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# Financial crisis and International Organizations

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## Introduction

The importance of the financial sector in any economy is a key area that needs to be addressed so as to design policies to foster the financial sector stability and development at the local and global level. Thus ways have to be considered in order to strengthen both the individual country's financial system as well as the global one. All concerned from financial analyst, economist, political analyst, international agencies and of course governments all round the world should collaborate to prevent financial crisis that present a threat to the world financial system and to a worldwide economic recession that it can provoke. The literature of Financial crisis agreed that most financial crisis was the result of the failure of the idea that the markets could regulate themselves. The international organizations, national authorities, and the private sector, should propose a series of initiatives that are intended not only to save the day during the crisis, but to find measures that contribute to a more stable and efficient financial system, and toward better preparedness to address future systemic problems.

## Significance of this paper

The importance of this paper stems from the importance of the stability of financial system to both the global financial system and global economy and the individual country financial system and economy. The global importance results from the Contagion Effects since a country's financial system is linked to other countries' systems through capital market flows (Financial Markets Correlation) and bilateral trade (trade Spillovers), the occurrence of financial crises in other countries could trigger a financial crisis or distress at the domestic level. Also the magnitude and mobility of

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international capital flow between the different countries made it increasingly important to have a sound domestic financial system as a way to build up resilience to capital flow's volatility. On the national level it is a known fact that financial instability harm economic growth and causes a major disruption of real sector development thus any weakness can trigger economic turmoil and amplify the effect of the adverse shock on the economy with sever economic and social consequences.

For the Sudan although the financial sector is only a small fraction of GDP the development of and the stability of the financial sector is important because of the potential growth of this sector and for the aim to reduce poverty through strengthening of the growing financial system and the activation of one of the component of the financial system microfinance. Sudan has to rely on International organizations, since as member country it has always participated voluntarily in the program and abided by the mandate of these organization for example participating in Financial sector Assessment Program and the application of article VIII section 2-3-and 4 on 2003 and was conclude in 2007 in which the Sudan maintained an exchange system free of restrictions on the making of payment transfers for international transactions.

**Objective of the paper**

This paper aims at looking into the role played by international organization in helping the countries to monitor their national financial system, identify its weakness and strength and its vulnerabilities to enhance the country's diagnostics skill and its crisis preventory role. Also to examine how international organizations help to promote more harmonization and international integration of the world financial systems . The role of International Monetary Fund (IMF) and the World Bank (WB) in particular will be extensively deliberate as they jointly funded programs and proposed policies in which most of its member accepted and participated.

**The question to be asked**

Did the international organizations provide guidance on approaches,

methodologies that succeed in helping countries to evade financial crisis?

It was assumed that International organizations with their ample financial resources, high caliber staff and international support should provide programs which:

a- Contribute to a more stable and efficient financial system and better preparedness to address any future systematic problems

b- Strengthen international financial system to face international financial turmoil

**Organization of the paper**

The paper is divided into two parts and a conclusion as follows:

[1] The first part_ represents a review of the financial crisis, definition, reasons and consequences, as well its impact An explanation of the Asian crisis and the 2008 financial crisis is also explained.

[2] The second part reviews the role of International Monetary Fund ((IMF) and the World Bank (WB) in helping its member countries.

[3] A critique to the role of IMF and WB and ends with several recommendations.

**Financial crisis**

The term financial crisis is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. Most of the financial crises were associated with banking panics, and many recessions coincided with them. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults. The literature proposed three theories for financial crisis **:** First World system recurrent major depressions in the world economy at the pace of 20 and 50 years is cyclic. Second Minsky theory assumes that financial fragility is a typical feature of any capitalist economy that leads to a higher risk and thus to financial crisis. Third Coordination games which are mathematical approaches to modeling of financial crises. There are four types of financial

crisis: the first Banking crises_ when a bank suffers a sudden rush of withdrawals by depositors, this is called a bank run. The second is Speculative bubbles and crashes economists say that a financial assets exhibit a bubble when its price exceed the present value of future income that would be received at its maturity. Third is Currency crises when a country that maintains a fixed rate is suddenly forced to devalue its currency because of speculative attack. The fourth is recession which is wider economic crises that exhibits a downturn in economic growth lasting several quarters or more.

