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## *Lesson No.*



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**LESSON NO. 2.1**

# INTERNATIONAL MONETARY SYSTEM
## (Bretton Woods System and Its Breakdown)

International monetary system includes any form of prevalent order according to which exchange and trade take place between various countries of the world. The basic purpose of any such system is to make possible an efficient allocation of world's real resources and to facilitate efficient trade in real goods and services. International monetary system helps in achieving greater international division of labour and specialization and facilitates the process of exchange between the countries.

**Main Functions**

Domestic monetary system of a country helps in achieving efficient allocation of resources and greater division of labour by facilitating the process of exchange. The international monetary system has to play this role at international level. But unlike the monetary system of a country, international monetary system lacks the strong political backing of the government. It has to depend on the willing cooperation of international community. For successfully helping international economic growth and trade, international monetary system has to perform following functions :

1. International monetary system must create an international medium of exchange and payment (Anything which serves as medium of exchange at international level constitutes international liquidity).
2. International medium of exchange should have stable value so that it creates confidence in itself in the world community.
3. International medium of exchange should be in adequate supply so that neither there is scarcity nor surplus of international liquidity.
4. The medium should not provide undue advantage to any one country in the form of seignorage.
5. It should provide stability in the international economic relations by making arrangements for correcting balance of payment disequlibrium, and stability in exchange rates.

Broadly speaking, international monetary system can be of two types. First, it can leave the determination of exchange rate completely to market forces. The balance of payments would fade into background in such a system since it would at all times be instantaneously adjusted by changes in the exchange rate.

Secondly, an international monetary system may be based on fixed exchange rates, with attendant problems of adjusting balance of payments by means other than exchange rate fluctutions.

**Background of Present International Monetary System**

The present international monetary system is a product of evolution as well as deliberate planning. The dominant centre of international trade and finance was London. Sterling and other currencies were freely convertible at given ratio into gold, which was the basis of their convertibility at fixed rates a into each other. There was no major currency crisis during that period, and no major currency had to be devalued or revalued. Disequilibrium in balance of payments was promptly corrected; the system worked successfully, and international trade and finance flourished during this period.

Gold and sterling constituted international liquidity. Growth of world stock of gold for monetary use and sterling balance contributed to growth of international liquidity. Sterling balances could be acquired by countries outside U.K. through various forms of loans from U.K. or by way of a balance of payments surplus. Britain's position as an international investor facilitated the flow of sterling into even the remotest corners of the world. Whoever controlled the availability of sterling balance controlled an important component of international liquidity. This was done by the Bank of England, whose dominance in international monetary affairs was almost legendary during this classical period of gold standard.

World War I gave a serious blow to the British leadership from which it never recovered. The war efforts forced Britain to sell parts of her foreign investments. Capital was badly needed to revitalize exhausted industries and it was, therefore, no longer available for overseas investment. The place of U.K. began to be taken up by the United States. In short the world economy had undergone a fundamental shock which would require major realignment in the relative positions of most of the countries. During first half-decade after the war, the international monetary situation was too unsettled to suggest even the existence of a monetary system. It was a period of temporary transition. Exchange rates had to float because no one knew just how to stabilize them in the face of the great upheaval the world had just witnessed.

The mid 1920's saw a concerned effort by major nations to re-establish the gold standard in essentially its old form. The world economy was taken over by the crisis created by the great depression. One can conclude that in the period between the two world wars international monetary system did not work successfully. This was a period of turbulence because of transition from international order under British leadership to an era of nationalism.

**International Monetary System since World War II**

The Second World War brought an end to the existing order. The world underwent a fundamental shock to its economic structure and this resulted in a realignment of economic relations between various countries. The U.S. emerged as the leader of the western world.

During war the U.S. supplies of armaments and essential consumer goods provided material backbone of the allied war efforts. After war the U.S. provided economic aid for reconstruction of European economies. Simultaneously the end of the war brought in process the disintegration of colonialism; and an era of national independence for colonies began. In this situation of protection, Western economic interests in the colonies on the way to achieve independence became a serious question in this situation. Western countries convened a conference at Bretton Woods in 1944 to design a workable international monetary system. The conference was attended by the representatives of 44 "United and Associated Nations". The task was to restore an international monetary order which had been scattered by economic depression and war. At the conference, two proposals were submitted. British proposal was prepared by J.M. Keynes, the world renowned economist, and U.S. proposal was prepared by Harry Dexter White. Ultimately, the U.S. proposal was accepted and the British view was accommodated into it. The result of this conference was a comprehensive blue print of an international monetary system. This sought to combine certain features of the old gold standard with a greater degree of flexibility and some measures of control over international liquidity. Under Bretton Woods Agreement, International Monetary Fund (IMF) was created for governing international monetary system. Article I of the Agreement states the following **objectives of IMF :**

1. To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
2. To facilitate the expansion and balanced growth of international trade and to contribute thereby to the production of and maintenance of high levels of employment of the productive resources of all members as primary objective of economic policy.
3. To promote exchange rate stability, to maintain orderly exchange arrangement among members, and to avoid competitive exchange depreciation.
4. To assist in the establishment of a multilateral system of payment in respect of current transactions between members and in the elimination of the foreign exchange restrictions which hamper the growth of world trade.

5. To give confidence to members by making the Fund's resources available to them under adequate safeguard, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive to national or international prosperity.
6. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

For playing this role, it was decided to create a fund or a pool of many different currencies on which individual countries would be able to draw in times of need. Each country deposits its quota with the IMF, 25 percent of which must be deposited in gold or U.S. Dollar, while the remaining 75 percent is in country's own currency. Equipped with deposits of gold, dollar and all member currencies, the fund could begin its operations. The IMF sells a particular foreign currency to a country, which needs that currency for this pegging operation in the foreign exchange market. The buying country pays with its own currency. These purchases are more properly viewed as foreign currency loans, since the buying country is expected to sell these foreign funds back to the IMF with the period upto three to five years. A country can automatically borrow upto 25 percent of its quota. This automatic drawing right is called a country's gold tranche*. Borrowing in excess of the gold tranche is possible, but not automatic. Such borrowing falls into a country's credit tranche. In order to make credit loans, the IMF has to be persuaded that borrowing country is taking appropriate steps to adjust its balance of payments deficit. This persuasion becomes more difficult as the credit tranche percentage increases. When the IMF's holding of a country's borrowing has reached 200 percent of its quota, this country has reached the limits of its credit tranche. In addition, IMF collects a service charge on all drawings. This charge rises with percentage of its quota a country wishes to borrow, and with the length of time a drawing has been outstanding.

**IMF and International Liquidity**

International liquidity includes the official reserves which include the gold held by the central banks, foreign currency held by central banks or treasuries, borrowing facilities available from international monetary institutions. Drawing facilities are available from the Fund under different schemes and financial assets which are mobilised when need arises. One of the functions of the IMF is to provide adequate supply of international liquidity. Under the Fund system, there are various components of international

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* (Now it is called reserve tranche)

liquidity.

1. Official Holdings of Monetary Gold.
2. Foreign Exchange Reserves and
3. Special Drawing Rights (SDR's)

With expansion of world trade, demand for international liquidity increases. This requires corresponding increase in the supply of various components of liquidity. But under IMF system, expansion in the liquidity has not kept pace with expansion of international trade. This resulted in continuous decline in the ratio of reserves to imports. This ratio stood at 37 percent in 1966, which declined to 25 percent in 1978. This points to inadequacy of international liquidity.

The Fund has been dealing in global liquidity and the principal source of supply of balance of payments credit for most of its members, with its total quotas of SDR 39,0165 billion and borrowings made from the members under different schemes. The Fund is an important source of international liquidity of its members. First is unconditional liquidity which members can use automatically. This is a drawing facility under gold tranche. Secondly, conditional liquidity, the use of which is subject to certain conditions imposed by the IMF, includes drawings under credit tranche. Besides one gold tranche and four-credit tranche, the members have access to permanent facilities for specific purposes, like compensatory financing, buffer stock financing facility and extended facility. The Fund also makes available temporary facilities to its members with borrowed resources.

**Special Drawing Rights**

The Special Drawing Rights scheme was first agreed in 1967 and ratified in 1969. SDR is a kind of paper gold created by IMF. It amounted to SDR 21.4 billion by January 1981. Under the SDR scheme, each member is entitled to participate in the Special Drawing Right Department. The member participating in the SDR's is able to use its holding of SDR's when facing balance of payment difficulties. This enables the country concerned to obtain convertible currency. The use of SDR's allocated to members is unchallengeable. This means SDR's are a form of unconditional liquidity.

Thus, drawing facilities under different tranches and SDR's are a component of the international liquidity. The major source of international liquidity remains the reserves of foreign exchange and gold. Monetary gold is growing at a very slow rate. The only component with flexible supply that remains is reserves of foreign exchange. It can be said that all components of liquidity under the IMF system have failed to keep pace with expansion of world trade. Therefore, there is a problem of inadequacy of international

liquidity.

**U.S. Balance of Payments and International Liquidity**

U.S. dollar is used as the main key currency in the world today (other being the pound sterling but it is less important). The supply of dollar in the world depends on the U.S. deficit in balance of payment. This is essential for the proper functioning of the international monetary system. The increased dollar supply in the world market amounts to U.S. liabilities abroad. To maintain convertibility of dollar into gold, the U.S. had to increase her reserves of gold. The U.S. failure to do that created a problem of confidence in the dollar. This ultimately led to devaluation of dollar and instability in the value of the most important component of international liquidity. The net increase in gold stock is only about 2 percent per year and the increase in liquidity has to be greater if the international monetary system is to function. The only way international liquidity can grow under the present set up is by increase in dollar holdings through increased U.S. balance of payments. But increased U.S. deficits make the dollar a weak currency and undermine its status as a key currency. Thus, the present international monetary system is based on an internal contradiction. Secondly, the U.S. can create international liquidity by printing more dollars whereas other countries earn it by exporting commodities. Therefore, the present system provided undue seignorage for the U.S. vis-a-vis other countries.

**Working of the Bretton Woods System**

The Bretton Woods system was an expression of power relations between the U.S. and its allies. It contributed greatly to be consolidation of U.S. hegemony and dominance-dependence relationship between the U.S. and other countries, which joined IMF system. Soviet Union and other East European countries, which joined it later on, withdrew from IMF. Since U.S. dollar was held outside the U.S.A. as a universally accepted means of payment and asset, Washington was in a position to increase the money supply without giving rise to significant inflationary pressures at home. The U.S. retained its privileged position in this respect for 20 years.

Till 1967, the U.S. was almost always in surplus in its trade balance. From monetary angle, this supplied the world community with international liquidity. But its economic and political consequences were questionable. The dollar outflow financed enormous direct and portfolio investment abroad on the part of U.S. Multinational Corporation, which has enabled them to acquire large sections of the productive capacity of Western Europe and the Third World. Military expenditure abroad and bilateral loans reinforced the U.S.Military might, as well as political influence. From economic viewpoint,

they also boosted U.S. exports and contributed to a large extent to the maintenance of the U.S. trade surplus. Dollars received by a country found their way primarily to central banks, which put them against currency thus increasing domestic money supply. The French government rightly qualified it as U.S. export of inflation to other countries.

Since mid 1960's, the economy faced stiff competition from the Western Europe and Japan. In the world market, U.S. deficit in balance of payments increased tremendously. The U.S. authorities relied on the privileged position of dollar and allowed these deficits to persist. The U.S. became the most indebted country of the world. The holding of dollars by private banks outside the U.S. created Eurodollars in huge quantity. This began to create panic, pushing holders of dollars to ask for gold.

In the meantime, agreement was reached on the need to create an international reserve asset, which would take some of the burden of expanding international liquidity from the U.S. dollar. The new asset took the form of Special Drawing Rights (S.D.Rs) : Agreement on establishment of S.D.Rs was reached in 1967 and ratified in 1969. While the S.D.Rs scheme may be seen as a step in the right direction, its inadequacies in relation to the need are evident.

