UNIT 13 INTERNATIONAL FINANCIAL INSTITUTIONS

Structure

13.0 OBJECTIVES

After going through this unit, you should be able to :

- describe the objectives and functions of IMF
- explain the exchange rate policies
- describe the financial assistance and other activities of IMF
- explain the working, financial operations and technical assistance programme of world bank.
- describe the objectives and functions of IFC
- discuss the objectives of International Development Association
- explain the role and functions of Regional Development Bank

13.1 INTRODUCTION

After the global conflict of the world war II, rehabilitation of world economy was the major concern of the international community. As a result of war, the entire apparatus of the world payments mechanism had shattered. Toward the close of the world war II in 1944, the major western governments met in Bretton Woods, New Hampshire, to restore the international institutions that were needed to restore economic stability and growth in the world trade. As a result of these meetings, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development, popularly known as World Bank were set up in 1945. These institutions have played a very significant role in restoration and subsequent growth of world trade through setting and maintaining the exchange rate system and mechanism of transfer of funds from capital rich to capital poor countries. A proper understanding of the objectives and working of those institutions is very necessary for understanding the international economic environment. In this Unit, you will learn the working of International Monetary Fund and World Bank. You will also be briefly acquainted with the International Finance Corporation, International Development Association, Asian Development Bank and African Development Bank.

13.2 INTERNATIONAL MONETARY FUND

The genesis of the International Monetary Fund (IMF) lies in the experience of countries during the great depression. In the 1930s, many countries attempted to maintain domestic income in face of shrinking markets through competitive devaluation of their currencies and resort to exchange and trade restrictions. Such measures could achieve their objectives only by aggravating the difficulties of trading partners who, in self defense, were led to adopt similar policies. There was a growing recognition of the largely self defeating nature of these 'beggar my neighbor policies' at the country level and of their contribution to lower trade and employment and a less efficient allocation of resources at the global level. This resulted in a widening acceptance of the need for an agreed code of conduct in international trade and financial matters.

It was against this background that at the United Nation Monetary and Financial Conference, which was attended by representative of 45 countries and was held at Bretton Woods, New Hampshire, on July, 1944, decision to set up the International Monetary Fund was taken. IMF came into existence on December 27, 1945, when 29 countries signed the Articles of Agreement. The inaugural meeting of the Board of Governors was held in Savannah, Georgia on March 8, 1946, and the first meeting of the Executive Board was held at Funds headquarters in Washington, DC on May 6, 1946. The Fund commenced financial operations on March 1, 1947.

Objectives

The first Article of the Fund's charter laid down six objectives for the organization. These are:

i) to promote international cooperation by providing the machinery for consultation and collaboration by members on international monetary issues.

ii) to facilitate the balanced growth of international trade and through this, contribute to high levels of employment and real income and the development of productive capacity.

iii) to promote exchange stability and orderly exchange arrangements and facilitate the avoidance of competitive currency depreciation;

iv) to foster a multilateral system of payments and transfers for current transactions and seek the elemination of exchange restrictions which hamper the growth of world trade;

v) to make financial resources available to members, on a temporary basis and with adequate safeguard to permit them to correct payment in balances without resorting to measures destruction of national or international prosperity and;

vi) to seek reduction of both the duration and magnitude of payments imbalances.

Functions

IMF's functions can be broadly classified into three main categories. These are

i) to formulate and administer a code of conduct regarding exchange rate policies and restrictions on payments for current account transactions.

ii) to provide members with financial resources to enable them to observe the code of conduct while they were correcting or avoiding payment imbalances.

iii) to provide a forum in which the IMF could consult with one another and collaborate on international monetary matters.

13.2.1 Exchange Rate Policies

In regard to code of conduct regarding exchange rate policies basic objective was avoiding disruptive fluctuations that had occurred in 1930s and the rigidity that prevailed under the international gold standard. It may be recalled that fluctuation under the international gold standard, disturbances in price level in one country would be wholly on partly offset by an automation of balance of payments adjustment mechanism called the price specific flow mechanism (specific refers to gold coins).

The gold standard broke down during the World War I and was briefly reinstated from 1925 to 1931 as the Gold Exchange standard. Under this standard, the United States and England could hold only gold reserves, but other nations could hold both gold and dollars or pounds as reserves. In 1931, England departed from Gold in the face of massive gold and capital flows, coming to an unrealistic exchange rate, and the Gold Exchange standard was finished. Thereafter, countries devalued their currencies to maintain trade competitiveness. These policies, in which nations cheapened their currencies in order to increase their exports at others expense and reduced imports, led to trade war. It is generally believed that the protectionist trade and exchange policies fueled the global depression.

Bretton Wood system and its working

Thus, it seemed clear at the Bretton Woods that neither a policy of fixed exchange rates nor of fully fluctuating rates is conducive to the balanced growth of international trade. Hence, under the Agreement implemented in 1946, every member country required to :

- establish a par value for her currency either directly in terms of gold or indirectly in terms of the gold content of the US dollar of July 1, 1944 (i.e. 888671 grams of fine gold or \$ 35 = 1 oz. of fine gold),
- maintain the market rate within 1 per cent on either side of parity,
- change the par value only, after consultations with IMF and, only to correct a fundamental disequilibrium
- avoid discriminatory currency practices and restrictions on payments. (Obligation under Article VIII to maintain current convertibility).

The Fund was provided with financial resources to assist members in financing temporary deficits and in adapting policies of adjustment without their having recourse to measures inconsistent with their code of conduct.

IMF charter laid down principles with respect to exchange restrictions. While Article VIII obliges members to avoid discriminatory currency practices and restrictions on current payments, provisions contained in Article XIV allow members to continue temporary certain restriction on international payments and transfers.

