

Introduction to International Financial Institutions

1. Financial Intermediation
 - a. What is a financial intermediary?
 - b. What types of firms are financial intermediaries?
 - c. What services do financial intermediaries offer?

2. Problems with Lending
 - a. An important problem faced by all financial institutions is the problem of asymmetric information—borrowers know more about their use of funds than lending institutions know.
 - 1) Adverse selection occurs when a financial contract constructed for a cross-section of borrowers tends to be attractive only to a relatively risky subset of those borrowers.
 - 2) Moral hazard occurs when a financial contract creates an incentive for a borrower to use funds in riskier ways than they promised when they borrowed the funds.
 - b. The standard loan contract provides a partial remedy for asymmetric information problems faced by lenders.

3. International financial transactions
 - a. The primary purpose of international financial transactions is to channel funds from savers to the most productive borrowers throughout the world.
 - b. Changes in the exchange value of currencies represent risks for international borrowers and lenders.

4. There are several types of financial institutions involved with international financial transactions.
 - a. Commercial Banks
 - b. Central Banks
 - c. International Monetary Fund
 - d. Others

1. **Financial Intermediation**

- a. Financial intermediaries channel funds from savers (who wish to move funds from the present to the future) to borrowers (who wish to move funds from the future to the present).
- b. There are many types of financial intermediaries.
 - 1) Commercial Banks
 - 2) Thrift Institutions
 - 3) Money Market Funds
 - 4) Mutual Funds
 - 5) Pension Funds
 - 6) Life Insurance Companies
 - 7) Casualty Insurance Companies
- c. Services Provided by Financial Intermediaries
 - 1) Financial Institutions “repackage” the obligations issued by borrowers so that they are more attractive to savers. Repackaging provides several types of valuable services:
 - a) Diversification of risk
 - b) Risk Pooling
 - c) Creation of liquidity
 - d) Underwriting
 - e) Maturity intermediation
 - 2) Financial Intermediaries reduce transactions costs through economies of scale.
 - 3) Financial Intermediaries are good at judging credit worthiness.

2. **Problems with Lending**

- a. Information costs are the costs that savers incur to determine the credit-worthiness of borrowers and to monitor how borrowers use borrowed funds.
 - 1) Asymmetric information describes the situation in which one party has better information than another.
 - 2) Adverse selection results when a lender cannot distinguish between low-risk and high-risk applicants. When the lender prices a loan high enough to allow for losses from high-risk applicants, it drives some low-risk applicants away.
 - a) The ‘lemons problem’ refers to a situation where ‘high’ risks drive ‘low’ risks from the market.
 - b) The lemons problem may lead to credit rationing by banks.
 - c) As a partial remedy, most industrialized countries require that firms that sell securities disclose certain information to prospective buyers.
 - 3) Moral hazard occurs when a financial contract creates an incentive for a borrower to use funds in riskier ways than they promised when they borrowed the funds.
- b. The standard loan contract provides a partial remedy for asymmetric information problems

faced by lenders.

- 1) The standard loan contract calls for a fixed repayment by a borrower. In this way the borrower has no incentive to under-report the success of the project for which borrowed funds were used.
- 2) The standard loan contract calls for the lender to monitor the project if the borrower reports that it cannot repay. It also calls for the lender to take all of the proceeds from the project (and perhaps additional collateral) if the borrower cannot pay.

3. **International financial transactions**

- a. The primary purpose of international financial transactions is to channel funds from savers to the most productive uses world wide.
- b. Changes in the exchange value of currencies are a source of risk for international borrowers and lenders.
 - 1) If international financial investors cared only about expected returns to investments then they would move funds throughout the globe until interest rates (adjusted for expected changes in exchange rates) were equal everywhere.
 - 2) Interest rate parity:
$$R_{US} = R_{UK} + \text{Expected Depreciation of Dollar against the Pound}$$

4. **There are several types of financial institutions involved with international financial transactions.**

- a. International banks provide risk sharing, liquidity, and information services to firms and individuals engaged in international trade and finance.
 - 1) Over 160 US banks have subsidiaries or branches abroad with about \$500 billions of assets.
 - 2) As of 1998, foreign banks held about \$900 billions of assets in the US accounting for about 16 percent of total bank assets.
- b. Central banks sometimes use international currency reserves to buy and sell their domestic currency in order to stabilize their exchange rate and, in some cases, in order to keep their exchange rate pegged to an agreed upon value.
 - 1) In the early 1980's, Congress passed the Reagan tax cut program. The program resulted in high fiscal deficits, high US interest rates and a high value of the US dollar.
 - 2) In 1985, the US, UK, Japan, France, and Germany agreed in the so-called Plaza Accord to trade in foreign currency markets in order to bring down the value of the dollar.
 - 3) Another round of intervention occurred in 1987 as part of the so-called Louvre Accord.
- c. The Bretton Woods agreement (which created a system of fixed exchange rates from 1945 until 1971) created the International Monetary Fund.

- 1) The IMF was designed to be a lender of last resort to prevent short-term economic fluctuations from disturbing the system of fixed exchange rates. The idea was to promote the growth of world trade by making loans to countries that experienced short-run balance-of-payments difficulties.
 - 2) In practice, the IMF encourages domestic economic policies that are consistent with exchange rate stability and gathers data to use in monitoring member countries.
 - 3) Currently over 180 countries belong to the IMF.
- d. The Bretton Woods agreement also created the World Bank to make long-term loans to developing countries. These loans were designed to build infrastructure (roads, power systems, bridges, water supply systems). The World Bank raises funds by selling bonds in the international capital market.