Creation of SDR's could not save the system. In August 1971, the U.S. administration announced a unilateral decision to suspend convertibility of gold. In December of the same year, the Smithsonian Conference of the Group of ten (G-10)* decided on a general realignment of parties which introduced a new form of revolution. In March 1973 industrialized countries introduced the practice of floating exchange rates modified by central bank intervention. Floating rates were in violation of the provisions of IMF concerning par values and exchange stability, but this did not raise any protest from the IMF. Instead, IMF bodies were given the task of legitimizing "managed floating" of exchange rates through an amendment of the article of Agreement.

It is now acknowledged that the international monetary system instituted at Bretton Woods did not work satisfactorily. A need was felt to reform and reconstruct the international monetary system.

**Plans to Reform International Monetary System**

There were many proposals to reform the international monetary system. We briefly describe the following proposals :

1. Harrod Plan;

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* G-10 includes United States, Canada, Japan, Belgium, France, Italy, Netherlands, Sweden, U.K. and Germany.

2. Keynes Plan;
3. Bernstein Plan and;
4. Triffin Plan;

**1. Harrod's Plan :** Harrod, the British economist, argued that a substantial increase in the price of gold would solve the problem of international liquidity. For instance, doubling the price of gold will double the value of the monetary stocks in gold. This will lead to large increase in world liquidity. The increase in the price of gold also implies worldwide devaluation of currencies. It is also argued that this will lead to increase in the production of gold on the one hand and dishoarding of gold on the other. All these factors, it is added, will increase international liquidity. This proposal had several drawbacks.

(i) It will benefit a small number of countries, which have a large stock of gold. South Africa and the (former) Soviet Union would be the main beneficiaries as they are the largest producers.

(ii) It will go against those who have co-operated with the present system by holding reserve currencies.

(iii) Doubts are also expressed on the increase in the stocks of monetary gold.

(iv) This will lead to inflationary pressures in the world economy.

To sum up, an increase in the price of gold will hardly solve the problem of international monetary system.

**2. Keynes' Plan :** This was proposed in 1943 as a background for the discussion of how the international monetary system should be organized after the World War II was over. A central feature of this proposal is the establishment of a clearing union. It aims at creation of an international Central Reserve Bank. A new international currency unit, called bancor, with a fixed value will be created. Holding of foreign currency will be abolished. Gold will be used for international monetary purposes. Thus, when the system was fully developed, only two means of international payments will be in use; gold and bancor. A country can acquire bancor in two ways. It can sell gold or use its overdraft facilities with the clearing union. The exchange of gold and bancor is one way i.e. gold can be used to acquire bancor, but bancor cannot be used to buy gold.

Keynes' plan is based on the concept that deficits or surplus in balance of payment change in cyclical fashion. A deficit country can borrow from the clearing union by using overdraft facilities. Each member has a quota in the union depending on the sum of its imports and exports. If a country uses more than one fourth but less than half of its quota it will pay a charge of one

percent per year on its borrowing. If it uses more than one half of the quota, the charge will be 2 percent. An interesting feature of the plan is that the surplus countries too will have to pay a charge if they are excessively liquid. If a surplus country has a credit balance with the union of more than one half of its quota, it will have to pay a charge of one percent per year.

The basic philosophy behind the plan is that external imbalances are of a cyclical and short-term nature. Connected with nature of imbalances is the adjustment mechanism, which works through expenditure reducing for deficit country and expenditure increasing in the surplus country. Capital movements can also play the same role, which are encouraged by the Keynes Plan. Another feature of this proposal is that it makes no provision for gradual long-term increase in international liquidity. The perfect state it envisages is that all external balances are in equilibrium where no international liquidity is needed.

**3. The Bernstein Plan :** The central theme of this plan is to give IMF a large place in the present international monetary system. It intends to extend the operation of IMF. It is suggested that IMF quota should be integrated into each country's working balance and as a result, amount of international liquidity will increase.

It suggests creation of Reserve Unit of Account within the IMF. The country should deposit its own equivalent currency with the reserve unit account department to get these units. The unit would then be used in settlement of balance of payment accounts. The creation of these units would be a way of institutionalizing capital movements.

According to this proposal, international liquidity can be increased. This can be done by increasing the total amount of reserve units.

This proposal has many attractive features. It is based on the existing institutions and is a feasible proposal. The main drawback of the proposal is that it does not solve the confidence problem. Reserve units will have to be guaranteed in gold value. In absence of this, chances of the system breaking down are much greater. There are problems connected with interest charges from the deficit and surplus countries.

**4. The Triffin Plan :** Like the Bernstein Plan, the Triffin Plan also starts from the IMF and seeks its extension. But it is a more ambitious plan. Triffin has attacked the irrationality of a system so dependent on gold. He has argued that sooner or later, paper money will replace present hybrid system with its element of community money.

The basic solutions to the problem of international monetary system lies in a centralization of world reserves. Members of IMF will have to start opening

deposits with the IMF which will act as the Central Bank. The deposits will originally be created by a transfer of existing reserves from the central banks to the Fund. The IMF will get reserves and the central banks will be credited with deposits with the IMF. The deposit with IMF will carry a gold guarantee. Triffin suggests that members be required to hold at least 20 percent of their total reserves as deposit with the Fund. In due course of time, IMF will expand activities and will acquire international reserves in the form of foreign currency. It will be permitted to gradually liquidate its holdings of those currencies and in the end, there will be only two means of international liquidity : deposits with IMF and gold.

This plan empowers the Fund to engage in open market operations to regulate international liquidity. The increase in the securities portfolio of the IMF can be used to increase international liquidity. To avoid inflationary expansion, Triffin suggested annual increase of monetary reserves, something like, 3,4 or 5 percent per year.

The major weakness of this plan is that Triffin retains gold as a means of international liquidity. Any move to convert IMF certificates into gold can create serious confidence problems. Triffin moves in the direction of a World Central Bank. This seems utopian.

On a pragmatic level, it can be argued that there is little reason to believe that countries will be willing to surrender their sovereignty over an important part of their economic policy to IMF.

**II**

**INTERNATIONAL LIQUIDITY :**

The late Jacobson said, “By liquidity, I understand the supply of credit in national currencies as needed to finance and provide the means of payment for trade and production. “International liquidity consists essentially of the resources available to national monetary authorities to finance potential balance of payments deficit. It may consist in the possession of assets like gold, foreign exchange, and in the ability to borrow internationally. Thus, in its international setting, liquidity includes all those assets including SDR's, which are generally acceptable without loss of value for settling international debts. It may include the following :

Gold stocks with Central Banks and with the IMF, foreign exchange reserves of countries, drawing rights of member countries with IMF, credit arrangement between countries, country's capacity to borrow in the money markets of another country, accumulation facilities (these arise when a foreign country accepts payment of debts in debtor's currency like sterling balance accumulated during World War II, Euro Dollar, SDRs etc.

**Problem of International Liquidity**

There is no agreement among the economists about the true nature of the problem of international liquidity. Some economists feel that the problem is quantitative and is of the inadequacy of the means of international payments. Others feel that the problem is qualitative in nature and pertains to the form and composition of international reserves for liquidity purposes. There are others who present the problem of international liquidity in a different way—they clain that the problem is more of confidence. It arises due to lack of adjustment on account of fixed exchange rates (as had been the case under Bretton Woods System till 1976).

According to them, the problem is one of adjustment. It may be true that a part of the problem of international liquidity (that is providing the means of international payments) may be that of confidence and adjustment. But it is mainly the problem of inadequacy of reserves to cope with the expanding requirements of international trade. It has been found that the growth in the liquidity has not kept pace with the growth in the world trade. During the sixties and the seventies, the world trade almost doubled in a decade but the world reserves increased by hardly 25 percent to 30 percent in a decade and even this increase was unevenly distributed not only amongst developed countries but also between developed and underdeveloped countries, thereby, causing a serious shortage of international liquidity. The average annual increase in world trade in the decade 1960-70 was 8% to 10% while the annual average percentage change in reserves was hardly 3% between 1960-70. International monetary arrangement, based on gold or gold exchange standard or dollar and sterling as international reserves, could no longer inspire confidence and provide for increased quantum of international liquidity on account of expanding world trade. Apart from this, the most baffling has been the problem as to the form the new international reserve assets should take. Opinions differed in the past amongst leading countries as to the true nature and form of the new international reserve asset.

**Problem of Adequacy :**

It is rather difficult to determine as to what will constitute the adequate level of international liquidity under the dynamic conditions of expanding world trade and growth in developing economies. It is said that the quantum of international money needed by the world depends on the size of international trade, that is, more trade will require more money to finance it. But this is not true because trade is not financed normally by reserves. International reserves finance not the volume of international trade but the

balance of payment deficits. The amount or the quantity of international reserves needed, therefore, varies with the size of the swings in the balance of payments. It may, therefore, be said that in a sense, the aggregate needs on international liquidity are in one way related to factors like world trade, capital movements and imbalance in balance of payment. But their adequacy is also affected by psychological attitudes towards what is minimum or desired levels or natural reserves by reserved movements and by the use of available credit facilities. Because other influencing factors cannot be quantified, growth in imports seems to be the most relevant indicator of the need for reserves. According to Triffin, "The ratio of gross reserves to annual imports is the first and admittedly rough approach to the appraisal of reserves adequacy." But it is not easy to determine the correct ratio of gross reserves to annual imports. It will thus be seen that the factors, which determine the adequacy of international liquidity, are, in practice, not precisely measurable. It is not simply a matter of arithmetical relationship. Broadly speaking, the question of adequacy of liquidity, national and international, is a matter of judgement, depending on the economic circumstances prevailing in a country, on the time and on the purpose for which the reserves are to be used. We may conclude that a country will regard its liquidity or reserves as adequate when, in its opinion, the level of liquidity or reserves are sufficient to meet unforeseen deficits in its balance of payment without adopting restrictive policy affecting economic growth and international trade.

**Importance :**

The importance of international liquidity lies in providing means by which disequilibrium in the BOPs of different countries participating in international trade is settled. As such, it helps in the smooth flow of international trade by facilitating the availability of international means of payment. It must be understood that these means of reserves are used to finance deficit in the BOPs. These reserves are not used to finance the inflows or outflows of trade. Changes in the balance of payments to temporary deficits and surplus must be met by transfers of gold, convertible currencies or international borrowing facilities. All these go to constitute international liquidity. The greater the stock of these items of international liquidity held by any country and by countries in the aggregate, the less will be the need for changes in exchange rates. In a world, in which there are considerable fluctuations in economic activities, accompanied by a growth demand for stability the importance of international liquidity reserves lies in serving as a buffer, giving each country some leeway for the regulation of its national income and employment and providing it with a means to soften the impact of economy fluctuations arising on account of international trade and

transactions. A greater world holding of international liquidity reserves becomes necessary to maintain stable exchange rates over the whole business cycle than to meet any seasonal or short run fluctuations. It is in this sense that adequacy or otherwise of foreign liquid reserves is an important determinant of the levels of world trade and economic activity. If there are enough or sufficient international liquid reserves, specially with those countries which are likely to incur deficits, there will be less worry or panic for adjustment. On the other hand, if there is too little international liquidity in the world, deficit countries will have no or little time to adjust and they will be forced to impose restrictions on trade and capital movements. As a result, the world growth is turning the terms of trade in an unfavourable manner for developing economies. Easy access to international liquidity reserves makes it possible for the swings in the balance of payments to be financed, otherwise, the world trade may be strangled for want of international liquidity. It implies not only sufficient quantity but the right composition and distribution of international liquidity reserves.

International monetary system based on IMF or Bretton Woods system had been the chief source and mechanism by which international liquidity had been provided in the past. It was one of the main objectives of the IMF. The Fund, since its inception, had been trying hard to cope with the problem of international liquidity, in various ways, that is, by increasing quantity, by changing the composition and by ensuring equitable distribution of the available sources. The fund managed the various forms and means of providing international liquidity like gold, foreign exchange, quotas and other borrowing facilities and credit arrangements. There is no disagreement amongst the economists that the IMF must somehow be so reformed as to augment international liquidity. In fact, the IMF continues to hold a commanding position on two fronts, exchange stability and international liquidity. Its attempts and achievements in fostering the growth of international liquidity have, no doubt, been impressive but a bigger and more important rule lies ahead in making need based allocation of quotas and SDRs.