The par value system and its adjustment mechanism appeared to have worked well during the first two decades of its coming into existence. Members with storing payments positions willingly accumulated US dollars and deficit countries with week adopted domestic measures to correct disequilibrium in their balance of payments. Exchange rate changes were confined on the whole to developing countries with high rates of inflation and in general did not lead to competitive depreciations or retaliatory restriction by other country.

However, in the sixties, cracks in the Bretton Woods System were clearly visible. Periodic foreign exchange crises arose when governments failed to make necessary adjustments to their economic policies. In principle, the stability of exchange rates removed a great deal of uncertainty from international trade and investment transactions, thus promoting their growth for the benefit of all the participants. However, the functioning of system imposed a degree of discipline on the participating nations economic policies. For example, a country when faced with a fundamental disequilibrium, would find its reserves including borrows from IMF totally inadequate. The reduction in money supply and the adoption of restrictive policies could reduce the country's inflation (thus bringing it in line with the rest of the world.)

Such policy measures would, however, be impracticable when considered from the view-point of their impact on output and employment. Decisions on exchange rate changes were either not taken or delayed. In fact, between 1946, 71, most changes, particularly, devaluations had taken place only under pressure from IMF; devaluation was made a precondition to accommodation from IMF. The death of this system came on August 15, 1971, when President Richard Nixon, convinced that the run on the dollar was reaching alarming proportions, and abruptly ordered US authorities to terminate convertibility even for Central banks. At the same time he devalued the dollar to deal with American's emerging trade deficit.

Bretton Wood System collapsed largely because of US inability to control inflation and maintain the price of gold at $ 35 anounce and also because some countries primarily West Germany, Japan, and Switzerland refused to accept the inflation that a fixed exchange rate would have imposed on them. Obviously some drastic corrective measures were needed and the US Government introduced a package of measure under New Economic Policy; with its emphasis on suspension of gold convertibility of dollar, floating the dollar and a surcharge of 10 per cent on all imports. This sparked off quick reaction on the part of the other countries and many of them decided to float their currencies heralding a collapse of the Bretton Woods System.

After 1971

Floating of major currencies resulted in uncertainties which could be removed only with Smithsonian Agreement providing for realignment of parities and widening of bands. Under the /agreement which was signed on Dec. 18, 1971, Japan and West Germany agreed to revalue their currencies in terms of US dollar by 16.7 and 13.6 per cent respectively. Other countries were: Belgium (11.6%,) Netherlands (11.6%) France (8.6%), Italy (7.5%) and Sweden (7.5%). In addition, the band for market fluctuations was revised to 2.25 per cent of each side of the parties. An increase in the official price of gold to $ 38 an ounce was yet another ingredient of the Agreement.

However, things did not in fact, go the way it was intended. Deterioration in its balance of payments forced the United Kingdom to float the pound on 23rd Jan. 1972. Soon after it has dollar's turn to float. These developments clearly indicate that the system of fixed rates had outlived its utility and something had to be done to reform it.

Kingston Accord

After a great deal of brainstorming, the Interim Committee of the IMF, in its meeting held on Jan. 7-8, 1976, produced a broad agreement on a range of issues. It legalised the floating exchange regime, revised the quotas, abolished the system of expressing par value in terms of gold and abolished the official price of gold. It suggested that out of 60 million ounces of gold held by the IMF, 25 million ounces may be returned to the member countries and the remaining balance be sold at market prices over a four year period. Profits from gold sales would provide the resources for the Trust Fund which would be used to assist least developed countries. For giving effect to these provisions, necessary amendments in the Articles of Agreement have been made.

13.2.2 The Current System of Exchange Rate Determination

The current system is a hybrid, with major currencies floating on a managed basis, some currencies freely floating, and other currencies moving in and out of various types of pegged exchange rate relationships. The following Table 13.1 presents a currency map that describes the various zones and blocks linking the world currencies as of April 30, 1997.

Table 13.1: Exchange Rate Arrangements April 30, 1997

Classification Status	Number of Countries
Currency Pegged to	
US dollar	21
French franc	15
South African rand	3
Deutsche mark	2
Australian dollar	1
Singapore dollar	1
Indian rupee	1
Italian lira	2
Currency composite — SDR	2
Currency composite — others	20
Flexibility limited vis-à-vis a Single currency	4
Cooperative arrangements	12
Other managed floating	47
Independently floating	51
Total	181

Source: IMF Annual Report pp 184-85.

Surveillance over the Exchange Rate Policies

The Fund is required to oversee both the international monetary system, to ensure its effective operation, and the observance by each member of its obligations. To do the later, the Fund must "exercise firm surveillance over the exchange rate policies of members" who are required to provide it with the necessary information and to consult with it on their exchange rate policies when the Fund requests them to do so. The Fund has approved three principles to guide members in conduct of exchange rate policies. These are:

i) obligation of members to refrain from manipulating exchange rates or the International monetary system to prevent balance of payments adjustment or to gain an unfair competitive advantage over other members.

ii) to intervene in their exchange markets if necessary to counter disorderly conditions that may be characteriesed by, among other things, disruptive short term movements in their currencies.

iii) members in their intervention policies, should take into account the interests of other members, including those of countries in whose currencies they intervene.

The Fund staff generally collects the required information during regular consultations with each member and during special consultations with certain members in connection with the Fund's world economic outlook exercises. The staff's report is submitted with the approval of the Managing Director, which revises it before determining whether the members policies are consistent with the principles of surveillance and its obligation under Article IV.

