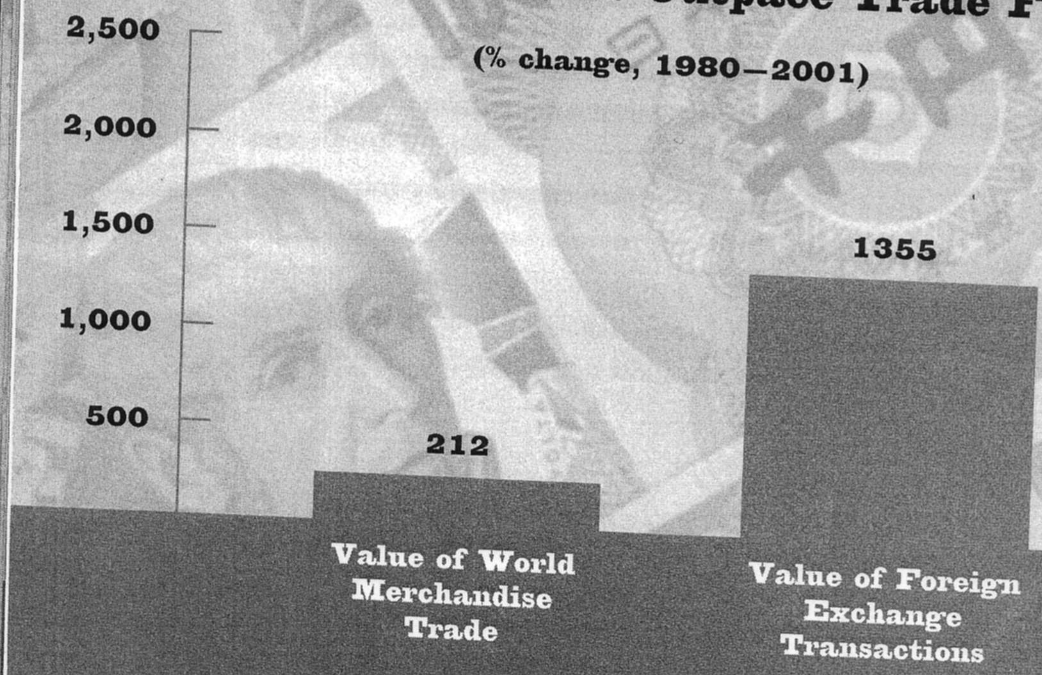
B. INTERNATIONAL FINANCIAL FLOWS

For most of history, finance followed and facilitated the production and trade of goods and services. In the late nineteenth and early twentieth centuries, large, privately owned banks emerged in North America, Europe, and Japan. They developed close relationships with large manufacturing firms and financed the activities of those firms around the world. Once established in other countries, they expanded their financing to firms in those nations as well.

Today, in addition to banks, individuals, corporations, and other institutions (e.g., pension funds) are heavily involved in cross-border financial transactions. Since 1980, all international financial flows have accelerated rapidly. This is reflected in the fact that foreign exchange transactions increased 1,355 percent between 1980 and 2001, compared to a 212 percent increase in world merchandise trade.[17] Governments have facilitated this boom by "liberalizing" (lifting barriers to) investment. Liberalizing in this sense might include removing a requirement that large loans get government approval or improving the speed at which funds may be transferred into and out of the country. According to the United Nations, more than 100 countries have passed such laws during the past twenty years.



International financial flows include public and private lending: Public lending comes from governments or from government-funded international financial institutions (e.g., a World Bank loan to the government of Honduras for road construction). This is sometimes called "official" lending. The main sources are the World Bank, the International Monetary Fund, regional development banks, and government aid agencies.

Private financial flows fall into three main categories:

1. FOREIGN DIRECT INVESTMENT (FDI) involves a corporation purchasing a lasting interest in, and degree of influence over, the management of a business in another country (e.g., General Motors and Ford purchasing plants in Mexico).