**Exchange Rate Adjustment**

Exchange rate adjustment is an important method of coping with the problems (shortage or otherwise) of international liquidity. The pertinent fact still remains that adjustment must occur, failing which any kind of monetary or reserve arrangement will collapse. Concentration on liquidity problem and its solution through satisfaction with the ways the adjustment mechanism is working. Quite apart from the quantity or reserves, an adjustment mechanism between different economies is also essential. An arrangement of sufficient reserves but fixed exchange rates could not be enough because it meant a

persistent imbalance between a weak and a strong currency. Under IMF system countries were allowed to adjust their exchange rate upto 10 percent without consulting the Fund and if a country could prove that it had a fundamental disequilibrium in the BOPs, it was allowed to depreciate its currency by more than 10 percent. But the circumstances during the sixties and the seventies rendered the Bretton Woods system of par value and fixed exchange rates entirely useless. Experts like Machlup, Mundell, Bernstein, Triffin, Harberler, Friedman and Meade supported the case for flexible and freely floating rates to overcome the problem of international liquidity through exchange rate adjustments. The IMF system of fixed exchange rates broke under the stresses and strains of an unbalanced development of the world economy, especially during the seventies in disorderly movements of short-term capitial.

As a result, there had to be a transition of the present system of floating and flexible exchange rates, which was fairly swift. As the picture emerged, 31 currencies were floating while 86 currencies used some peg or the other; 55 were pegged to the U.S. dollar, 13 to the French Franc, 4 to the pound sterling, and 3 to other currencies. Some countries peg their currencies to a composite of the currencies of their main trading partners. Under the **'Jamaica Plan'** of March/June 1976, gold stands dethroned. The Jamaica Plan, no doubt, provided a freedom of choice but not a freedom of behaviour. The new Articles of the Fund establish a set of obligation, both for the members and for the Fund's regulatory role as regards exchange rates, by exercising firm surveillance over member's policies and actions regarding exchange rates. Under this surveillance the Fund will see the countries pursue orderly exchange arrangement and a stable system of exchange rates, and must avoid manipulating exchange rates to prevent effective BOPs adjustment or to gain an unfair competitive advantage. The Fund will be able to recommend exchange arrangements that are in conformity with the development of international monetary system.

Under the Jamaica Plan, the Fund has also tried to increase the overall international liquidity by supplementing and increasing the supply of conditional liquidity in various ways; (a) by increasing quotas, (b) by introduction of new credit facilities over and above the regular credit traches, (c) by creating a new international reserve asset called the SDRs.

**(a) IMF Quotas and International Liquidity**

Each member of the Fund is assigned a quota. The subscription of each member is equal to its quota.

Whenever international liquidity is to be increased, the usual way is to increase the Fund's total resources by increasing quotas generally. Quotas

once fixed can be changed or adjusted according to variations in circumstances. The IMF has reviewed the quotas of its members from time to time. Until now the quotas were expressed in terms of gold or hard currencies but after the Jamaica Plan, quotas would be expressed in SDRs. In March, 1976 Fund's Governors voted for the 6th revision resulting in a substantial increase in Fund Quotas. This expanded the resources of the Fund by about one third, from SDR 29.2 billion to SDR 39 billion thereby giving a fillip to international liquidity. India's quota also increased from 940 million SDR's though in terms of overall IMF reserves, India's quote stands reduced from 3.22 percent to 2.93 percent. This may appear strange but India and other non-oil producing countries (rich and poor) had agreed for a cut in percentage in order to enable the new rich oil producing countries to benefit from percentage increase in accordance with their newly acquired wealth. The sixth revision increased the Fund's resources by 33.6 per cent. The increase in USA's quota was nearly 25 percent, U.K's by 4 percent. France's by 28 percent, Italy's 24 percent, Japan's by 38 percent and India's by 22 percent. But one unsatisfactory feature of distribution of quotas and of international liquidity based on such distribution is the lack of equity and uniformity amongst members. This revision did not make the distribution of international liquidity in any way better in the past. Hence, the problem of unequal distribution of international liquidity still remains.

**(b) The Trust Fund and Credit Arrangements :**

International liquidity has been augmented by what is called IMF reserve position, also called' IMF Tranche Positions'. These have been an important element of international liquidity. These reserve positions have been increasing over the years. A member's IMF position in the Fund represents the amount that a member, facing balance of payment deficit may draw essentially automatically under the Fund's gold tranche. In other words, these reserves of gold and credit tranche position in the IMF refer to the short-term financial assistance to its members to meet balance of payments deficits. Under gold tranche, a member could draw on the Fund without any question being asked. It represented unconditional liquidity. After it, a member could draw from the first or subsequent credit tranches, if the countries made reasonable efforts to solve their problems by setting right the deficit. However, requests for drawing beyond the first subscription was 25 percent of the quota, it represented the gold tranche, and each credit tranche was equivalent to one fourth of the quota. The Fund also provided liberal credit facilities, allowed frequent waivers, stand by agreements, and general arrangements to borrow all with a view to meeting the increased requirements of international liquidity.

Under the Jamaica Plan supply of liquidity has been increased by the Fund

also by the creation of new facilities. Before the Jamaica Plan of 1976, there was the compensatory financing facility in 1963, the buffer stock financing facility in 1969, the Extended Fund facility in 1974 and the Trust Fund facility in 1976, created out of the profits of gold sales by the IMF. Besides, fund also provided a temporary oil facility, which was in operation in 1974 and 1975.

**(c) SDRs and Jamaica Plan 1976**

A number of confrontations took place between US and other countries regarding the amount and magnitude of the creation of SDRs; till they finally agreed to create $9.5 billions (about Rs. 7125 crores) worth new money (paper gold) between 1970 and 1972 alongwith increase in quotas worth $6 million to $ 7 million to solve the problems of international liquidity. In this way, for the first time, a supplement of existing unconditional liquidity came into being by a deliberate decision of the international community itself rather than through an erratic accumulation of gold and reserve currencies. By March 31, 1973 out of 125 members of the IMF, 113 were participants in the SDR scheme. During the course of its working, many limitations came to the surface. For example, their quantity and the rate of growth were found to be inadequate. Their nature and scope and use were found limited because they were available for meeting the balance of payments difficulties only. IMF had to play an active role and direct designation. The distribution was found to be unjust. Developed countries felt that their creation gave undue advantage to developing economies and additional liquidity created by them was the main cause of global inflation. Major disagreement amongst members of IMF prevented the activation of the scheme for second basic period and this gave a setback to the whole scheme. Developed countries argued that existing reserves were in excess of needs and as such they had not been interested in the creation of more SDRs. The Fund allocated 4032.7 million SDRs on January 1, 1979 to 137 members. India would receive SDRs 120 million each year in the terms of its quota in the fund.

However, under the Jamaica or Kingston Plan, SDRs occupy a significant place. Numerous changes have been made in the Articles of the Fund in March 1976 at Jamaica dealing with special drawing rights. As such the present international monetary system may rightly be described as 'SDR' standard as against gold standard or gold exchange standard or the dollar standard of Bretton Woods System. SDR as the Fund's unit of account will be increasingly used in international transactions. As such the reformed system envisaged under the above reforms at Jamaica is an internationally managed system. Participants will have full freedom to enter into transaction in SDRs without being subject to some of the requirements in the present articles. The possible uses of SDRs

operations and transactions have been expanded. The Fund will also be empowered to permit more public (though not non-official) entitles to hold SDRs. Lord Keynes, in his proposal for an International Clearing Union, wrote of the need to establish “an instrument of international currency having a general acceptability between nations." The amendment of the Articles of the Fund at Jamaica continues the process of establishing the SDR as such and members are required to collaborate with the Fund in pursuit of the objective of making the SDR, the principal reserve asset of international monetary system. Its link with gold has been given up. Gold is no more in the picture and stands dethroned. In order to make SDR an effective international asset, there will be both immediate changes in the characteristics of the assests and possibilities for further development. Immediately; there will be far greater freedom for members to engage in transactions by agreement in SDRs and much wider possibilities for transfer of SDRs to and from the Fund itself. Official entitles will hold more SDRs and engage in broader range of transactions than at present. Provisions have also been made in the above plan for the Fund to permit new forms of operations in SDRs, for example loans or grants, thus, helping to bring the characteristics of SDRs closer to those of traditional reserve assets.

**IInd Amendment to Fund's Article 1978**

The second Amendment to the Fund's Article of Agreement came into effect on April 1978. It generated important changes in the fund's activities including surveillance over members, exchange arrangements, changes in the role of gold and wider uses of the SDR, as well as important innovations in the Fund's operations and transactions. In addition, the Fund's resources were enhanced in 1978, when its Board of Governors adopted two major resolutions, one of which enables members to raise their quotas in the fund from the present equivalent of SDR's 39 billion to SDR's 58.6 billion as a result of the completion of the Seventh General Review of Quotas; the other provide for the allocation of SDR Department in the three years 1979-81. In addition, the Fund Executive Board made further changes in the basket of currencies that determines the value of the SDR and established a method for its adjustments. Moreover, virtually all of the quota increases that were proposed in February 1976 under the Sixth General Review of Quotas came into effect in 1978 as a result of the completion of Seventh General Review of Quotas in 1978.

Other steps to improve the SDRs are in hand. SDRs can now be exchanged freely among the participants against currency and such voluntary transfers have already taken place on a large scale. In addition, the interest rate on the SDR will be increased and it will be possible to use SDRs to settle obligations without

changing them first into currencies to lend SDRs, and to pledge them as security for a loan by another central bank or Government. Further improvements are high on the agenda. They include forward operations in the SDRs and swap of SDRs and enlarging the number of official institutions that may deal in SDRs. The last point is potentiality of great significance for enlarging the volume of SDR denominated financing in the private markets, since many of the institutions unlike in the Fund, have direct links with the private market. Once such institution holds SDRs in their books, they are likely to increase their SDR denominated liabilities by developing transactions in the private markets.

**Conclusions**

It is thus clear that the new international monetary system emerged out of the present amendment of the IMF Article of Jamaica. The new articles are complete in themselves and confirm the role of the Fund in overseeing the international monetary system. They provide a much more workable basis for the Fund's financial operations than the existing Articles. There are far reaching changes in the field of exchange rates and the Fund is given a variety of powers and possibility. In this respect the role of gold stands reduced and the role of SDR is strengthened and the new Articles provide the Fund with powers so that its own role, and the monetary system itself, can respond to changing circumstances within an agreed legal framework. It is evident that the Fund will remain at its centre circumstance. Any discussion of the future of the Fund after Jamaica has to deal with two important and closely interrelated subject of exchange stability and international liquidity. A bigger battle, however, lies ahead i.e. a need-based allocation of quotas and SDR; the new Article put the SDR into central place that was vacated by gold. The value of the SDR is no longer determined in grams of gold but in terms of package of 16 currencies (and now five major currencies only). Hence the Fund will continue to hold a commanding position in the international monetary system and arrange for both adjustment as well as increased international liquidity. It is, thus, wrong to say that with the abolition of conventional Bretton Woods System (1946), the IMF is over. As a matter of fact, IMF has been radically empowered to perform its new role in a more effective manner under the dynamic circumstances of world economy. That is why it is said that the new international monetary system is not evolving but emerging as a result of Articles of Jamaica in 1976.

**Summary :**

1. The greatest problem is that of increasing the reserves of countries to meet the BOPs difficulties, popularly known as the problem of

international liquidity.

2. International liquidity includes the resources and the means available to national monetary authorities to meet the BOPs exchange, ability to borrow internationally assets available to national monetary authorities like gold,foreign exchange SDRs etc.
3. The problem of international liquidity arises due to lack of confidence, adjustment and quantity. It also includes the problems of components of international liquidity.
4. Its importance lies in providing enough means of international payments to meet the requirements of setting international debt and of meeting the BOPs difficulties.
5. IMF has been the main source of providing international liquidity by increasing its quantum by changing compositions and by ensuring distribution of the means of international payments.
6. Gold, which was the kingpin of the system stands dethroned. Gold is no more an international asset nor the par values expressed in gold, Gold revaluation as a solution for increasing international liquidity did not work.
7. A flexible system of exchange rate adjustment is a must to cope with the problem of inadequacy of international reserves. Fixed exchange rates of the old Bretton Woods System have been replaced by flexible rates under IMF control.
8. Under the Jamaica Plan of March 1976, IMF Articles have been amended to establish a trust fund increase in quotas and credit arrangement of the IMF.
9. Special Drawing Rights, called SDRs or paper gold is the new international reserve asset, created in 1969. This new reserve asset replaced gold.
10. Member countries can draw on the IMF and make use of these rights to meet BOPs difficulties.