The causes and consequences of financial crisis can be summarized as follows:

1- Strategic complementarities in financial markets: It is often observed that successful investment requires each investor in a financial market to guess what other investors will do.

2- Leverage: means borrowing to finance investments, is frequently cited as a Contributor to financial crises.

3- Asset-liability mismatch another factor believed to contribute to financial crises It is a situation in which the risks associated with an institution's debts and assets are not appropriately aligned.

4- Regulatory failures Governments have attempted to eliminate or mitigate financial crises by regulating the financial sector.

5- Œcopathy a Swedish psychologist Torbjorn K A Eliazon have proposed a new psychological concept of œcopathy, when economic smartness or greed crosses the borders to an extreme blinding speed that is an economic understanding without moral values.

6- Contagion refers to the idea that financial crises may spread from one institution to another, such as when a bank run spreads from a few banks to many others, or from one country to another.

7- Recessionary effects some financial crises have little effect outside of the financial sector, but other crises are believed to have played a role in decreasing growth in the rest of the economy.

**Table (1)**

**A short list of some major financial crises since 20th century**

| Date | Event |
|---|---|
| 1910 | Shanghai rubber stock market crisis |
| 1980 | Latin American debt crisis |
| 1989-91 | United States Savings & Loan crisis |
| 1990 | Collapse of the Japanese asset price bubble |
| 1992-93 | Speculative attacks on currencies in the European Exchange Rate |
| 1994-95 | 1994 economic crisis in Mexico |
| 1997-98 | Asian Financial Crisis |
| 1998 | Russian financial crisis |
| 2001-02 | Argentine economic crisis (1999-2002) |
| 2008 | Global financial crisis in USA, Europe |

**Table (2)**

**A list of some episodes of financial instability in the 1990's**

| Date | Event |
|---|---|
| 1990 | Collapse of market liquidity and issuance of Swedish Commercial papers |
| 1990-91 | Norwegian banking crisis following loan losses |
| 1991-92 | Finnish banking crisis following loan losses |
| 1991-92 | Swedish banking crisis following loan losses |
| 1992-96 | Japanese banking crisis following loan losses |
| 1992 | ECU bond market collapse |
| 1992-93 | ERM crisis Speculative attacks on currencies |
| 1995 | Mexico crisis default on Mexican debt |
| 1997 | Asian Financial Crisis: devaluations and banking |
| 1998 | Russian financial crisis: currency devaluation |

**Asian Financial crisis**

The basic diagnosis was that East Asia had exposed itself to financial chaos because its financial systems were riddled by insider dealing,

corruption, and weak corporate governance. Asian crisis was created by policies that distorted incentives within the lender-borrower relationship. The resulting large quantities of credit became available generated a highly-leveraged economic climate, and pushed up asset prices to an unsustainable level. These asset prices eventually began to collapse, causing individuals and companies to default on debt obligations. The resulting panic among lenders led to a large withdrawal of credit from the crisis countries, causing a credit crunch. Investors attempted to withdraw their money, the exchange market was flooded with the currencies of the crisis countries, putting depreciative pressure on their exchange rates. The rapidity with which the crisis happened has prompted many economists to compare it to a classic bank run prompted by a sudden risk shock. Other economist pointed to strict monetary and contractory fiscal policies implemented by the governments on the advice of the IMF in the wake of the crisis, while others point to the role of asymmetric information in the financial markets that led to a "herd mentality" among investors that magnified a relatively small risk in the real economy. The role of the International Monetary Fund was so controversial during the crisis that many locals called the financial crisis the "IMF crisis’. Many commentators criticized the IMF for encouraging the developing economies of Asia down the path of "fast track capitalism", meaning liberalization of the financial sector, maintenance of high domestic interest rates in order to suck in portfolio investment and bank capital; and pegging of the national currency to the dollar to reassure foreign investors against currency risk. In other words the IMF itself was the cause.