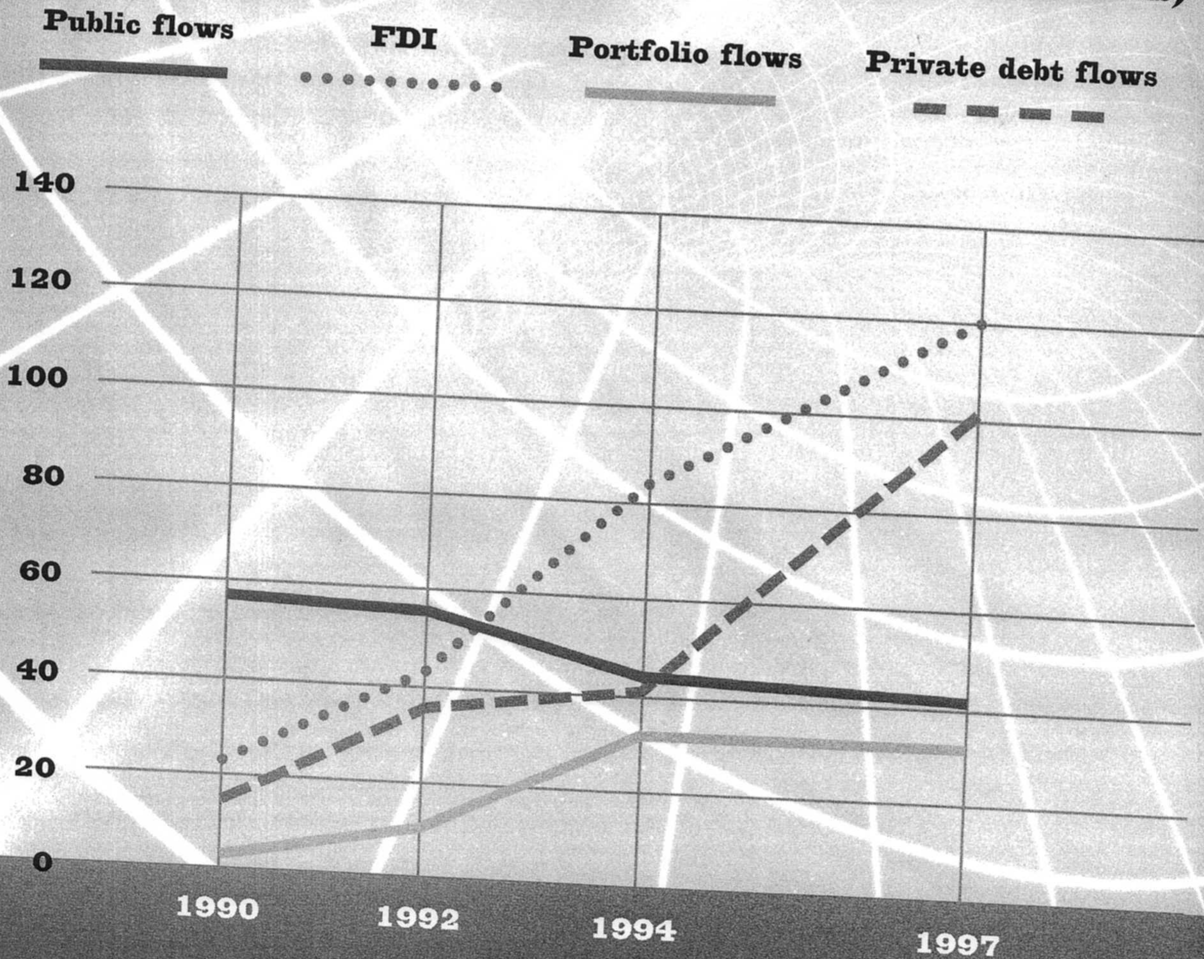
2. PORTFOLIO INVESTMENT is the cross-border purchase of stocks, bonds, derivatives, and other financial assets. It differs from direct investment in that the investor is generally not seeking management control of local companies (e.g., a U.S. citizen's purchase of a few shares of stock in a German-owned company).

3. DEBT FLOWS include commercial bank loans and bonds (e.g., a Citicorp loan to a Brazilian firm to purchase new equipment).

Financial Flows and the Developing World

Although public lending declined somewhat during the 1990s, private financial flows boomed, particularly into the developing world. Developing countries' share of total foreign direct investment jumped from 20 percent in 1990 to 34 percent in 1995–96.[18] Portfolio investments in the developing world also soared. Some rejoiced over this capital influx, arguing it was the developing world's ticket to prosperity. However, countries soon learned of the dangers of fickle international capital. By 2003, the developing-country share in worldwide foreign direct investment had dropped back to less than 20 percent, with almost 40 percent of that poor-country share going to China alone. Net portfolio flows dropped from $23 billion in 1997 to less than $5 billion in 2002, before rising somewhat in 2003.[19]

Financial Flows to Developing Countries ($ billions)[20]