## SUGGESTED READINGS

1. John Evans : International Finance
2. Bo Sodersten : International Economics
3 Vaish and Sudama Singh : International Economics

## SUGGESTED QUESTIONS

1. Discuss Bretton Woods System.
2. Give the main funtions of international monetary system.

LESSON NO. 2.2 AUTHOR : DR. M.L. SHARMA

## INTERNATIONAL MONETARY FUND (IMF)

The collapse of gold exchange standard in the 1930's, competitive exchange depreciation, exchange restrictions, wide fluctuation in the exchange rates, discriminating trade policies, and general uncertainty about the medium of international exchange were some of the factors responsible for economic instability and decline in world trade in the post-world war period. The lack of cooperation in matters of trade and payment was the main problem in the field of international economic policy. The international community was, therefore, in search of a substitute for the old gold standard and an alternative to a system of completely free exchange control. It was also considered desirable to evolve an international monetary system, which could reconcile the autonomy of international economy with the discipline of international mechanism of payments. A conference was, therefore, organised in 1944 under the auspices of the United Nations at Bretton Woods in U.S.A. The conference was attended by the representatives of 44 countries. Many experts contributed to the Bretton Woods Agreement but the major influence was exterted by Lord Keynes and Harry Dexter White, Under Secretary of the US Treasury. As a result of the Bretton Woods Agreement, the International Monetary Fund (IMF) was set up in 1945 and started functioning in 1947.

**Objectives of IMF**

The International Monetary Fund started functioning on the 1st of March 1947, with the following objectives :

(1) To promote international monetary co-operation amongst the various member countries.

(2) To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high level of employment and real income.

(3) To promote exchange stability to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(4) To assist in the establishment of multilateral system of payment in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(5) To give confidence to the members by coming to their timely rescue by giving them short period monetary resources to help them tide over the temporary maladjustments in their balance of payments, without

resorting to measures, destructive to national or international prosperity.

(6) To shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

The above mentioned objectives as embodied in the Articles of Agreement clearly indicate the obligations of the International Monetary Fund. These objectives indicate that the IMF shall be required to regulate monetary relationship among the member countries in accordance with the code of good conduct, and also to provide finance to members facing balance of payments deficit.

**Organisation of IMF**

The total membership of IMF was only 45 at the time of its inception on March 1, 1947. In April 2012, the IMF had a total membership of 188. The capital resources of the IMF consist of the total of the quota allotted to member countries. The quota of a member country is based upon its importance as measured by the value of the foreign trade, gross national product, gold and foreign exchange and certain other related factors. Each member country is required to contribute its quota both in terms of gold as well as in its national currency. Each member has to pay its quota in gold (either 20 percent of the quota or 10 percent of its entire gold and dollar holding whichever is less). The aggregate of quota amounted to $ 7.5 billion on 1st March, 1946.

The IMF has also appointed certain Central Banks as its gold depositories where members can deposit gold to the credit of IMF. The gold and the national currencies deposited with the IMF are the properties of the IMF. The IMF utilizes its gold holdings to acquire dollars and other currencies for its operations. The IMF holds two kinds of accounts with the Reserve Bank of India, A/C No. 1 and A/C No. 2. The A/C No. 1 is the major account in which the proportion of India's IMF quota subscription and other payments in rupees are credited and through which all the major transactions with the IMF involving purchase of foreign currencies (sale of rupees) are routed. For day to day use, the IMF maintains A/C No. 2 with the Reserve Bank of India. This is a current account. Deposits in A/C No. 2 produce their impact on the supply of money in India.

There are two bodies to run the management of the IMF (1) The Board of Governors and (2) The Board of Executive Directors. Every member country appoints one Governor and one alternate Governor. The alternate Governor participates in the meeting in the absence of the Governor. The Board of Governors meet every year and formulates the general policy of the IMF. Thus, the Board of Governors is a decision making body of IMF. There are 24 members in the Board of Directors. Of these, eight countries each appoint an Executive Director : the United States, Japan, Germany, France, the UK, China, the Russian

Federation and Saudi Arabia. The remaining 16 Directors represent constituencies consisting of 4 to 22 countries. The Board of Directors has to carry out the day to day working of the IMF. The chief executive of the IMF is the Managing Director. The head office of the IMF is at present located at Washington D.C.(USA).

**Functions and Working of the IMF**

**1. Determination of Exchange Rates :**

The very first article of the IMF agreement stipulates that one of the purposes of the IMF is to promote exchange stability. The IMF adopted the 'par value' system* of determining the exchange rates for member countries. Under the 'par value' system, each member country is required to define the value of its currency in terms of weight of gold as a common denominator or in terms of the United States dollar of the weight and fineness which in effect on July 1, 1944 was $ 35 = one ounce of gold of 0.995 fineness. The initial par value of the Indian rupee, established with the IMF on December 18, 1946 was 0.268601 gram of fine gold or 30.2250 U.S. cents. In other words, the exchange rate determined in the terms of par value was Rs. 30.30 = $1.00. When all the member countries express the values of their currencies in gold or dollars, it becomes easier for the IMF to fix the foreign exchange rate of the concerned countries.

**2. Management of Exchange Stability :**

In order to facilitate multilateral trade among member countries, the IMF bars competitive exchange alternation and requires each member-country to "maintain orderly exchange arrangement with other members." It does not mean that the IMF favours a fixed exchange rate system. As a matter of practice and principle, the IMF is against the floating exchange rate policy. The IMF believes in the merits of stable exchange rate policy. In order to achieve the goal of exchange stability, the IMF provides for a 10 percent adjustment, upward or downward, in the external value of member country's currency without its prior approval, and for a more than 10 percent adjustment with its prior consent. It must, however, be pointed out that the adjustment in the external value of the currency is permitted only for correcting a fundamental disequilibrium in a member country's balance of payments. The downward adjustment in the external value of the Indian rupee was made when the rupee was devalued on September 18, 1949 and again on June 6, 1966. Thus, the IMF seeks to manage the stability of exchange rate. It must, however, be pointed out that from December 18, 1975 the IMF allowed the fluctuation in the exchange

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* Par value : The official fixed exchange rate of currencies in terms of gold or US dollar, as declared to IMF.

rate of member's currency within a wider margin of 2.25 percent in place of old margin of 1 percent, in either direction of the parity relationship.

**(3) Establishment of a Multilateral System of Payments and Elimination of Foreign Exchange Restrictions :**

Article I (IV) of the IMF agreement indicates that IMF shall operate to assist in the establishment of multilateral system of payments in respect of current transactions between members and in the elimination of foreign restrictions which hamper the growth of world trade. In order that this objective may be achieved, Article VIII provides that no member-country may, without the approval of the IMF, impose restrictions on the making of payments or transfers for current international transactions or engage in discriminatory currency arrangements of multiple currency practices. It is also stipulated that the monetary authority of each member- country shall convert any balances which another member-country's monetary authority has acquired from or needs for current transactions, into gold or into currency of that member- country. In short, all the member- countries shall abolish restrictions upon current payments, avoid discriminatory currency practices and promote convertibilities of foreign held balances. As a result, multilateral system of payments will be established and trade volume will be increased.

**4. Lendings to members to cover up deficits in Balance of Payments :**

The IMF's resources consist of a common pool of gold and currencies, which in turn consist of an aggregate "quota" paid in or payable by its members countries. The IMF lends to a member country which is in need of a short-term credit to settle current deficit in its balance of payments. The deficit country "borrows", the necessary funds in exchange from the IMF with its own currency. It implies that a deficit country "borrows" the necessary funds in exchange for its I.O.U.s If the short-term credit thus acquired helps the deficit country to overcome its adverse balance of payments, the country is required to 'repurchase' its own currency in exchange for gold or 'convertible currencies'. As a result, the IMF is protected against quick depletion of its scarce currencies (e.g. dollar resources). It must however be pointed out that a member-country can buy foreign exchange from the IMF upto an amount equal to 25 percent of its quota in any given year. However, the currency of a member country with the IMF at any time should not exceed 200 percent of its quota. Let us suppose, as an example, that the quota of a member country is $ 100 million comprising $ 25 million in gold and $ 75 million in its own national currency. If this country wishes to obtain some foreign currency from the IMF, it cannot secure the foreign currency of the value greater than $ 125

million. The IMF charges rate of interest, which varies between 0.5 and 2.5 percent. It also levies service charges to the extent of 0.75 percent on its loans. These drawings of the member-countries from the IMF are conditional.

**5. Dealing with the problem of 'scarce currencies' :**

The currency of a member- country is said to be 'scarce' if its supply is less than its demand. If a country sells its goods to other countries but does not buy from them, then the other countries are not able to acquire the currency of the former. As a result, the currency of the export surplus country becomes scarce in relation to demand. Dollar, for most of the times, has been a scarce currency. The IMF can deal with the problem of dollar scarcity in two ways, namely, (a) by increasing its supply of dollars through purchase of dollars with its gold and (b) by declaring the dollar to be a 'scarce currency'. If the IMF's gold assets are enough to buy all the dollars needed by deficit members, then it will not have to ration its scarce dollar holdings among the dollar needing members. Fundamentally, however, it is more important to correct a sustained disequilibrium between those members whose currencies are scarce and those whose currencies are not scarce, because that is what gives rise to a general scarcity of the former's currencies. This suggests that the burden of responsibility should not rest on the shoulders of deficit countries alone.

**6. The Special Drawing Rights (Paper Gold) :**

Under the original articles of the IMF it had powers to lend to member countries, but this lending was conditional, and it was repayable. The unprecedented growth in international trade in the post war era has posed a serious problem of international liquidity. The introduction of special drawing rights (SDRs) by the IMF was an important step in improving international liquidity. The plan for SDRs was approved in September, 1967 and were introduced in 1969. The essence of these special drawing rights (SDRs) is that they create a new international reserve asset. They can be used unconditionally by the participating countries, and they are not backed by any assets. Unlike existing IMF drawing rights, SDRs are not created by countrie contribution of gold and currency to the IMF and once drawn they do not have to be paid back to the fund. The peculiarity of the new drawing rights is that they would not be treated as borrowing as the existing claims on IMF are. The SDRs are sometimes nicknamed 'paper gold'. They could be used as gold in as much as they would be the ultimate resource for purchasing other currencies. They are not pieces of paper like bank notes or treasury bills. They are simply entries in a special account kept by the IMF. The SDRs are allocated to each member country in proportion of its IMF quota. They can only be transferred to another member country in exchange of usable foreign

exchange. It means they cannot be spent directly on goods and services. In short, SDR is an international medium of exchange and store of value.

Alongwith financial help, the IMF also grants technical assistance to the member countries. The experts and specialists of the IMF render valuable help to the member countries in solving their complicated economic and monetary problems. In fact, the under-developed countries have been helped in the formulation of their monetary, fiscal and exchange policies. Thus, the IMF helps the member countries to stabilize their economies.

**Fund Lending**

Initially, the purpose of IMF lending was to provide member countries resources to correct maladjustments in their balance of payments. In practice, the purpose of IMF lending has changed since its organization. Over time, the IMF's financial assistence has evolved from helping countries deal with short term trade fluctuations to supporting adjustment and addressing a wide range of balance of payments problems resulting from terms of trade shocks, natural disasters, economic transition, poverty reduction and economic development, and banking and currency crises.

Following are the main lending facilities of IMF:

**(i) Stand By Arrangements (SBA):-** This is a non- concessional loan facility. The SBA is designed to help countries address short term balance of payments problems. Programme targets are designed to address their problems and disbursements are made conditional on achieving these targets (conditionality) the length of SBA is typically 12- 24 months, and replayment is due within $3\frac{1}{4}$ -5 years of disbursement. SBA was upgraded in 2009 to be more flexible, borrowing limits were doubled, and conditions were simplified.