**2008 financial crisis**

This crisis confronted both national financial system and international financial system. The beginning was with failures of large financial institutions in the United States, it rapidly evolved into a global crisis resulting in a number of European bank failures and declines in various stock indexes, and large reductions in the market of stocks and commodities worldwide. The crisis has led to de-leveraging and liquidity problems. In 2008, the credit crunch, which had emerged a little more than a year before,

ballooned into Wall Street's biggest crisis since the Great Depression. The largest American insurance company and the largest saving and loans company were seized by the government. In response, the federal government (USA) tried to bailout in order to reassure the markets and get credit flowing again. But the crisis began to spread to Europe and to emerging markets. The literature of the crisis gave several reasons of what trigger the crises some of them are:

1- The absence of regulation of Mortgage Company, the adequacy of its capital was waived by the American regulators

2- The absence of regulation of sub- prime Mortgage Company

3- The absence of regulation of the bond rating agencies which have rated the risky bonds according to the fees paid.

4- Unregulated institutions which had the ability to take much bigger risks than regulated banks and unlimited leverage.

5- Commercial banks are regulate and protected as opposed to investment bank which have the freedom to speculate freely, most of the American are becoming financial supermarkets.

The literature blamed the regulatory failure to guard against excessive risk-taking in the financial system especially in the USA. Countries throughout the world are bailing out their financial systems because the financial system crisis is leading to an economic recession which will spill over to become a wide world recession. The international organization did not propose any solution to overcome the crisis. The response was only warning no practical solution was presented . Some economists think that may be the failure to over the Asian crisis and the recurrence of the other strong financial crisis made these organizations more reserved. On the other hand many Islamist economists presented a way out of this crisis by applying the Islamic economy rules and regulation. Many world leaders are calling to "recast the capitalist system" and to create an international system to watch over the world's banks.

## Second part

### The role of Financial International organization

At Britton Woods in 1944 and Savannah in 1946 the task of both the International monetary fund and World bank were outlined according to the financial circumstances of the 21st century. Later in 1976 the Second Amendment to the Fund Articles were made. In this paper the focus is on the WB and IMF's task in promoting national and international financial stability as a part of their mandate in 1944 through financial surveillance, financial assistance and technical assistance. The WB and IMF have three important roles in international financial crises. The first is to help countries to fashion programs to rest on currency and market stability. The second role, under certain circumstances at least, become a lender. The third is as a rallier of others in support of actions necessary to end the crisis. Therefore the IMF's surveillance activities are the core task to focus on the sources of crisis and on strengthening crisis resilience. That is should be able to assist countries to:

- Forestall crises
- Adapt programs and policies to rapidly evolving circumstances.
- Prevent crises from escalating

Surveillance is the backbone of crisis prevention. It must also be implemented by stability-oriented policies and to be effective and requires a periodic reassessment from a fresh perspective that is fully cognizant of evolving economic and political circumstances especially in the last decades (see table 1and 2) which are characterized with financial instabilities and crisis. There were three important programs launched and they illustrated the role of the IMF and WB in the task of surveillance they are.

**[i] The financial sector assessment program FSAP**

The Financial sector assessment program is a joint IMF and WB initiative introduced in1999 as a response to the nineties' crisis. The program aimed to promote the soundness of the financial system by looking

particularly at the structure and the regulation of the financial sector. The program is a tool for conducting systematic assessment of the country financial sector and benchmarking regulatory effort. The program is designed to identify the strength, risks and vulnerabilities of the financial sector. The program depicts four type of financial surveillance:

- Macro-prudential surveillance.
- Financial soundness surveillance.
- Surveillance of market financial condition to assess the risk of shock and analysis of micro-financial linkage.
- Surveillance of macroeconomic conditions.