13.2.3 Exchange Restrictions

The Fund's principles with respect to exchange restrictions and multiple practices by members are intended to foster a multilateral system of payments for current transaction between members and to contribute to the balanced growth of world trade through elimination of restrictions. These principles are contained in Article VIII of the Funds Agreement, which obliges members to avoid discriminatory currency practices, and in Article XIV, which allows members not yet able to accept the provisions of Article VIII to continue temporarily certain restrictions on international payment and transfers. In April 1997, 125 out of 181 member countries had assumed the obligations of Article VIII and 56 members were availing themselves of the transitional arrangements under Article XIV.

It may however be reiterated that provision of Article VIII relates to restrictions on current transaction only. In regard to capital transactions, Article VIII remained silent, implying thereby that the member countries were free to follow policies of their choice. However, in light of the very rapid growth and increased integration of international capital markets and mindful of the need to ensure that the Fund was able to discharge effectively its mandate of overseeing an international monetary system increasingly dominated by capital flows the Board look up the issue of capital account convertibility in February and April 1997. In their discussions, directors expressed the view that the Fund should play a central role in promoting capital account liberalization and fostering the smooth operation of international capital markets. As there is no formal mandate to foster capital account liberalization, most directors supported an amendment of the Fund's Articles.

Interim committee at its April 1997 meeting endorsed the concept of an amendment to the articles to make the promotion of capital account liberalization a specific purpose of the Fund and to give the Fund appropriate jurisdiction over capital movements. The committee asked the Board to continue its work with a view to make specific recommendation on the key elements of the amendment by the time of committee's next meeting.

Check Your Progress A

1) Write two objectives of IMF.

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2) What was Bretton Wood system?

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3) What do you mean by par value System?

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4) What was the basic objective of exchange rate policy?

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13.2.4 Financial Resources and Policies

The resources of the IMF come from two sources viz (i) subscription by members and (ii) Borrowing.

Every member of the Fund is required to subscribe to the Fund an amount equivalent to its quota. According to IMF rules, each member is assigned a quota expressed in Special Drawing Rights (SDRs). Quotas are used to determine the voting power of members, their contribution to the Fund's resources, their access to these resources, and their share in allocation of SDRs. A member's quota reflects its economic size a relation to the total membership of the Fund. Each member pays a subscription to the Fund equivalent to its quota, and the Board of Governors decide on the proportion to be paid in SDRs or in the member's currency. A member is generally required to pay 25 per cent of its quota in SDRs or in currencies of other members selected by the IMF; it pays the remainder in its own currency. These quotas are reviewed at interval of not more than five years.

The IMF is authorised to supplement its ordinary resources by borrowing from official entities as well as from private sources. Under the General Agreement to Borrow (GAB), IMF entered into an agreement, initially in 1962 and renewed, revised and enlarged from time to time. As on April 30, 1997, amount potential is 18.5 billion SDRs (including 1.5 billion SDRs under the associated arrangements with Saudi Arabia). To further supplement the resources, on January 27, 1997, IMF decided to establish the New Arrangements to Borrow, (NAB).

The NAB does not replace GAB which will remain in force. However, the NAB will be the facility of first and principal resources in the event of a need to provide supplementary resources to the Fund. The amount potentially available under the NAB will be upto SDR 34 billion which will also be the maximum combined account under the GAB and NAB. As on April 30, 1997, the Fund had no outstanding borrowing since it repaid all its remaining debt to lenders in March 1996.

13.2.5 Financial Assistance

'Transactions' of the Fund are exchanges of money assets for other assets, while "operations" are other uses or receipts of monetary assets by the Fund, such as allocations of SDRs on the payment of charges to Fund. In other words, Transactions of the Fund are exchanges of money assets for other assets, while operations are other uses or receipts of monetory assets by the Fund, such as allocations of SDRs on payment of charges to Fund.

The financial operations and transactions of the Fund are carried out through the General Department and the SDR Department. The Fund provides balance of payments assistance by selling to members in exchange for their own currency, the currencies of other members SDR. The members to which the Fund sells currencies or SDRs are said to make 'purchases' (also referred to as 'drawings') from the Fund. Technically, purchases are not the borrowings since the purchasing country deposits an equivalent amount of its own currency with the Fund, but their economic effects are the same as those of borrowings.

The Fund's resources are available for limited periods, and members that purchase from the Fund must subsequently buy back their currencies or SDRs. Members doing so are said to make repurchase of their currencies from the Fund. The economic effect of such repurchases are identical to those of repayments.

The Fund's resources typically support programmes under one **stand-by arrangement**. However, with the larger scale and greater intractability of payments imbalaces that have emerged, the Fund has been increasingly supporting programmes calling for adjustment over longer period. In some cases, this is done by approving consecutive one year stand by arrangements linked to achieve medium term adjustment. In others, when authorities are able to make the necessary policy commitment, the Fund gives support in the form of a three year extended arrangement, or occassionally a three year stand by arrangement.

The number of facilities under which the Fund provides financial assistance has increased considerably since mid 1970s. Access to these facilities has also been liberalized, partly by raising quota limits and partly by excluding drawings under specific facilities in determining the amount that may potentially be drawn in the reserve tranche. Let us discuss these facilities briefly:

Reserve Tranche Drawing: It refers to a member's right to make drawing to the extent the Fund's holdings of its currency in the General Reserve Account, excluding holding arising out of purchases under all facilities. Such purchases are subject to the requirements of balance of payments. Nevertheless, the Fund has no power to challenge the member's statement of need. For purchases in the reserve tranche there are no charges and there is no requirement to repurchase.

Credit Tranche Facilities: These facilities are made available to members in four tranches on segments of 25 per cent of quota each. For first credit tranche purchases, members are required to demonstrate reasonable effort to overcome their balance of payment difficulties. Upper Credit tranche purchases are normally associated with stand by arrangements. These typically cover periods of one to two years and focus on macro economic policies — such as fiscal, monetary, and exchange rate policies — aimed at over coming balance of payments difficulties. Performance criteria to assess policy implementation — such as budgetary, credit, and external debt ceiling and targets for reserves are applied during the period of the arrangement and purchases are made in quarterly instalments. Repurchases are made in 3½ to 5 years.