**(ii) Flexible Credit Line (FCL):-** FCL is for countries with very strong fundamentals, Policies, and track records of policy implementation. The length of the FCL is either one year or two years with an interim review of continued qualification after one year. Access is determind on a case by case basis and is available in a single disbursement. Disbursements under FCL are not conditional on implementation of specific policy understandings as is the case under SBA, However, repayment term is the same as under SBA.

**(iii) Precautionary and Liquidity Line (PLL):-** PPL provides financing to meet actual or potential balane of payments needs to countries with sound policies and is intended to serve as insurance and help resolve crises. Duration of PLL arrangements range from 6 month to one or two years. Access under 6 months PLL arrangement in limited to 250 percent of quota in normal times, but can be raised to 500 percent of quota in exceptional circumstancs. One to two year PLL arrangements are subject to an annual access limit of 500 percent of quota.

**(iv) Extended Fund Facility (EFF):-** This facility was established in 1974 to help countries address medium and long term balance of payments problems. Arrangements are for a period of 3 - 4 year. Repayment is due with 4 -10 years.

**(v) Rapid Financing Instrument (RFL):-** RFL provides rapid financial assistance to member countries facing an urgent balance of payments need, without the need for a full- fledged programme. These loans are subject to the same terms as FCL, PLL and SBA, with a repayment period of 3 - 5 years.

**Concessional Lending Facilities:**

These facilities are to help the low income countries. Loans are available under the Poverty Reduction and Growth Trust (PRGT) scheme at concessional rates of interest. This scheme was introduced in 1999. In 2010 the IMF revamped these concessional lending facilities. Three types of loans were created under PRGT:

**(i) Extended Credit Facility (ECF): -** This succeeds the PRG facility as the funds's main tool for providing medium- term support to low income countries with protracted balance of payments problems. Financing under ECF carries a zero interest rate.

**(ii) Stand by Credit Facility (SCF): -** This provides financial assistance to low income countries with short term balance of payments needs. The facilities allows for high access and carries a low interest rate.

**(i) Rapid Credit Facility (RCF): -** Provides rapid financial assistance with limited condionality to low income countries facing on urgent balance of payments needs. Financing under RCF carries a zero interest rate, has a grace period of 5 years, and a final maturity of 10 years.

**IMF and Under-developed Countries**

The stable exchange rate system was set up in the Bretton Woods System. The developing countries have been favouring stable exchange rate system because it is in the interest of such countries. These countries often face adverse balance of payment problem. The stable exchange rate system with the support of international liquidity is a better arrangement because they are in a better position to pursue their development programmes under such international monetary system. The developing economies, want an adequate supply of international liquidity to meet the adverse balance of payments. But the allocations of SDRs to under developed countries has been much less as compared to their requirements.

The adverse balance of payment of under-developed countries has also been affected further by rise in oil prices. In order to meet the situation created by the rise in oil prices and consequent effect on balance of payments, the

IMF created an "oil facility arrangement." Though the oil facility of 1975 gave some relief to the under-developed countries, yet the scheme has not benefited them substantially owing to insignificant amount of facility. These countries had to drop some of the projects envisaged under the development plans.

The world economic developments in 1971 were characterized by the realignment of major currencies. Currency floats became the order to the day. It led to the demise of the 'Par Value' system enshrined under IMF agreement. It must however, be pointed out that most of the under-developed countries did not resort to floating currency system. They have been supporting the case for a fixed exchange rate system because of the relative absence of uncertain exchange rate under this system. In short, the IMF has not succeeded in safeguarding the interests of under developed countries. The deficits in balance of payments, adverse terms of trade, rising bill of oil import, uncertainty of the inflow of aid, insignificant availability of SDRs and fluctuations in the exchange rates suggest that the IMF should evolve suitable policies to suit the interests of developing economies.

**Critical Appraisal of the Policies of IMF, with special reference to Triffin Plan**

Robert Triffin predicted the breakdown of the international monetary system evolved at the Bretton Woods. His prediction recorded in his classic book "Gold and the Dollar Crisis" proved true with the advent of 1970s.

The International Monetary System under the auspices of the IMF has been relying on a major national currency, the US dollar. This is clear from the fact that the dollar was chosen as a common denominator in terms of which all exchange rates were in fact defined and readjusted from time to time. The dollar was regarded as the main component of international reserve accumulation by all countries other than the United States. As a result, the dollar came to be used as the main instrument for central bank interventions in the exchange markets and for the settlement of balance of payments, surpluses and deficits. But at the same time gold formed the basis of the monetary system institutionalized in the form of the IMF because of the convertibility of dollar into gold. This meant, in practice, that the growth of international reserves became more and more a byproduct of the United States balance of payments deficits. As a result, the deficits in the balance of payments of the United States resulted in its indebtedness to foreign central banks (dollar balance). The United States was required to convert the dollar balance of foreign central banks into gold.

This system worked reasonably well as long as the deficits in the balance of payments of the United States did not exceed the normal needs for the growth

of world reserves. As a matter of fact, 96 percent of the overall deficits of the United States balance of payments were financed by the acceptance of American dollars as international reserves by other countries. In 1971, the position was such that the world, having acquired dollar balances for the American gold reserves finally lost its confidence in the dollar as the principal reserve currency. This forced U.S.A. to abrogate convertibility of dollar into gold on August 15, 1971. The countries having surplus balance of payments had to adopt the floating rate system because of the inflationary implications of rising dollar balance with them. In short, the inconvertibility of the dollar and the generalized adoption of floating rates is the basic contraception of the Bretton Woods agreement. These were the manifestations of the total breakdown of the international monetary system institutionalized in the form of the IMF. Gold has been dethroned from its position of constitutional head of the international monetary system. Thus, we see Triffin's prediction come true : "man made credit reserves will continue to displace and will eventually replace gold reserves just as man- made credit money has long replaced gold money in every national monetary system, the world over." He had criticised the use of gold as a component of international liquidity on the ground that for a long time, the monetary stock of gold has been rising more slowly than the volume of world trade. It is significant to point out than even though the IMF evolved, in 1969, SDRs as an international liquidity, the fixation of its value in terms of gold proved ineffective. In accordance with the recommendations made by the G-20 (the committee of twenty), the SDRs was delinked from gold in July 1974. Triffin argued that it does not sound logical that gold should also compete with the newly created reserve asset, SDR.

Triffin had given a proposal for reform of the international monetary system. He had advocated the centralization of reserves and establishment of an international reserve-creating institution. He suggested to adopt the model of domestic monetary systems and establish an international reserve creating institution to perform tasks similar to those of domestic central banks.

A new international monetary system was born on January 8, 1976 as a result of the conference of the G-20. The old Bretton Woods monetary system had collapsed on December 18, 1971 when the dollar was devalued. The basic features of the new monetary system were as follows. Firstly, the new monetary system now gave legal recognition to the fluctuation of currencies in the foreign exchange market of the world. Secondly, the new monetary system instituted a "Special Trust Fund" with the same proceeds of gold stock of the IMF. This fund was intended to be utilized to help the developing countries to meet chronic deficits in their balance of payments. However, the assistance from

this fund would be given only to those developing countries whose per capita was less than $ 360. Thirdly, the quotas of the member countries in the capital resources of the IMF had been increased by 33 percent under the new system. Fourthly, the paper gold i.e. SDRs has been declared as the principal reserve asset of the international monetary system.

The above discussion clearly brings out that the IMF succeeded in achieving such objectives like exchange rate stability, convertibility of a new currency and multilateral payments system. But it could work satisfactorily only in the first two decades of its existence. The reliance on one national currency (dollar) and convertibility of dollar into gold, enshrined under the IMF agreement, brought a halt and ultimately collapse of the Bretton Woods system in the beginning of 1970s. Triffin had always been against the induction of gold in the edifice of International Monetary System. Fortunately in the amended 1976 international monetary system, the yellow metal was dethroned from its central position.

## SUGGESTED READINGS


1. John Evans : International Finance
2. Bo Sodersten : International Economics
3 Vaish and Sudama Singh : International Economics


## SUGGESTED QUESTIONS

1. Discuss the objectives and organisation of IMF.
2. What are the funtions of IMF.
3. Discuss the main fund lending facilities of IMF.
4. Write short notes on:
   i. Special Drawing Right (SRD's)
   ii. Quotas
   iii. IMF and India.

LESSON NO. 2.3 AUTHOR : DR. M.L. SHARMA

## INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT(IBRD) (WORLD BANK)*

The International Bank for Reconstruction and Development, better known as the World Bank, was established at the same time as the International Monetary Fund to tackle the problem of international investment. Since the IMF was designed to provide temporary assistance in correcting balance of payments difficulties, an institution was also needed to assist long-term investment purposes. Thus, IBRD was founded in 1944 and began its operations in 1946 for promoting long-term investment loans on reasonable terms. The Second World War had given a severe blow to global trade by disrupting the world economies. The economies of England, Germany, France and other countries had suffered on a large scale. Economic reconstruction was the immediate need of war-torn Europe. Besides, the task of re-building the war shattered economies of European countries was another problem which required urgent attention. This problem was that of vast gap of economic inequalities between the developed and developing countries. The entire countries of Asia, Africa and Latin America were immersed in seething poverty. The widening gap in the living standards of the rich and poor nations breeded social unrest and political upheavals which had the potential of originating the flames of war once again. It was realised that the only way to ensure lasting world peace was by eradicating poverty in the underdeveloped economies through economic development of these countries. To solve this problem, the Bretton Woods Conference established the International Bank for Reconstruction and Development.

**Functions** :

IBRD is an inter-government institution, corporate in form, the capital stock of which is entirely owned by its members.

**The main functions of the Bank are :**

(1) to assist in reconstruction and development of the economies of its member governments by faciliting investment of capital for productive purposes;

(2) to promote foreign private investment by guarantees or through participation in loans and other investments made by private investors;

(3) where private capital is not available on reasonable terms, to make loans for productive purposes out of its own resources or out of the funds

* The World Bank comprises IBRD and IDA, whereas the World Bank Group comprises IBRD, IDA, IFC, Multilateral Investment Guarantee Agency (MIGA) and International Centre for Settlement of Investment Disputes (ICSID)

borrowed by it;

(4) to promote the long-term balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of member countries.

A little reflection will reveal that the objectives of the IMF and IBRD are complementary. Both aim at increasing the level of national income and standard of living of the member nations. Both serve as lending institutions, the IMF for short term and the IBRD for long term capital. Both aim at promoting the balanced growth of international trade.

**Organisation of the Bank**

Initially, only a country which was a member of IMF could become a member of IBRD. But now, other countries can also become a member if the application of a country is supported by 75 percent existing members. Thus any country is eligible for membership of the Bank if it subscribes to the charter of the bank. The bank has a Board of Governors, Executive Directors, a President and other staff. All powers of the bank are vested in the board of governors. Each governor has the voting power, which is proportional to the financial contribution of the government, which it represents. The voting power of the big shareholders far outweighs the voting power of the smaller ones. The Board of Governors meet once a year. This annual meeting is an important occasion for informal exchange of views at high level on major international, financial and monetary issues.

The initial authorised capital of the World Bank was 10 billion, subscribed by its members in accordance with their economic growth. The United States of America is the largest subscriber, followed by the United Kingdom. Each country's quota is divided into three parts :

(i) Two percent of the subscription is payable in gold or U.S. dollars and is freely available for lending :

(ii) 18 percent of the subscription is payable in member's own currency and is available for lending with the consent of the member country whose currency is involved; and

(iii) The remaining 80 percent of the subscription is not payable for lending but is subject to call as and when required to meet the Bank's obligations.

The subscribed capital of the Bank is increased as a result of the enhancement of its resources in the form of increase in member's susbcription and also due to the increase in membership. The principal purpose of increasing World Bank's capital resources is to increase its ability to lead for economic development. The Bank also borrows from international capital market through sale of securities.

**Aims**

**The fundamental aims and objectives of the Bank are :**

(i) To provide a catalyst by which production may be generally stimulated and private investment encouraged.

(ii) To encourage necessary action by the member governments to ensure that the Bank's loans will actually prove productive; and

(iii) To initiate and develop plans to see to it that the Bank's resources are used wisely from the standpoint of the world.