The FSAP uses a wide range of analytical tools and techniques that include:

- Macro-prudential analysis including stress testing, scenario analysis and analysis of financial soundness and macro-financial linkage.
- Analysis of financial sector structure, efficiency, competitive-ness, concentration, liquidity and access.
- Assessment of observance and implementation of relevant international standards codes and good practice in the financial sectors.
- Analysis of specific stability and development issues tailored to the individual country circumstances.

These tools and techniques assess the financial system through an assessment frame work. The first step is to compile a set of three indicators the first set are the financial structure and development which comprise of system wide indicators, breath of the financial system, competition, concentration and efficiency of the financial system and scope and coverage of financial services. The second set of indicator is financial soundness indicator. The third sets of indicators are aggregate balance sheet structure of financial and non financial sector linkage.

The second step is an overall framework assessment of:

- Financial stability assessment which is referred to as Macro-prudential surveillance. It includes quantitative analysis of risks and vulnerabilities and qualitative assessment of the institutional capacity and financial infrastructure that help to manage the risks.
- Financial structure and development assessment consist of assessing of the functioning of the financial sector.

An integrated analysis and assessment of stability and development can be summed up into assessing financial system risk and vulnerability, and assessing non financial sector condition.

The third step evaluates:

1- Financial sector supervision of banking, insurance and security market this include Legal and institutional framework for financial supervision, financial safety net, supervision specifically Basel I and II and insurance and securities market regulation

2- Assessing the supervision of other financial intermediaries, rural and Microfinance institutions, financial system integrity, information and governance, legal infrastructure of the financial system and finally systematic liquidity infrastructure.

The fourth step provide guidance on sequencing of financial reform which deals with factors that should be considered when setting priorities among a multitude of polices, institutional, and operational reforms that has been identified as a result in the participation in the FSAP. The IMF has review the FSAP in 2003 by an independent evaluation office and by IMF operation evaluation department to provide information on the development and on the update on the analytical tools of the program and include proposal to help different countries to strengthen their financial sectors.

**[2] <u>Financial Soundness Indicators (FSI)</u>**

The development of the financial soundness is coordinated by the IMF with the support of the World bank, the Organization for Economic Co-

operation and Development, Bank for International settlement, and the European central bank. FSI are statistical measures for monitoring the health and soundness of the financial sector and its corporate and household counterpart. A compilation guide on financial soundness indicator was produced in which the definition, the interpretation and analysis were undertaken by the IMF. The data compiled by each country facilitate monitoring the financial systems and can be compared at globed level, this is important in view of the magnitude and mobility of international capital flow and the risk of contagion of financial crises from one country to another. Finally a benchmark is developed for the level of FSI that would help to monitor and to interpret the development of the financial system. FSI are calculated and disseminated for the purpose of supporting macro-prudential analysis.

The FSI are two set of indicators that are considered useful for the purpose of periodic monitoring and for compilation. The <u>core set</u> which include indicators for the banking sector and the <u>encouraged set</u> which include additional banking indicators as well as other institutions and markets. FSI indicators are:

a- **Core set** for deposit-taking institutions Capital adequacy Regulatory capital to risk-weighted assets, regulatory Tier I capital to risk-weighted assets, Asset quality Nonperforming loans to total gross loans, Nonperforming loans net of provisions to capital, Sectoral distribution of loans to total loans, Earnings and profitability Return on assets Return on equity, Interest margin to gross income Non-interest expenses to gross income. Liquidity Liquid assets to total assets (liquid asset ratio), Liquid assets to short-term liabilities and Sensitivity_to market risk Net open position in foreign exchange to capital.