Extended Fund Facility: Loans are usually for a longer duration than under stand by arrangements.

Buffer Stock Financing Facility: Under the facility the Fund provides resources to help finance members contributions to approved buffer stocks. Repurchases are made in 3½ to 5 years.

In addition to balance of payments support under its regualr and special facilities, the Fund provides emergency assistance in the form of purchases to help members overcome balance of payments problems arising from sudden and unforseen natural disasters or in part conflict situations. Such purchases involve neither performance criteria nor, normally, the phasing of disasters or in part conflict situations. Such purchases involve neither performance criteria nor, normally, the phasing of disbursements. Repurchases are made in 3½ to 5 years.

Facilities for Low Income Countries Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF) : Under these facilities, the Fund provides resources on concessional terms to support meduim term macro economic adjustment and structural reforms in low income countries facing protracted balance of payments problems. The member develops and upates, with the help of IMF and world Bank experts, a meduim term policy framework for a three year period, which is set out in a policy framework paper. Within this framework, detailed yearly policy programmes are formulated and are supported by SAF or ESAF drawings. SAF and ESAF programmes include quarterly bench marks to assess performance. These loans are to be repaid within 5½ to 7 years.

ESAF arrangements differ from SAF arrangements in the scope and strength of structural policies, and in terms of access levels, monitoring procedures and sources of funding.

Systemic Transformation Facility (STF) : It was created in response to the needs of the economies in transition from centrally planned to market based systems. It provided financial assistance to eligible members experiencing balance of payments needs resulting from severe disruption in their traditional trade and payments arrangements. It was created in April 1993 and was in effect through April 1995. Access to the facility was limited to not more than 50 per cent of quota and could be in addition to financing obtained under the Fund facilities, and the repurchase period was the same as that for the extended Fund facility.

It may be mentioned that the Fund attaches to the use of its resources a degree of conditionality sufficient to provide confidence that the borrowing member will covercome its balance of payments difficulties and be able to repurchase its currency from the Fund without under strain during the specified period. The degree of conditionality thus depends largely on the character of the member's balance of payments problem. If the problem results from temporary factors, such as a cyclical decline in export earnings, the member need only continue its existing policies until the situation returns to normal. On the other hand, if the difficulty is caused by deep seated factors; such as a persistent deterioration in terms of trade, excessive domestic demand, cost price distortions, including orvervaluation of the domestic currency, or a permanent decline in net capital inflows, the members policies need to be changed. To support Programmes supported by the use of Fund resources, IMF emphasizes measures that affect the balance of payments through the level and operation of demand. The original Articles of agreement did not specify conditions for the use of Fund resources. Conditionality evolved as the practice of extending assistance under stand by arrangement developed. It was in March 1997, the Executive Directors agreed on a revised set of twelve guidelines on conditionality.

13.2.6 Special Drawing Rights

Recognizing the need to free international monetary growth from dependence on either gold or dollars for reserve growth, a new reserve asset in the form of special Drawing Rights (SDR) was created by a resolution adopted in IMF's annual meeting in 1969. Initially an allocation of 3.5 billion SDRs, to be created in three instalments beginning January 1, 1970, was made. In subsequent years, supplementary allocations were made.

The SDR is a fiduciary reserve asset, a supplement to existing reserve asset. SDRs are allocated by the Fund to members participating in its SDR Department. Neither the allocation nor the case of SDRs is subject to conditionality. Participants holdings of SDRs form part of their international reserves, along with official holdings of gold, foreign exchange, and reserve positions in the Fund. SDRs can be used for a wide range of transactions and operations among official holders, and participants are assured that they can also use them to obtain foreign exchange. The SDR is the unit of account in which the Fund expresses the value of its assets and is also for many purposes unrelated to the Fund. All members of the Fund are participating in the SDR department.

Reserve position in the Fund are assets that arise unconditionally from countries' subscriptions of other reserve assets, from the Fund's net use of member's currencies to finance drawings of other members and from Fund borrowings that are readily payable in case of need.

Initially, the value of the SDR was made equal to one US dollar and its equivalent to 0.080671 gm. of fine gold. After 1971 and 1973 dollar devaluation in terms of gold,the SDR had to be revalued in term of dollar while rebating its gold par. In June 1974, the SDR was redefined as a cocktail or basket importance. SDR Valuation baskets are revised from time to time.

13.2.7 Other Activities

As stated earlier, IMF provides a forum in which the IMF could consult with one another and collaborate on international monetary matters. To perform this function, the Fund collects and maintains upto date information on the economic conditions and policies of the .

member countries. Holding on consultations with member countries is an important means of doing so.

The nature of the Fund's work, including in paticular regular consultations with member countries and its assistance to them in designing programmes to be supported with Fund resources, enabled it to build up a considerable body of practical knowledge of balance of payments statistics, analysis, and policy, and of associated subjects. In addition, the Fund has directed a major part of its research to these topics and as a result, it is well placed to provide training for officials dealing with the compilation of statistics and the formulation and execution of policies related to balance of pyaments. The Fund provides training by giving regular courses and seminars at the IMF Institute.

This provisions of technical assitance is yet another activity. Fund provides assitance to member countries in many fields including fiscal, monetary and balance of payment policies, banking, exchange and trade systems, government finance and statistics. Assistance is provided mainly through staff members, field assignments by staff members or outside experts, and studies and recommendations prepared at headquarters.