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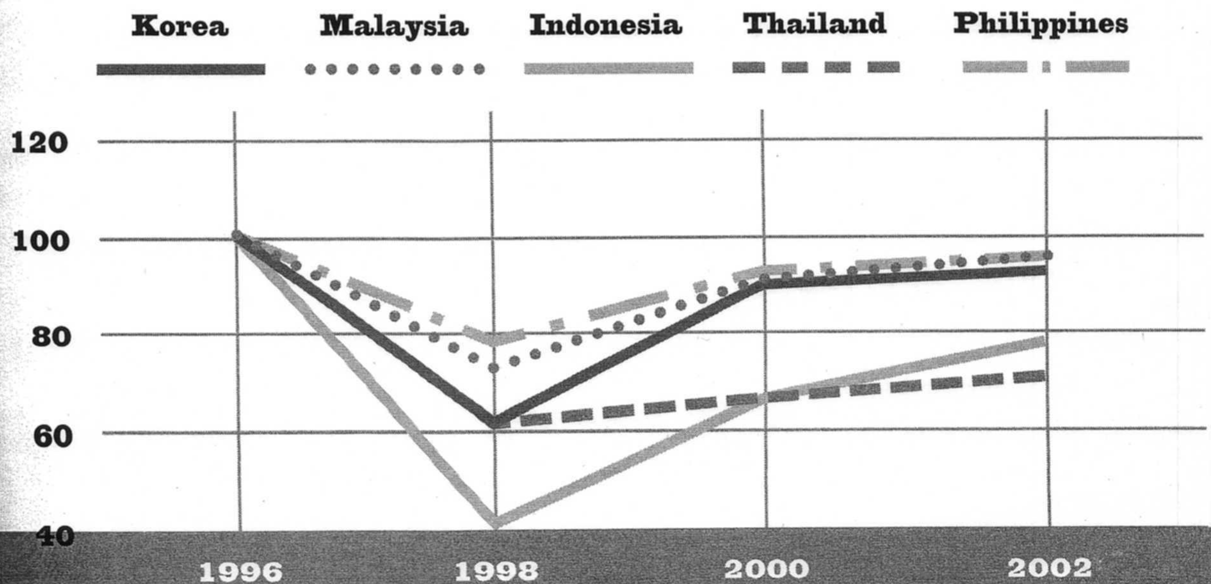
The Chain Reaction of Global Financial Crisis

In mid-1997, jittery Western investors began pulling billions of dollars worth of short-term "hot money" out of Asian countries whose economies were strapped by huge external debts. This began a chain reaction of currency devaluations and stock-market plunges throughout Asia and into other countries, including Russia and Brazil. By the end of 1998, numerous countries showed negative economic growth while their citizens struggled with rampant unemployment, bankruptcies, and in some cases, political unrest. Two years into the crisis, an estimated twenty-seven million workers had lost jobs in the five worst-hit Asian countries alone (Philippines, Indonesia, Malaysia, Thailand, and Korea).[21]

Although these countries have begun to regain what was lost in the crisis, none have attained the GDP levels they enjoyed in the year before the crisis. Compared to 1996, 2002 GDP (in U.S.$) was 30 percent lower in Thailand, 24 percent lower in Indonesia, 8 percent lower in Korea, and 6 percent lower in both Malaysia and the Philippines.[22]

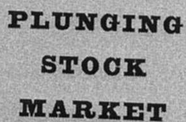
Financial Crisis Struck Lasting Blow to East Asia (GDP, 1996=100)



Signs of Financial Crisis — Description

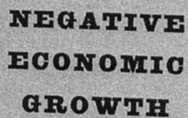
CURRENCY DEVALUATION

When a government increases the amount of its currency it will exchange with other currencies at current exchange rates. For example, three weeks after Brazil devalued in January 1999, the amount of its currency (the real) needed to purchase $1 had jumped from 1.25 to more than 2. Most governments try to avoid sharp devaluations by hiking interest rates and using foreign reserves to buy up the local currency. However, big-time speculators can undermine these efforts by selling off vast amounts of a currency considered to be shaky.

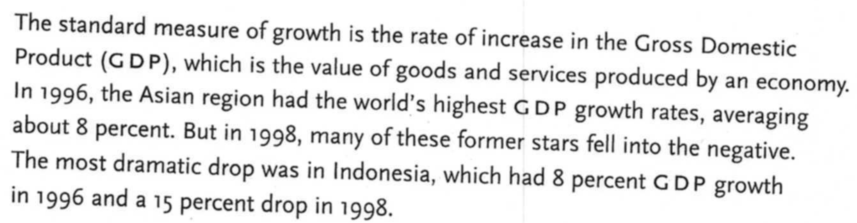


PLUNGING STOCK MARKET

Fearing that the decade-long flood of investment into Asia had created a bubble that was about to burst, investors began selling off stocks with values thought to be inflated. Markets in the United States and elsewhere outside Asia also experienced record one-day plunges. Some analysts said the U.S. market's volatility was partly due to worries that U.S. firms would be hurt by an import surge from desperate Asian nations.



NEGATIVE ECONOMIC GROWTH



The standard measure of growth is the rate of increase in the Gross Domestic Product (GDP), which is the value of goods and services produced by an economy. In 1996, the Asian region had the world's highest GDP growth rates, averaging about 8 percent. But in 1998, many of these former stars fell into the negative. The most dramatic drop was in Indonesia, which had 8 percent GDP growth in 1996 and a 15 percent drop in 1998.

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Impact

Over time, the devaluation should make the country's exports more competitive, but only if markets for the products exist. Yet, because it takes more of the local currency to buy foreign goods and make payments on foreign debt, prices rise and government budgets are strained. Also, debtors suffer from interest rates kept high to prevent further devaluation.

Stock market plunges quickly erode domestic and foreign investor confidence, often leading to greater capital outflows.

Crisis nations import less, causing a decline in world commodities prices. For example, from June 1997 to August 1998, prices for oil dropped 30 percent, coffee 43 percent, and gold 17 percent.[23]