b- **Encouraged Set** for deposit-taking institutions: Capital to assets, Geographical distribution of loans to total loans, Gross asset position in financial derivatives to capital, Gross liability position in financial derivatives to capital, Trading income to total income, Personnel

expenses to non-interest expenses, Spread between reference lending and deposit rates, Spread between highest and lowest inter-bank rate Customer deposits to total (non-inter-bank) loans, Foreign currency-denominated loans to total loans, Foreign currency-denominated liabilities to total liabilities, Net open position in equities to capital, Large exposures to capital Other financial corporations, Assets to total financial system assets to GDP Non-financial corporate sector, Total debt to equity, Return on equity Earnings to interest and principal expenses, Net foreign exchange exposure to equity Number of applications for protection from creditors, Market liquidity Average bid-ask spread in the securities market, Average daily turnover ratio in the securities market Households Real estate markets Household debt to GDP, Household debt service and principal payments to income Real estate prices, Residential real estate loans to total loans and Commercial real estate loans to total loans.

c- IMF recommended assessing the observance of the Basel Core Principles conducted by the authorities of countries participating in FSAP. It should be prior to the FSAP or at the request of the FSAP team, and a questionnaires is prepared by the staff of the IMF and filled out by the authorities of the country in preparation for the FSAP. This should provide an overview of the supervisory environment, also summarize the capacity, competence, internal controls, integrity of operations, and operational autonomy of the supervisory function.

**Critique of the Role**

The IMF's surveillance activities should focus more on the sources of crisis vulnerability and on strengthening crisis resilience. There is concern about the IMF's ability in assisting countries to forestall crises or to adapt programs and policies to rapidly growing circumstances. It is broadly recognized that effective surveillance periodically requires a reassessment from a fresh perspective that is fully cognizant of evolving economic and political circumstances. Above all, crisis prevention has to be strengthened

through more transparency.

The IMF is criticized for being too reluctant to assess corruption, tax evasion and other governance issues in its surveillance. Such an assessment by the IMF is naturally fraught with difficulties because it is likely to be viewed by governments as political interference. More work could be done on setting up a voluntary debt resolution forum. It is necessary to decide the role the IMF in relation to such a Mechanism. The IMF would often be a creditor towards countries whose debt is being treated by a debt resolution forum. This potential conflict of interest, the IMF's role in such a mechanism is not easy to define. Ideally the IMF should be able through its surveillance function to prevent crises from escalating. The proliferation of conditions in IMF programs has apparently been halted and awareness seems to be growing about the need to restrict the number of performance criteria and to ensure the achievement of its goal. Lastly the IMF and WB exerts pressure on low income country more than high income countries which usually are the sources of financial turmoil to themselves and other countries in the world.

## Recommendations

IMF has to redefine its role in the global economy, the global financial crisis has created an opportunity for the IMF to reinvigorate itself and possibly play a constructive role in resolving, or at the least mitigating, the effects of the global downturn, on two fronts:

(1) Contributing to long-term systemic reform of the international financial system.

(2) Through immediate crisis management,

Here are some recommendations to achieve this:

- The tasks of the IMF and world bank should be reviewed and should adapt programs and policies to rapidly evolving circumstances.
- IMF should continue to concentrate its work on surveillance, financial assistance and technical assistance.

- IMF with the cooperation of World bank should create a global bank regulator.
- Improving Co-operation between the IMF and the WB.
- To accommodate more African chairs.
- The Role of the IMF in Low-Income Member Countries should be at the right balance and adequate for dealing with the challenges.
- Development Goals by focusing on its core areas of competence by promoting a stable macroeconomic and institutional framework.
- The staff of IMF should put firmer emphasis in their surveillance to assess the implications of policies of the major economies for global economic growth and to encourage policy reforms in industrial countries.
- Shareholders of the IMF, through the Executive Board, have the responsibility to take sensible decisions to safeguard the credibility and soundness of the institution.
- The IMF should be a forum in which countries can discuss financial risks.
- The IMF must not only be competent and financially sound, it must also be able to preserve its own independent judgment outside international political pressure.