labor moved in response to international pricesignals much more sluggishly than fluid funds, and prices in goods and labormarkets moved more sluggishly than prices of financial assets. (McCallum,1995:16) Others attack the view that excess volatility would be eliminatedbecause deciding whether volatility is excessive is complicated by difficultyof determining the fundamental value of a security (Hakkio, 1994:22).Opponents of the tax argue that it could be avoided by product substitution andregulatory arbitrage and that the government revenue created would beoverestimated because the tax base would decline as security prices and thevolume of trading decline (Hakkio 1994: 26). Advocates of the efficient market hypothesis argue that if financialmarkets are allowed to freely operate, there will be a revaluation of assetvalues that will produce the most accurate price signals on which to base long-term resource allocations. They say that a STT would be detrimental to less developed countries so reliant on short term investment. Another highly noted policy aimed at curbing international financialinstability is the adoption of a targeted exchange rate system. A sort of hybrid regime, target zones allows currencies to fluctuate within predeterminedand set bands, thus allowing a float but at the same time keeping a fix. Since the main sources of conflict have been the unpredictability of exchangerates (Frenkel, 1990:318) a target zone approach would in theory alleviate thisunpredictability, while keeping the appealing attributes of a floating system.Seen to be the optimal answer for coordinated exchange rate stabilization, target zones would involve the determination of an international consensusregarding an appropriate and globally feasible range around which currencyvalues could fluctuate (Grabel, 1993:77). The adoption of a target zone system would not be universallybeneficial. Naturally, the size, status and sector of the economy play animportant role in its desirability. Government officials and central bankerswill likely oppose the adoption of a targeted exchange rate due to the fact thatit would hurt their ability to change the value of their currency in the face ofhigh capital mobility. With a targeted exchange rate, it is argued that there islimited room for fluctuation which infringes on the effectiveness of domesticpolicies. On the other hand, the fixity of the target zone would in theorystabilize purchasing power of wage earners in both developed and less developed. The overriding problem of the adoption of a target zone regime is thatthere is no clear way in which target zones could be calculated. If they wereto be calculated what would be the ramifications if a country was to fluctuateout of the specific bands? Would the target zones be global or regional? Ifglobal, how could the less developed countries be able to stay in the same bandsas the developed countries? If a target zone was adopted, what is to say themaldistribution of wealth would not remain idle? There seems to be little, ifany, evidence that a fixed, stabilized exchange rate leads to higher or lowerinterest rates. If the value of a currency is not able to adapt to hightendencies of capital mobility, then it is only rational to say that thedeveloped countries would continue to sap the wealth of less developed countries. The last major policy aimed at quelling financial instability is thecreation of a supranational institution aimed at coordinating financial reformand adopting a system of regulatory supervision. Processing along the lines ofa Bretton Woods architecture, this would in a sense institutionalize the role ofa hegemon with a creation of a common currency for all of the industrialdemocracies and a joint Bank of Issue to determine monetary [and financial]policies (Cooper, 1984:166). This policy proposal endorses the adoption of anglobal financial institution managing the operation of coordinated supervision. Experience shows us that coordinated supervision is not possible ininternational financial markets. For instance, the Basel Concordant was neverable to reach organizational level to properly respond to a crisis.Additionally, the BCCI affair demonstrated the limitations of internationalbank supervision when confronted by unscrupulous operators intent on exploitingthe gaps in national bank supervisory systems (Herring and Litan, 1995:105). Proponents of re-creating a Bretton Woods-type system are unaware of thelessons to be learned from that period. The theoretical brethren of hegemonicstability advocates, proponents of this policy seek too place the direction ofworld monetary policy in the hands of a single country or institution thatwould have great influence over the economic destiny of others (Williamson,1977:37). As seen under the Bretton Woods system the destiny of others was inthe hands of a country that was unable to maintain stability. It is yet to bedemonstrated how an institutional framework would sidestep the same faultlinesand management problems experienced by the United States under the Bretton Woodsregime. The organizational barriers to creating such cooperation andcoordination would be insurmountable. Secondly, whose view would most likely bepresented in the supranational forum? Experience in international organizationsshows us that it will probably be the powerful, industrialized nations. Thevoice and needs of the less developed countries is likely to be marginalized andsituations such as the Latin American debt crisis would continue to occur. When looking at the progress of the European Monetary Union we see thatthe completion of a single market is far too radical for today’s internationalfinancial climate. Just as the costs of qualifying for the EMU has become toohigh it becomes unrealistic to hope that the major industrial countries canmake comparable strides toward political [much less financial] unification inour lifetime (Eichengreen and Tobin, 1995:170). Ideally, the best policy for stemming financial instability andspillover effects would be one that extinguishes the problem at its roots. Ifderegulation in itself causes instability in financial markets, then regulationwould be appealing. Even when the benefits of financial deregulation areapparent, there is a role for regulatory policy that would leave the worldeconomy less vulnerable to financial collapse (Eichengreen and Portes, 1987:51). . If we also hold true the conclusion that the best explanation for financialinstability is speculation, then a global securities transaction tax such as theone proposed by Tobin would be optimal. The discouragement of short termspeculative excursions and the endorsement of long-term investment willeliminate the problem of volatility based on speculative attacks that so oftenstray from market fundamentals. Critics are quite correct when they arguethat the tax could induce financial arbitrage and substitution. However thisproblem would be solved as long as the tax was globally adopted. Secondly, thetax would be applied to goods, services, and financial instruments that had fewor no substitutes. The view that the creation of new government revenues isoverestimated and that Third World countries would carry the financial burden isnullified when we see that a .5 percent tax on exchange transaction wouldaugment government revenues globally by as much as $300 to $400 billion per anum and devoting merely 10-20 percent of that revenue to a revolving fund forlong-term lending to Third World countries would be a healthy substitute forthe hot money on which some have become disastrously overdependent (McCallum,1995:16). The recognition and ceasing of financial instability and its globaltransmission is becoming more and more universally endorsed. To decide on aprudent and practical policy will prove to be a major hurdle of internationalfinancial leaders around the world. However, if we look closely, we will findthe locus of instability in financial markets to be deregulation and speculativeattacks. Government and central bankers can no longer adopt an attitude of benign neglect toward international financial instability as it becomesincreasingly apparent that there are far reaching consequences on real sectors.We can see that there is one policy that supersedes the rest. If the worldfinancial system hopes to curb these real sector ramifications of speculativeattacks and financial liberalization, then it becomes indisputable that the STTis an idea whose time has come.BIBLIOGRAPHYRichard N. Cooper, A Monetary System for the Future Foreign Affairs Fall,1984.Barry Eichengreen and Richard Portes, The Anatomy of Financial Crisis, inRichard Portes and Alexander Swoboda, Threats to International FinancialStability, (Cambridege University Press, 1987). 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