13.2.8 Structure and Management

The Fund is an intergovermental organization based on a treaty; its Articles of Agreement, drafted by representatives of 45 nations at a Conference held is Bretton Woods, New Hampshire, USA, on July 1-22, 1974. The articles were ammended in 1969 and 1978.

Membership in the Fund is a prerequisite for membership in the World Bank (International Bank for Reconstruction and Development), and a close working relationship exists between the two organizations, also with the World Trade organisation (WTO) and the Bank for International Settlements (BIS). The Fund is a specialised agency of the United Nations System and 182 countries are members of the IMF.

The work of the Fund is carried out by a Board of Governors, an Executive Board, a Managing Director, and a staff including three Deputy Managing Directors, 22 Directors, a Secretary, Treasurer, a Special Advisor to the Managing Director, 2 Consultants, one Economic and another legal. Each member country is represented by a Governor and an Alternate Governor on the Board of Governors, which is the Fund's senior decision making body and meets annually. A member country's voting power is related to its subscription to the Fund's financial resources, which in turn, is broadly reflective of the relative size in the world economy. The largest member, the United States, has 17.78 per cent of the total voting power, while the smallest country Marshall Islands, has only 275 out of 1.49 million votes on .001 per cent of total voting strength.

The daily business of the Fund is conducted at its headquarter in Washington D.C., by an Executive Board consisting of 24 Directors, chaired by the Managing Director. The Executive Board acts on members' request for financial assistance, takes decision on general policies, and makes recommendations to the Board of Governors on matters that require a vote of the Governors, such as the admission of new members and increases in the Fund's resources. Each of the five members having the largest quotas, and thus the highest voting power — the United States, the United Kingdom, the Federal Republic of Germany, France and Japan — appoints an Executive Director.

The Interim Committee, a 22 member ministerial level group that is parellel in structure to the Executive Board, usually meets twice a year. It reviews world economic conditions, the international monetary system, the operation of adjustment process, and the role of Fund. A Development Committee, also known as Joint Ministerial Committee of the Board of Governors of the World Bank and the Fund on the Transfer of Real Resources to Developing Countries, is concerned with development policy issues and financing requirements.

Check Your Progress B

1) Distinguish between transactions of fund and operations of funds.

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2) What is reserve tranche drawing?

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3) What is credit tranche facility?

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4) What is buffer stock financing facility?

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5) State whether following Statements are **True** or **False**.

   i) IMF is not authorised to supplement its ordinary resources by borrowing from private sources.

   ii) Transactions of the fund are exchanges of money assets from other assets.

   iii) Credit tranche facilities are made available to members in three tranches.

   iv) Systematic transformation facility was created in response to the needs of the economies in transition from centrally planned to market based systems.

   v) The Special Drawing Rights (SDR) is a fiduciary reserve asset.

13.3 THE WORLD BANK

You have learnt the objectives. functions and various activities of IMF. Let us now learn the operations of World Bank.

The Need

The World Bank came into existence in response to felt need that attention of the world would have to be given to not only the immediate relief and physical reconstruction of the economies disrupted by war but also to the "expansions, by appropriate International and domestic measures of production, employment and the exchange and consumption of goods which are the material functions of the liberty and welfare of all people...." The participants of the Bretton Woods conference realized that at the end of the War there would be a pressing need for international capital to finance both the reconstruction of production facilities destroyed by the war, principally in Western Europe, and an increase in the production and living standards, especially in the under developed areas of the world. The requirements were recognized as being so big, and the risk of such a nature, that private capital would be unable to fulfil them without some sort of Government guarantee. The Bretton wood conference felt that the problem could best be solved by the creation of a new type of international investment institution which would be authorised to make and guarantee loans for productive reconstruction and development projects both with its own capital funds and through the mobilization of private capital, and which would be provided with financial structure under which the risk of such investment would be shared by all member countries roughly in accordance with their economic strength. This is the solution which was embodied in the Bank's Articles of Agreement.

It is against this background that the World Bank was founded at the Bretton Wood Monetary and Financial Conference in 1944 and began operations in 1946. It is a specialised agency of the United Nations, as are its two affiliates the International Finance Corporation (IFC) established in July 1956 and the International Development Association (IDA) established in September 1960. International Centre for Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA) are the two other affiliates. Each of the these institutions was established to fulfil a distinct function, but all were devoted to the same general objective-the provision of financial and other assistance for the economic development of member countries.

Membership of the Fund is a pre-requisite of membership in the World Bank. Subscription to the capital stock of the Bank are based on each member's quota in the IMF, which is designed to reflect the country's economic strength, voting rights are related to shareholdings.

The work of the Fund is carried out by a Board of Governors appointed by member countries (one each). Typically a Governor is the country's finance minister or the central bank governor. The Board normally meets once a year. Day to day business is conducted at its head quarter in Washington, D.C., by a Board of Executive Directors Like IMF, each of the five members having the largest quotas, and thus the highest voting power — appoints an Executive Director. Nineteen Directors are elected for two year terms' by other members. The President of the Bank is Chairman of the Board.

13.3.1 Financial Operations

IBRD capital is derived from member's subscription to capital schemes, the calculation of which is based on their quotas in the IMF. Most of loanable funds come from borrowing, on commercial terms, in world capital markets, and also from its retained earnings, and the flow of repayments on its loans. IBRD loans carry a variable interest, rather than a rate fixed at the time of borrowing.

IBRD loans, made to governments directly on guaranteed by them, are repayable over 15 years with a grace period of 5 years. These loans are normally made for projects likely to offer a commercially viable rate of return. In 1980, the Bank introduced structural adjustment lending, which (instead of financing specific projects) supports programmes and changes necessary to modify the structure of an economy so that it can restore or maintain its growth and viability in its balance of payments over the medium term.