The World Bank is more than the usual type of lending institutions. Its concern is primarily to ensure that its loans make the greatest possible contribution to increasing the production, raising the living standards and opening opportunities for further investment in the borrowing member country. Recently, the scope of Bank's assistance to the members has been considerably widened. In its early years, most of the economies borrowed for purposes like dams, roads and power plants. Now, Bank is also lending for "purposes", like education, population, planning, urbanisation, water supply and sewerage.

**Granting of Loans**

In the granting of loans and their administration, there are four stages involved. The first stage may be characterised as exploratory and preliminary investigation. At this stage, there are discussions between a mission sent by the prospective borrower about the latter's ability to repay the loan.

If the mission is satisfied with preliminary investigation then the second stage of investigation of the specific project starts. The mission investigates the specific project in its technical, financial and administrative aspects — whether the project plans have been properly drawn, whether the required local capital would be entrusted to capital management etc.

If the second stage of technical investigation is satisfactory, the third stage of negotiation of the terms of loans starts. This involves borrowing country and checks the end use to which funds are put, in order to determine the part of total investments to be provided by the Bank, the interest rate, the period of the loan and securing of several assurances and guarantees for safeguarding the interests of Bank.

The final stage is that of the administration of the loan which is a special feature of the Bank loans. The Bank representatives visit borrower country to determine that the use conforms to the loans agreement.

**Guiding Principles of the Bank**

In its lending operation, the Bank is guided by certain guidelines which have been formulated on the basis of the Articles of Agreement.

In the first instance, the Bank should assess properly repayment prospects of the loans. For this, it should consider the availability of natural

resources and existing productive plant capacity to exploit the resources and operate the plant, and the country's past debt record, and technical soundness and high priority nature of the project.

Thirdly, it is the Bank's policy to maintain continuing relation with borrowers so as to check the progress of the projects and to keep in touch with financial and economic development in the borrowing country.

The rate of interest charged by the Bank is based on the rate, which it would itself have to pay to borrow money at the time the loan is made, plus one percent commission charge which is allocated to a special reserve.

The Bank has advanced loan for specific development project in the fields of agriculture, electric power, transport, telecommunication, industry, population planning, water supply, project preparation, urban development and education. Bank's loans are long term loans granted on the conventional rate of interest for projects of economic priority.

An intermediate financial facility was created in 1975-76 to enable the Bank to provide development assistance on term's intermediate between those of the Bank and IDA.

A majority of IBRD's loans have gone to developing countries for development projects. These loans were meant for the creation and development of infrastructure projects in the developing countries in Africa, Asia and Western Hemisphere. More than 10 percent of the total loan assistance has been given for the development of electric power projects. About 72 percent of the total amount had been utilised for providing transportation and telecommunication facilities. About 22 percent of the total accumulative loan amount has financed the development of agriculture and rural development projects. Rest of the loan assistance has been given for the development of education, project preparation and technical assistance, population, planning, water supply and sewerage. Region wise, about 7 percent of the total loan amount has been given to South Asia and pacific region countries. Africa claimed about 13 percent of the total loan assistance provided by the Bank.

The substantial growth in the lending activities of the Bank would not have been possible without a corresponding expansion in its resources. The paid-in capital of the Bank has risen to more than four fold. Besides the increase in its capital resources, the Bank has also borrowed funds on a mass scale by successfully floating loans in the international financial market. Investors of about hundred countries hold the security of the Bank which have been established in the money markets of Belgium, Canada, Germany, Italy, Netherlands, Switzerland, U.K. and U.S.A. and thirteen petroleum-exporting countries including Saudi Arabia.

**Technical Assistance :**

The Bank, apart from granting loans, has also provided technical assistance in developing countries through various Survey Missions which make intensive studies of national resources of developing member countries. The Economic Development Institute of the Bank was established in 1955 to provide training for senior officials of member countries.

In 1965, IBRD established a machinery- convention on the Settlement of Disputes between states. Under the convention, an International Centre for Settlement of Investment Disputes (ICSID) has been established for providing facilities for settlement by voluntary recourse to conciliation or arbitration of investment disputes between contracting states and foreign investors who are nationals of other contracting states.

World Bank has also promoted international peace by successfully resolving difficult international disputes — between UK and UAE on the nationalisation of Suez Canal; between India and Pakistan over sharing of waters of Indus System of Rivers.

**World Bank and India**

In addition to the conventional loans, which it has made available for development projects, the Bank has made sincere efforts to secure outside assistance from developed countries for underdeveloped countries. The Bank has taken the lead in organising aid coordination mechanism for a number of developing countries, which receive assistance from several bilateral and multilateral sources. It has helped in the establishment of International Development Association from which underdeveloped countries can borrow in hard currencies without worrying to repay in the same currencies. Another contribution of the World Bank was the amendment to the charter of International Finance Corporation to enable it to provide equity to private industrial undertakings in underdeveloped countries. These developments have helped the developing countries to effectively implement their development plans. Moreover, lending has been in favour of agriculture and rural development, transaction and industrial sectors where development is vital for the development of member countries. India is a founder member of the Bank and holds a permanent seat on the Bank's Board of executive directors. In view of its achievement, the role of the Bank has been commendable. The proof of its popularity is the rapid increase in its membership. The Bank has sent several missions to India to assess the country's development programmes and also for field surveys of various projects. The Bank has appointed a resident representative in New Delhi who remains in close contact with the government of India in regard to the country's

development plans and the projects.

India has gained from assistance given to it by the Bank. It was due to its concerted efforts that a consortium of twelve lending Western countries known as 'Aid India Club' comprising of the U.K., U.S.A., Germany, Japan, France, Canada, Italy, Sweden, Austria, Belgium, Netherlands and Holland was formed.

But, much more significant is the involvement of the Bank in India's development programmes. The proof is the massive assistance of 85.472 million, which she received from the members of the consortium for development programmes during the Third five-year plan and the non- project aid of $ 3,700 million would never have been made available without the support of the Bank. Apart from providing the massive loan assistance, the Bank also paid the foreign exchange cost amounting to $ 862,000 for a study aimed at improving the transport of coal in India. In 1965, the Bank helped in financing a survey of transport in the eastern region in order to enable the Government to formulate a transport investment programme for the fourth and fifth five year plans (1966-76).

The Bank also gave a loan of $ 39 million in 1971 and 1972 to the Punjab Agricultural Project to boost farm production. Projects financed with the help of the Bank have strengthened the Indian economy.World Bank is the largest financier of India's National Aids Control programme (NACP) with a commitment of around US $ 275 million in interest free credits.

The World Bank Group has granted massive loan and credit assistance of more than 9 million to India for the planned economic development of the country's economy.

**Critical Appraisal**

The 'modus operandi' of the Bank has been criticised on various grounds. Firstly, it is alleged that the Bank charges a very high rate of interest on its loan, even when the loans given by it are guaranteed by Governments of the borrowing member countries and there is no risk of loss of capital. The purpose of the Bank to make economically weak nations as strong can be fulfilled only when the rate of interest charged by it, is low enough for all countries to enable them to take loans from the Bank more frequently.

Secondly, the Bank's insistence on judging the repaying capacity of a borrowing country before granting the loan is faulty. The repaying capacity follows rather than proceeds the utilization of the loan. It is created as the project financed by loans materialize. Trying to estimate repaying capacity before granting the loans betrays lack of judgement on the part of the Bank.

Thirdly, the Bank is a non- political and nonpartisan financial institution. It is expected to treat all members equally, being enjoined not to discriminate against some and in favour of others in the granting of loans. However, in practice, loans have not been given purely on economic considerations. It is only recently that the economically backward countries of Asia and Africa have caught the eyes of the Bank and even now these areas are not getting the attention they need. The Third World countries, Europe and Western Hemisphere are smaller both from population and area considerations and even then they have received huge amount of loans. All this cannot be defended on economic consideration alone.

Fourthly, the Bank is still far from playing an effective role in reshaping the economic structure of member countries because the amount of financial help given by it, falls far short of the vast requirements of resources needed for accelerating the process of economic development.

Inspite of these shortcomings, in evaluating the Bank's role we should not forget the limitations with which the Bank works. The Bank has been largely instrumental in quickening the tempo of economic development in different countries of the world. Although the Bank has failed to finance all the development projects, it has financed a large number of them, which have proved quite successful. In future, the Bank will be in a stronger position to render financial assistance to the member countries with its increased capital resources and the active co-operation of its affiliates, International Development Association and International Finance Corporation. We will study about these institutions in the next lesson.

## SUGGESTED READINGS


1. John Evans : International Finance
2. Bo Sodersten : International Economics
3 Vaish and Sudama singh : International Economics


## SUGGESTED QUESTIONS

1. Discuss the objectives and funtions of World Bank.
2. Write a detailed note on World Bank and India.
3. Explain the organisation of World Bank.

# INTERNATIONAL FINANCIAL INSTITUTIONS: IDA, IFC, ADB

**Structure of the Lesson**



## 2.4.1 Introduction

In the previous lessons, we studied about the International Monetary Fund (IMF) and the World Bank (or IBRD). In this lesson we will study about some other international financial institutions. These are the IDA, IFC, and ADB. Of these, IDA and IFC are members of the World Bank Group, while the ADB is a regional development bank aimed at facilitating economic development of Asian countries.

In addition, information will also be provided on two other members of the World Bank Group – the Multilateral Investment Guarantee Agency (MIGA), and the International Centre for Settlement of Investment Disputes (ICSID).

**2.4.2 Objective of the lesson**

The objective of this lesson is to know about and evaluate some international financial institutions which are actively engaged in assisting the economic development of developing countries.

**2.4.3 International Development Association (IDA)**

The IDA is the soft lending window of the World Bank. It was established in 1960 as a development finance institution, with its headquarters at Washington, D.C., United States. The need for setting up this institution arose because developing countries were not able to afford IBRD (International Bank for Reconstruction and Development, or World Bank) lending, and needed more favourable lending terms. Although IFC was established in 1956, developing countries persisted in their demand. In 1969, their demand met the approval of the World Bank's Board of Governors, and in January 1960, 15 countries signed the articles of agreement which led to the establishment of IDA. This institution provides financial assistance for purposes which are not catered by World Bank, such as sanitation, urban development etc. The IDA is the single largest provider of finance for economic and human development projects in the poor countries.

**2.4.3.1 Objectives of IDA**

The main objective of the IDA, as stated earlier, is to help the poorest of poor countries in growing quickly and equitably. Specifically, it aims at:

(i) poverty reduction in poor countries by providing finance at concessional rates;

(ii) to work for the development of human capital in poor countries, which includes population control, health, nutrition and education;

**(iii)** to serve as a complement to the objectives and activities of the World Bank.

**2.4.3.2 Membership and Organizational Structure**

IDA's membership is available only to those countries who are members of the IBRD. AT present it has 172 member countries. The members of IDA are divided into two parts – Part I consisting of developed countries, and Part II comprising developing countries. Member countries replenish the funds of IDA through contributions. Apart from this, IBRD and IFC provide it with supplementary funds. Every three years, the member nations providing funds gather to replenish the IDA's resources.

The IDA is governed by the Board of Governors of the World Bank. It consists of one governor per member country (who is usually the finance minister of

the country). The Board of Governors delegates authority to the Board of Directors for its daily matters. The President of the World Bank Group chairs the Board of Directors. Besides, the Board has 25 executive directors.

#### 2.4.3.3 Working and lending policy

In order to provide assistance, IDA assesses countries on the basis of their poverty and lack of credit worthiness for IBRD borrowing. For this, per capita income, non access to private capital market, and policy performance in pro-growth and anti-poverty reforms of the borrower country is taken into account. IDA lends to countries to finance projects for developing infrastructure, education, sanitation facilities, healthcare, clean water, and environmental issues. The loans carry a maturity period of 25 to 40 years, with a grace period of 5 to 10 years. The loans do not carry any rate of interest for countries who are regular IDA – eligible borrowers; otherwise it varies from 1.25% to 2.8 per cent. The Country Policy and Institutional Assessment (CPIA) development indicator of the World Bank is used for prioritizing lending to each country.