In mid 1994, the World Bank Group published a review of its role and activities (to commemorate the 50th anniversary of its foundation) entitled 'Learning from the Past, Embracing the future'. In this, the Bank identified the following five major development issues on which it is intended to focus in the future:

- the pursuit of economic reforms
- investment in people, in particular through education
- health, nutrition and family planning programmes.
- the protection of environment
- stimulation of the private sector and
- reorientation of government, in order to enhance the private sector by reforming and strengthening the public sector.

The Bank's efforts to reduce poverty comprise two elements : the compiling of country specific assessments and the formulation of country specific strategies to ensure that the Bank's own projects support and complement the programmes of the country concerned. A committee on Development Effectiveness addresses issues relating to the relevance and effectiveness of operations and monitors implementation of decision taken by the Board of Governors on the matter. These principles of lending policy enunciated by the Bank are reflected in its lending.

The Bank also collaborates with other UN agencies in tackling problems of developing countries. In Sept., 1996, the World Bank / IMF Development Committee endorsed a joint initiative to assist heavily indebted poor countries to reduce their debt burden, in cases where it impedes poverty reduction and economic growth. A new trust fund for that purpose was established by the Bank.

13.3.2 Technical Assistance Programmes

The provision of technical assistance has become a major component of World Bank activities. The economic sector and project analysis undertaken by the Bank in the normal course of its operations is the vehicle for considerable technical assistance. In addition, project loans and credits may include funds earmarked specially for feasibility studies, resource surveys management or planning advice, and training. In 1975, the Project Preparation facility (PPF) was established to provide cash advance to prepare projects which may be financed by the Bank. Technical assistance (usually reimbursable) is also extended to countries that do not need Bank financial assistance e.g. for training and transfer of technology.

In 1992, the Bank established an Institutional Development Fund (IDF) which become operational on 1st July, for providing rapid, small scale financial assistance to a maximum value of $ 500,000 for capacity building proposals.

13.3.3 Other Activities

The Bank has a strong research programme focussing on issues such as maintaining sustainable growth while protecting the environment and the poorest sections of society, encouraging the development of the private sector, and reducing and decentralizing government activities. It also cooperates with FAO and UNDP in the area of agricultural research.

The Bank collaborate with IMF in implementing structural adjustment programmes in developing countries. It has also collaborated with the UNDP and the UN Environment Programme, which aims at assisting developing countries in implementing projects that benefit the global (and not just the local) environment. Areas covered are : biodiversity, climate change, the phase out of ozone depleting substances; and international water.

To provide training for government officials at the middle and upper level of responsibilities, who are concerned with development programmes and projects, the IMF established Economic Development Institute in 1955. In 1996, the World Bank founded International Centre for Settlement of Investment Disputes. The broad objective of the centre is to settle any dispute that might arise out of investment between the contracting state and the foreign investor by conciliation and / or arbitration before an impartial/ international forum.

Establishment of a **Multilateral Investment Guarantee Agency (MIGA)** in April 1988 yet another dimension of the World Bank activities. MIGA's purpose is to guarantee eligible investment against losses resulting from non-commercial risk under four categories: transfer risk, risk of loss arising from legislative or administrative actions of host government, repudiation or contracts by host governments and the risk of armed conflict and civil unrest. MIGA also provides policy and advisory services to promote foreign investment in developing countries and in transitional economics and to disseminate information on investment opportunities.

13.4 INTERNATIONAL FINANCE CORPORATION

International Finance Corporation (IFC), a member of the World Bank Group was founded in 1956 to stimulate economic growth in developing countries by promoting private enterprises in these countries. Three major principles guiding IFC's activities are :

i) **The catalytic principle:** IFC should seek above all to be as catalyst in helping private investors and markets to make good investments.

ii) **The business principle:** IFC should function like a business in partnership with private sector and take some commercial risks, so that its funds although backed by public sources are transferred under market disciplines.

iii) **The principle of special contribution:** IFC should participate in an investment only when it makes a special contribution that supplements or complements the role of market operators.

The International Finance Corporation (IFC), a member of the *World Bank Group,* shares the primary objective of all bank Group institutions: to improve the quality of the lives of people in its developing member countries.

Today IFC is the largest multilateral source of loan and equity financing for private sector projects in the developing world. IFC finances and provides advice for private sector ventures and projects in developing countries in partnership with private investors and, through its advisory work, helps governments create conditions that stimulate the flow of both domestic and foreign private savings and investment. Its particular focus is to promote economic development by encouraging the growth of productive enterprises and efficient capital markets in its member countries. IFC participates in an investment only when it can make a special contribution that complements the role of market operators. It also plays a catalytic role, stimulating and mobilizing private investment in the developing world by demonstrating that investments there can be profitable. Since its founding in 1956, IFC has committed more than $21.2 billion in financing for its own account and has arranged $15 billion in syndications and underwriting for 1,852 companies in 129 developing countries.

IFC coordinates its activities with the other institutions in the World Bank Group the *International Bank for* Reconstruction and Development (IBRD), the *International Development Association (IDA)* and the *Multilateral Investment Guarantee Agency (MIGA)* but is legally and financially independent, with its own *Articles of Agreement,* shareholders, financial structure, *management* and staff. Its share capital is provided by its 174 *member countries,* which collectively determine its policies and activities. Strong shareholder support and a substantial paid-in-capital base have allowed IFC to raise most of the funds for its lending activities through its triple-A rated bond issues in the International financial markets.

IFC provides advisory services, particularly in connection with privatization and corporate restructuring, private infrastructure and the development of capital markets. These services are offered under (i) Technical Assistance Trust Funds Programme (TATF) established in 1968, (ii) The Foreign Investment Advisory service (FIAS), established in 1986. In 1989, it began operating the African Management Services company (AMSCO) to work with African countries. IFC's Africa Enterprise Fund (AEF) provides financial assistance to small and medium enterprises in Africa. In 1995, a new facility-the Enterprises Support Service, (ESSA) was established to provide technical assistance to businesses after they secure financing.

Besides, IFC has conducted several single enterprise advisory assignments in transitional economies of central and East Europe. It has undertaken work to formulate models that can be replicated, notably for the privatization of land in Russia.

13.5 INTERNATIONAL DEVELOPMENT ASSOCIATION

International Development Association (IDA), another affiliate of the World Bank, began operations in November 1960. IDA assistance is aimed at the poorest developing countries (i.e. those with an annual per capita gross national product in 1997 of $925 or less. By this criterion, about 70 countries are eligible. Under IDA lending conditions, credits can be given to the countries whose balance of payments could not sustain the burden of repayment required for World Bank loans. Terms are far more favourable than those provided by the World Bank. IDA credits are made only to governments. Credits are for a period of 35 or 40 years, with a grace period of 10 years and carry no interest charges.

IDA's total financial resources, consisting of member's subscriptions and supplementary resources (additional subscriptions and contributions), are replenished periodically by contributions from the more affluent member countries. In addition, IDA receives transfers from the net earnings of the IBRD and repayments on its credits.

IDA gives priority to the funding for education, an AIDS programme in Africa, the reduction of poverty, economic adjustment and growth, and the protection of the environment. IDA administers a Trust Fund set up as part of World Bank / IMF initiative to assist heavily indebted poor countries.

13.6 REGIONAL DEVELOPMENT BANKS

Three sets of ideas widely held in developing countries in 1950s contributed to the establishment of regional development banks. Firstly, there was a strong feeling that the flow of external capital for financing their development was greatly inadequate in relation to their needs and that existing international mechanism for transfer of long and medium capital could not be relied upon to fill the gap. Second, the existing international credit mechanism was considered quantitatively defective in that it did not provide finance for many types of projects and activities that could make a highly productive contribution to economic development. Third, the developing countries came to realize that the existing international financial institutions could not be expected to take care of many financial problems inevitable in the implementation of regional cooperation programmes, which were receiving considerable emphasis by mid-1950s, particularly in Latin America. Underlying all of these views was a persistent feeling in developing countries that the policies of existing international financial institutions such as the World Bank were excessively influenced by the views of developed countries, which held the great majority of voting rights in these institutions.

Though there are a number of development financial institutions surving needs of their respective regions, three regional development banks are of special significance. These are: Inter American Development Bank (established 1959), Asian development Bank (Established 1963) and the African development Bank (established 1966). Let us learn them briefly.

13.6.1 Inter American Development Bank

Inter American Development Bank (IADB) the earliest of the regional development banks, has a membership of 46 countries, which includes not only South Americans but also developed countries of Northern America (USA and Canada) West Europe (France, Germany, Italy, Netherlands, Sweden Switzerland and UK) and Japan. IADB lends to governments and to public and private entities for specific economic and social development projects and for sectoral forms for terms ranging from 15 to 40 years. Its sources of funds include capital stock and market borrowing.

Most of IDB lending consists of long term, market based, loans backed by ordinary capital. It also operates the Fund for Special Operations for giving loans for economic and social projects and Multilateral Investment Fund for technical cooperation, human resource development and Small Enterprises Development.

13.6.2 The Asian Development Bank

The Asian Development Bank was founded in 1966 by 31 member governments to promote the social and economic progress of the Asian and Pacific region. Over the past 31 years, the bank's membership has grown to 57, of which 41 are from within the region and 16 from outside the region. The bank gives special attention to the needs of the smaller or less developed countries and priority to regional, subregional, and national projects and programmes.

The bank's principal functions are :

i) to extend loans and equity investments for the economic and social development of its devloping members countries.

ii) to provide technical assistance for the preparation and execution of development projects and programmes, and for advisory services

iii) to promote and facilitate investment of public and private capital for development purposes, and

iv) to respond to requests for assistance in coordinating development policies and plans of its developing members countries.

The bank's strategic development objectives, as defind in the bank's Medium-Term Strategic Framework (1995-98) are to promote economic growth, reduce poverty, support human development (including population planning), improve the status of women, and protect the environment.

The bank's operations cover a wide spectrum of activities and have been classified into various sector which includes : (i) agriculture and natural resources (ii) energy (iii) industry and nonfuel minerals (iv) finance (v) transport and communication, and (vi) social intrastructure.

13.6.3 The African Development Bank

The African Development Bank was established in 1964 and started functioning in 1966. Its shareholders are 53 countries in Africa and 24 countries in the Americas, Europe and Asia. The bank is engaged in promoting the economic development and social progress of its Regional members countries in Africa.

The banks principal functions are:

i) to make loans and equity investments for the economic and social advancement of the regional members countries.

ii) to provide technical assistance for the preparation and execution of development projects and programmes

iii) to promote investment of public and private capital for development purposes and

iv) to respond to requests for assistance in coordinating development policies and plans of regional member countries.

In its operations, the bank is also required to give special attention to national and multinational projects and programmes which promote regional integration. The banks operations cover the major sectors, with particular emphasis on agriculture, public utilities, transport, industry, the social sectors of health and education, and concerns cutting across sectors, such as poverty reduction, environmental management, gender mainstreaming, and population activities. Most of the bank's financing is designed to support specific projects. However, the bank also provides programme, sector, and policy based loans to enhance national economic management. The bank also finances non publicly guaranteed private sector operations. The bank actively pursues co-financing activities with bilateral and multilateral institutions.

Check Your Progress C

1) Enumerate two guiding principles of International Finance Corporation's activi ties.

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2) Enumerate two functions of Asian Development Bank.