The IDA has allocated nearly half of its resources towards financing projects in African countries. The projects are in the sphere of electricity, roads, and education. In South Asia, IDA has focussed on education, healthcare, transportation, agriculture and energy.

#### 2.4.3.4 Evaluation

The IDA has done commendable work since its establishment in 1960. Its financial assistance has resulted in lower birth and death rates, decline in infant mortality rate, and increase in average life expectancy and education in many countries. However, resources with IDA are limited to support its good work. The voluntary contributions made to IDA are not a regular feature. Moreover, sometimes the sanctioned amount is not fully disbursed.

### 2.4.4 International Finance Corporation (IFC)

The IFC is an international financial institution, which is also a member of the World Bank Group. It was established in 1956, and is known as the private sector arm of the World Bank Group. Its headquarters are in Washington, D.C., United States. The IFC supplements the financing activities of the World Bank. The idea of setting up IFC was proposed in 1950, for the purpose of making private investments in developing countries served by the World Bank. The IFC was to invest in private firms, rather than lending to governments, but it was not to manage the projects in which it invested.

#### 2.4.4.1 Objectives

The main aim of the IFC is to help people escape poverty and attain better standards of living.It creates opportunities for achieving this aim by mobilizing financial resources for private enterprise, supporting businesses and other private sector entities, creates jobs and delivers necessary services to the poor and vulnerable.It aims at increasing sustainable agricultural opportunities, improve health and education, infrastructure and invest in climate health. The IFC thus supplements the financing activities of the World Bank. It seeks its objectives by providing and bringing together finance, technical assistance and management. Thus,it provides not only financial and technical assistance, but also equity capital.

#### 2.4.4.2 Membership and Organizational Structure

Like IDA, the membership of IFC is open only to countries who are members of the World Bank. It is a corporation whose shareholders are member governments who provide paid-in capital, vote on matters of policy and approve its investing activities.

The IFC is governed by its Board of Governors comprising of one governor per member country. Again, the governor is usually the country's finance minister. The Board of Governors usually delegate their corporate powers and authority over daily matters to the Board of Directors. The Board of Directors consists of 25 executive directors, with the President of the World Bank Group acting as the Chairman of the Board. Each executive director's vote is weighted in accordance with the total share capital of the member countries represented by that director. At present, there are 182 member countries. Although the IFC co-ordinates its activities with the other institutions of the World Bank Group, it generally operates independently, as it has a separate legal and finance autonomy.

#### 2.4.4.3 Working and Lending Policy of IFC

The IFC provides financial assistance in the form of loans, equity, syndicated loans and liquidity management. These loans do not require government guarantee. The IFC makes loans to business and private projects generally with maturities of 7-12 years. The repayment schedule and grace period of each loan is decided separately. Long-term loans are provided either on project-cost basis or corporate finance basis. The loans which are written against IFC's own account are known as A-loans. In case IFC's own funds do not permit making big loans, commercial banks and other financial institutions join in loan syndication. Such loans are known as B-loans.

Apart from granting loans in hard currencies, the IFC also tries to structure loan products in local currencies. For example, in 2011, its disbursement portfolio included loans denominated in 45 local currencies. Also, the IFC was authorized in

1961 to make equity investments. It usually invests for a period of 8-15 years, and then exits through sale of shares on a domestic stock exchange. However, despite investing in a company, the IFC does not play an active role in the management of the company.

The IFC has also started a global trade finance programme, through which it guarantees trade payment obligations of over 200 approved banks in around 80 countries to mitigate the risk for international transactions.

The IFC also provides a range of advisory services. These services are for the purpose of supporting corporate decision making regarding business, environment, sustainability etc. Its advice targets governance and managerial capacity. In addition, it advises governments on infrastructure development and public-private partnerships. In 2009, the IFC established the IFC Asset Management Company, which is its wholly owned subsidiary and manages all capital funds to be invested in emerging markets.

#### 2.4.4.4 Evaluation of IFC

The IFC is assessed by an independent evaluator each year. It has received high credit ratings by international credit rating agencies due to its strong financial standing with adequate capital, geographic diversification, and management policies. It helped developing countries to deal with the aftermath of the crisis of 2008, by providing credit to small and medium businesses. However, it faces higher risks than other multilateral institutions due to its emphasis on private sector investing.

### 2.4.5 Asian Development Bank (ADB)

Although international development banks had been established for catering to the development needs of member countries, their norms could not be applied to each region equally, because each region has separate economic needs. Particularly, it was Japan that felt that its interest in Asia was not served by the World Bank. ADB was set up in this context. Though, the efforts had started in 1963, it was only after USA and Japan offered to subscribe US $ 200 million each in 1965, that ADB came into being from 22 August 1966, and began functioning in December 1966. Its membership was open to the regional countries and the non-regional developed countries (to obtain resources). The headquarters of the bank is at Manila, Philippines.

#### 2.4.5.1 Objectives of ADB

The main aim of ADB is to promote economic development and cooperation in countries of Asia and Far East. For this purpose it provides loans and equity capital, technical assistance for preparing and carrying out development projects. It also helps mobilize additional resources within the region and attract investment

from outside. It is committed to providing loans for social issues such as education, health, population, urban development, and environment.

**2.4.5.2 Membership and Organizational Structure**

ADB admits members of the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP). It had 31 members at the time of establishment, but now has 67 members – 48 from within Asia and the Pacific, and 19 from outside. Like the World bank, it has a weighted voting system where votes are distributed in proportion with the member country's capital subscription.

The policy making body is the Board of Governors which is composed of one representative from each member state. This Board elects a Board of Directors, twelve in number, from amongst themselves. The chairman of the Board of Director is the President of the ADB. The President is elected by the Board of Governors for a term of five years. Every member country has one basic vote plus additional votes in proportion to their number of shares held in the capital structure.

**2.4.5.3 Working and Lending Policy**

ADB offers two types of loans – one is "hard" loans (offered on commercial terms) from ordinary capital resources (OCRs); the other are "soft" loans (on concessional conditions) offered from the Asian Development Fund (ADF). OCRs comprise of equity and borrowings. ADF is replenished by member countries. The replenishment is authorized from time to time by a resolution of the Board of Governors.

A member developing country can borrow from ADB for a public or private sector enterprise. ADB aids only economically and socially viable projects. The maturity period is between 10 to 30 years, with a grace period of 2 to 7 years. The concessional loans have a longer maturity period of 35 to 40 years, with a grace period of 10 years. OCR and ADF loans often involve supplementary loans also.

ADB also offers Technical Assistance Development Special Fund (TASF) for financing technical assistance operations and Japan Special Fund (contribution of Japan) for financing or co-financing technical assistance projects through equity investment.

**2.4.5.4 Evaluation of ADB**

At the organizational level, ADB has two types of evaluation. One is self evaluation which is conducted by the units responsible for designing and implementing strategies. The other is Independent Evaluation. ADB's Independent Evaluation Department (IED) conducts systematic and impartial assessment of the programmes and projects.

However, it has been repeatedly pointed out by the critics that ADB's lending, policy and staffing decisions are extensively influenced by its two major donors i.e. Japan and U.S. ADB has also been accused of bypassing rural population in its growth programmes, and causing social and environmental damage due to lack of oversight.

**2.4.6 A note on MIGA and ICSID**

The Multilateral Investment Guarantee Agency (MIGA) is also an international development finance institution, which was set up in 1988, with the World Bank Group as its parent organization. The headquarters of MIGA at Washington D.C., USA. MIGA provides an investment insurance facility to help investors overcome political and other non-commercial risks while investing in developing countries. Its aim is to promote foreign direct investment (FDI) in developing countries so as to promote economic growth and reduce poverty.

The membership of MIGA is only for those countries who are members of the World Bank. It is governed by a Council of Governors which represents its member countries. This Council delegates powers to a Board of Directors comprising of 25 directors.

MIGA offers insurance cover for five types of non-commercial risks: currency inconvertibility and transfer restriction; government expropriation; war, terrorism and civil disturbance; breaches of contract; and the non-honouring of sovereign financial obligations.

MIGA is evaluated by the World Bank's Independent Evaluation Group. This evaluation is carried out every year.

The International Centre for Settlement of Investment Disputes (ICSID), as the name suggests, is a dispute resolution organization concerned with conciliation of legal disputes between international investors. It was set up in 1966, and is a member of the World Bank Group. The ICSID is governed by its Administrative Council, which consists of one representative from each of the centre's contracting member states. It is chaired by the President of the World Bank Group. The Council is supported by a Secretariat to conduct the Centre's proceedings.

The ICSID offers institutional and procedural support to conciliation commissions, tribunals and committees instated of conducting such proceedings itself.

Although availing of ICSID conciliation and arbitration is entirely voluntary, but once the parties consent to arbitration under the ICSID Convention, neither party can withdraw its consent.

### 2.4.7 Summary

In this lesson, we have studied about some international financial institutions, other than the IBRD. These are the IDA, the IFC and the ADB. While the IDA is the soft lending window of the World Bank, the IFC supplements the financing activities of the World Bank by giving equity finance and loans without the guarantee of the government of the borrowing country. The ADB is a regional development bank of the Asian region.

### 2.4.8 Suggested Readings

(i) V. Sharan: International Financial Management

(ii) Official website of the concerned organization

### 2.4.9 Questions for Practice

(i) Write a detailed note on the working and lending of Asian Development Bank

(ii) What are the objectives of IDA?

(iii) Write a note on MIGA.

(iv) Write a brief note on IFC.

**Lesson No. : 2.5** **Author: ANITA GILL**

# INTERNATIONAL BANKING

**Structure of the Lesson: -**



## 2.5.1 Introduction

We are already familiar with the structure and functions of commercial banks acting domestically, i.e. within the physical bounds of the country. The second half of the twentieth century, however, witnessed the emergence and fast expansion of multinational corporations (MNCs), and with this arose the need for greater sources of funds, and required an expansion in the dimensions of services of commercial banks. This led to the development of a number of agencies and instruments through which funds move internationally to the resource needy institutions or firms. The channels for the flow of funds, i.e. the resource-providing agencies may be official or non-official (i.e. non-governmental). The official agencies can be classified as (i) multilateral agencies like the international development banks (World Bank, IFC etc.) and regional development banks (Asian Development Bank) (ii) bilateral agencies, such as the different governmental agencies. The non-official channel comprises the borrowing and the lending streams such as the international banks on the one hand, and the securities market on the other. International banks, thus, occupy an important position as a non-official funding agency. In this lesson we

will study their development, reasons behind their emergence, their different organisational formats etc.

### 2.5.2 Objectives

The main objective of the present lesson is to familiarize the students with the concept of international banks. We have already mentioned that the development of MNCs has necessitated the flow of finance beyond the physical boundaries of any country. International banks have become a major source of such finance. How these banks have undergone a structural change over the years, what were the motivating factors behing their emergence and development, all this will be dealt with in this lesson. The student will also obtain information regarding the scope of international banking, lending by international banks, and also the need to control such banks despite their usefulness, in the present lesson.

### 2.5.3 Development of International Banks (Structural Changes)

This essentially means the structural changes that these banks have undergone, especially since the twentieth century. These changes can be broadly divided into three main parts, as discussed below:

#### 2.5.3.1 Traditional international banks

Beginning from the first half of the twentieth century and till the late 1950s, international banks were mainly domestic banks performing the functions of international banks. In other words, they operated in foreign countries accepting deposits from and making loans to the residents of the host countries. They dealt in the currency of the host countries, and at the same time, dealt in foreign currency also to make finance available for foreign trade transactions. The traditional international bank is subjected to the rules and regulations of the host country. The deposits and loans of these banks are remunerated at the interest rate set by the interest rates prevailing among the domestic banks in the host country.

#### 2.5.3.2 Euro Banks

Towards the early 1960s, banks with purely international character emerged. These banks came to be known as Euro Banks. Such banks deal with both the residents and the non-residents, but they deal essentially in any currency other than the currency of the host country. For example, a Euro bank located in London will deal with any currency, but not the British Pound. Also, unlike the traditional international banks, the deposits and loans of the Euro bank are remunerated at the interest rate set by the market forces operating in the Euro-curency market. (Euro-currency market is concerned with the deposit and lending operations conducted by banks in currencies other than those of the countries in which the banks operate). The Euro banks are free from the rules and regulations of the host country. This is because Euro banks do not have an impact on the domestic economy as they are concerned with placement of funds (which is in form of foreign currency) from one foreign market to the other and hence do no affect the balance of payments

of the host country.