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3) What is International Development Association?

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4) Enumerate two functions of African Development Bank.

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5) State whether following statements are **True** or **False**.

   i) IFC is the largest multilateral source of loan and equity financing for private sector Projects in the developing world.

   ii) The World bank and IMF Development Committee have endorsed a Joint initiative to assist heavily indebted poor countries.

iii) Technical assistance programme of world bank has not been extended for training and transfer of technology.

iv) Most of Inter American bank's lending consists of short term market based loans.

v) Asian Development Bank was founded to promote the social and economic progress of the Asian and Pacific region.

13.7 LET US SUM UP

The International Monetary Fund, seeks to foster a multilateral system of payments and transfers for current transactions. IMF formulates and aministers a code of conduct regarding exchange rate policies and restrictions of payments for current account transactions and provide members with financial resources to enable them to observe the code of conduct while correcting and avoiding payments imbalances. Besides it also provides a forum in which the IMF members could consult with one another and collaborate on international monetary matters.

The Fund provides balance of payments assistance by selling the members in exchange for their own currencies, the currencies of other members or Special Drawing Rights. The number of facilities under which the Fund provides financial assistance has increased since mid 1970s. These facilities have been liberalized, partly by raising quota limits and partly by excluding drawings under specific facilities in determining the amount that may be potentially drawn in the reserve tranche.

Besides, Reserve and Credit Tranche facilities, IMF funds are available under the Extended Fund Facilities, Compensatory and Contingency Financing Facility and Buffer Stock Financing. For low income countries Structural Adjustment facility (SAF) and Enhanced Structural adjustment Facility (ESAF) have been created. Besides, SDRs have been created which can be used by member countries as reserve assets. SDRs can be used for acquiring currencies of the other member countries.

In addition to providing financial support, the IMF provides a forum in which IMF could consult with its members and collaborates on international money matters. Fund also undertakes extensive research on matters relating to balance of payments and allied issues and provides training to the senior officials of the member countries at the IMF Institute. Besides IMF also provides adisory services to the member countries under its technical assistance programmes.

The World Bank came into existence in response to felt need that there would be a pressing need for international finance to finance both the reconstruction of productive facilities destroyed by the war, principally in Western Europe, and an increase in the productivity and living standards, specially in the underdeveloped areas of the World. World Bank started functioning in 1946. It is a specialised agency of the United Nations, as are its two affiliates International Finance corporation set up in 1956 and the International Development Association established in 1960. International Centre for Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA) are other official organs of the Bank.

International Finance Corporation (IFC) came into existence in response to the Bank's concern for stimulating private sector. The unique feature of the IFC programmes is that its loans are given without government guarantee. Besides direct loans, IFC is also engaged in syndication of loans and underwriting of security issues and investment funds. IFC also provides advisory services through Technical Assistance Trust Funds, Foreign Investment Advisory Service and African Management Services Company.

International Development Association (IDA) is a World Bank affiliate, aims its assistance to poorer developing countries whose balance of payments could not sustain the burden of repayments required for World Bank loans. Terms are more liberal than provided by the World Bank;

Regional Development Banks came into existence as a result of strong feeling among the developing countries that the flow of external capital was greatly inadequate in relation to their needs. Intèr American development Bank (IADB) was first to come into existence in 1959, followed by Asian Development Bank (ADB) in 1963 and African development Bank in 1966. Besides providing loans, these institutions are also providing technical assistance particularly in the area of project formulation to the member countries.

13.8 KEY WORDS

Buffer Stock Financing Facility: The facility under which the fund provides resources to help finance members contributious to approved buffer stocks.

Floating Currency: A currency whose value responds to the supply of and demand for that currancy.

International Monetary Fund (IMF): A multigovernmental association to promote exchange rate stability and to facilitate the international flow of currencies.

Operations of Funds: Uses or receipts of monetary assets by Fund, such as allocations of SDRS on payment of changes of fund.

Par Value: The benchmark value of a currency, quoted in terms of gold or US dollar.

Special Drawing Right (SDR): A unit of account issued to countries by the International Monetary fund to expand their officials reserves bases.

Transactions of Funds: Exchanges of money assets for other assets.

13.9 ANSWERS TO CHECK YOUR PROGRESS

B5 i) False ii) True iii) False iv) True v) True

C5 i) True ii) True iii) False iv) False v) True

13.10 TERMINAL QUESTIONS

1. What were the basic reasons for setting up the International Monetary Fund?
2. Discuss the role of IMF in present day exchange rate system.
3. Has the IMF succeeded in achieving its objectives? If not, what are the con straints?
4. Explain the objectives and functions of IMF.
5. What were the causes of failure of Bretton wood system. Explain the current system of exchange rate policy.
6. What is the role of World Bank in promoting economic development? Do you see any significant change in the Bank's lending policies? Discuss.
7. Discuss the achievement of the International Finance Corporation in promoting investment in private sector?
8. What are the functions and activities of International Development Association? Has the IDA succeeded in its efforts to promote economic development in developing countries?

9. What were the basic reasons behind establishment of the Regional Developments Banks? Discuss their role and contribution they have made in promoting development in their respective regions.

10. Write notes on :

    (a) Asian Development Bank

    (b) African Development Bank.

SOME USEFUL BOOKS

Anand K. Sundaram and J. Stewart Black, *The International Business Environment — Text and Cases*, Prentice Hall of India (Recent Edition), New Delhi.

Bibek Debroy, *Beyond the Uruguay Round: The India Perspective on GATT*, Response Books (Recent Edition), New Delhi.

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John D. Daniels and Lee H. Radebaugh, *International Business — Environment and Operations*, Addison Wesley (Recent Edition), New York.

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WTO. *WTO Annual Report*, 1999, Geneva.

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