One of the reasons for the emergence of Euro Banks was that after Stalin's death, the then USSR moved towards an expansion of trade with the West and the South. Since the US Dollar was the most powerful and used currency in international transactions, the USSR also used and earned dollars through trade. But due to the cold war between USSR and USA, the former deposited its earned dollars in banks outside USA. The preferred banks were mostly in London and other European countries, because of their superior infrastructure and stable political climate. These dollar deposits came to be known as Euro Dollars, and the banks accepting such deposits were now known as Euro banks.

Moreover, due to the foreign exchange crisis in 1955-57, the British government placed restrictions on the use of pound sterling for external transactions and the dollar was in great demand in the UK for external transactions. Also, the emerging convertibility of some European currencies by late 1950s led to the emergence of an active foreign exchange market in Europe linking the US dollar with those currencies. These links enhanced the use of US dollar by the banks located in Europe.

Apart from this, some other factors like the introduction of Voluntary Foreign Credit Restraint Programme in 1965, limiting the ability of US based banks to lend directly to non-residents also supported the opening of foreign branches of US banks, mainly in Europe. Further, restrictions imposed by the European governments on holding of deposits by non-residents in domestic currency and on paying of interest on non-resident deposits encouraged non-residents to hold deposits in Euro banks (which were not subject to such restrictions).

All these factors led to the emergence and spread of Euro banks.

**2.5.3.3 Off-shore Banking Centres (OBCs)**

In the 1970s emerged another type of international banks, which came to be known as off-shore banking centres (OBCs). OBCs dealt only with non-residents, and did not deal in the currency of the host country. OBCs channelled funds from one country to another without influencing the domestic financial market.

OBCs mainly came up in places/countries where governmental control and regulations were non-interfering, tax rates were low, necessary infrastructure existed and where economic and political conditions were stable. Hence, places like London, Singapore, Hongkong, Luxembourg, Bahamas, Kuwait, Bahrain etc. attracted OBCs.

In its purest form, an OBC offers some banking services to local residents but its reason for being is to allow non-residents to conduct banking operations with minimal government control. The country in which such a centre is located derives some income and employment from the centre's activity, and its government obtains some revenues from the taxes, fees and other charges levied on the banks that avail themselves of its hospitality.

A common feature of off-shore banking is the use of shell branches, which are nothing more than booking offices. Upon payment of a low fee and meeting minimum capital requirements, a bank can set up an OBC that requires only a handful of employees and an office with good communication facilities. All of a shell's transactions are worked out elsewhere, and yet a country in which transactions are booked is considered, from the legal perspective, to be the home of resulting financial obligations.

In some OBCs, private banks play a prominent role. The clientele of these facilities consist largely of wealthy individuals who find it advisable to arrange for the management of at least some of their wealth outside their home countries.

**2.5.3.4 Syndication of Lending**

Another structural change that took place during the 1970s was in the form of syndicated lending. This development mainly took place in the wake of the international oil price rise, when a number of oil-importing countries had to resort to bigger loans which were not within the capacity of a single bank to provide. The banks then joined hands for providing these large loans and to reduce the individual risk of lending. Such lending came to be known as syndicated lending.

In syndicated Euro currency market lending, a bank known as the lead manager or loan arranger assumes primary responsibility for working out the loan terms and bringing in other banks, known as participating banks, to share in the loan. Frequently, one or more banks other than the lead manager play some role in these arrangements. Such banks are known as co-lead managers to distinguish them from participating banks. A co-manager's main distinction is that it often accepts a larger share of the loan. In addition, a bank known as the agent bank, which is likely to be a managing bank, oversees the loan by collecting payments due and distributing them to the other lending banks.

To achieve and hold a high ranking as a syndicated Eurocurrency loan arranger is an important objective for banks that participate heavily in international lending. This is largely because of the fee income that is generated directly by the loan arrangement process.

After studying the changing structure of international banking in different forms, let us study the motivating factors behind the banks going international.

**2.5.4 Motivating factors**

Banks' international lending has expanded in response to several factors. Some of these factors are:

**(i) Spread of multinational enterprises**

This is basically the tendency of banks to follow their clients abroad. A particular bank serving a particular multinational corporation (MNC) prefers to accompany it. When a MNC moves abroad and sets up its subsidiaries in different countries the bank too moves there to provide banking services to its clients. Since that bank is close to the parent company, it can provide necessary services to the

client in a better way. In this regard the bank enjoys an edge over other banks.

**(ii) Differences in the cost of capital**

Another reason responsible for internationalisation of banks is the difference in the cost of capital among different countries. Since capital is abundant in industrialised countries, its cost is low. In developing countries, capital is scarce and hence its cost is high. Naturally, a bank moves its operation from an industrialised country to a developing country.

**(iii) Gain from portfolio diversification**

The process of diversification brings in stability in profits of the banks and also reduces their systematic risk. The more the spread of a bank over different countries, the greater the diversification it derives.

**(iv) Increasing custodial function**

Custodial services are granted to clients who make investment in overseas securities. The banks have to collect the securities, collect dividend and offer other related services. The rapid growth in such services require banks to have overseas offices, and thus banks have moved abroad.

**(v) Avoidance of regulations**

Banks also move abroad to avoid reserve requirements, cumbersome reporting requirements, corporate taxes and such other regulations that are found in the domestic jurisdiction.

On the reverse, banks' international lending has also expanded as a result of encouragements from both home and host country governments.

### 2.5.5 Scope of International Banking

Commercial banks dominate forex dealing. They are predominant among financial institutions that engage in direct lending (i.e. lending that does not occur through the medium of securities). They are involved in the creation of negotiable CDs, bankers' acceptance and commercial paper (none of which are usually classified as securities).

They are increasingly prominent in the international aspects of markets in securities, not only because they lend money for purchases of securities, but also because they perform investment banking functions, borrow by issuing internationally traded securities of their own, and buy securities as investments. Included among the securities that they buy as investments are not only obligations issued by their own govts, but also securities issued by other govts. and pvt. corporations.

In investment banking, financial firms assist govts., private corporations and international organisations to raise funds by issuing securities. Investment banks manage, underwrite, and serve as marketing agents for new security issues. As underwriters, they temporarily purchase securities from their issuers with the intention of reselling them for profit net of the underwriting fees that they receive.

Merchant Banks blur the lines between commercial and investment banking.

They are largely British in origin, and historically associated with trade financing. These firms typically conduct deposit banking while simultaneously engaging in operations with new security issues that are associated with investment banks.

Deposit and direct lending operations of merchant banks are confined almost exclusively to their corporate and governmental clients. They have very limited retail commercial banking ties with the general public.

Some merchant banks, like some investment banking firms, and even some commercial banks, have attained prominence as investment managers for institutional investors notably pension funds.

Supplementing operations of commercial, investment and merchant banks are those of various govt. agencies and international organizations that are in the broad sense of the word, "banks" (IMF, World Bank group). These are divided as those that are primarily concerned with financing trade, and those that are primarily concerned with financing economic development. In general, official banks that finance trade tend to be govt. owned institutions designed to stimulate exports. Development banks are often jointly operated by various govts. for the benefit of particular world regions, but also common are institutions run by a single govt.

Let us now test our knowledge gained so far of international banks by answering these questions:

**SELF-CHECK EXERCISE**

**Q1: What do you know about Euro banks?**

**Q2: Why do banks go international?**

### 2.5.6 Direct International Lending (DIL) by Commercial Banks

Commercial Banks have largely dominated the activity of direct lending. The history of DIL by commercial banks is as old as the history of banking itself. In medieval times, not only did foreigners borrow from money lenders in northern Italy and elsewhere, but merchants also frequently lent to the residents of the countries to which they travelled - the dry-fruit and nuts selling 'Kabuliwala' lending to Indian residents (mostly in Bengal) is the most common example. The loans were, very often, for the purpose of movement of goods. Borrowing by rulers striving to extend and consolidate their power was not unknown.

Over the centuries, although banking practice has changed dramatically, features of banks' international lending has remained broadly similar. Such lending has tended to develop in the financial centres of countries that have accumulated relatively large pools of savings. As these countries expanded their international trade, their banks tended to increase their financing of domestic firms' imports and exports. With the expansion in the operations of trading and manufacturing firms of domestic origin abroad, domestic commercial banks tended to establish offices abroad to lend not only to these firms, but also to local firms that either had business ties to domestic firms, or were otherwise engaged in international trade.

International banking has had its most spectacular growth since the late 1950s. We already have studied the structural changes and motivating factors behind internationalisation of banks.

Although most of the direct international lending by banks is effected through the Eurocurrency market, a large volume of such lending can be classified as traditional. International lending which is traditional is subject to the conventions of domestic lending. In the United States, the prime interest rate is used as a benchmark loan rate for both international and domestic bank loans (the conventional definition of prime rate is that it is the short-term rate charged by US banks to their best or prime business customers). In Eurocurrency lending, the benchmark bank lending rate is the LIBOR (London interbank offered rate).

The prime rate and the LIBOR are not strictly comparable, because U.S. banks often require business borrowers to maintain minimum amounts, known as compensating balances, on deposit. No such balances are required in Eurocurrency lending. However, the interest rate is the key factor in the choice between Eurocurrency borrowing and traditional borrowing. Although the tilt is usually towards the Eurocurrency market, traditional borrowing is favoured when a foreign firm wishes to cultivate a relationship with a particular local bank.

Traditional bank borrowing commonly finances international trade. One reason for this is that governments commonly sponsor credit insurance programs to stimulate exports by protecting lending domestic banks and exporting firms from the commercial and political risks associated with credit purchases of exports. Also, small scale borrowers involved in international trade tend to rely on traditional financing sources. Traditional borrowing also has an edge over Eurocurrency market in terms of convenience and familiarity.

Although the Eurocurrency market and traditional banking markets are imperfect substitutes, they are close enough that traditional banking markets are greatly affected by developments in the Eurocurrency market. Growth in the Eurocurrency market is, many times, at the expense of the traditional market.

### 2.5.7 Alternative Organisational Formats for International Banking

The process of internationalisation is a complex one, and in deciding how to arrange their international operations, commercial banks can adopt various organisational forms. The choice depends on a bank's goals, its volume of business and the rules and regulations in the host country. The different forms and ways in which a bank goes international are:

#### 2.5.7.1 Correspondent Banking

A correspondent banking relationship exists when a bank uses the services of another bank with a separate corporate identity that is located in another city or country. The latter performs all the transactions on behalf of the former. The relationship is often reciprocal. The services include forex transactions, originating and processing of

bills of exchange, providing credit information about potential borrowers, etc.

Correspondent banking system does not involve additional establishment cost. With a given outlay a bank can achieve greater geographic coverage in its operations with correspondents than by using some other alternative. The host coutry bank is frequently in touch with the local customers, the benefit of which is reaped by the international bank.

The main disadvantages of this system is that the host-country bank does not always prove sincere, as it is more concerned about its own business. There is a lack of full control and the range and extent of services offered is limited.

**2.5.7.2 Representative Offices**

This is a medium of internationalisation in those cases where the host government does not permit any branch of a foreign banking company or provides only a limited entry for the foreign banks. These offices are mainly to conduct operations that do not requrie deposit and lending facilities in the host countries. Representative offices locate potential borrowers, furnish intelligence about local business conditions, and provide assistance to clients who either do business in the host countries or are interested in doing business there.

The greatest advantage of representative offices is that the cost of operation is minimum. But the disadvantage is that it cannot penetrate deep into the foreign market.

**2.5.7.3 Foreign Branches**

A foreign bank branch is a deposit banking unit that is legally an office of a corporation that is headquartered in a country other than the one in which the unit operates. This format offers the best possibilities for achieving unified and efficient full-service banking across international boundaries. A branch office can lend far greater sums than it can generate from its own resources because the resources that are potentially at its disposal are those of the entire corporation.

A major factor behind the extensive reliance on the branch format in foreign banking operations is that it provides greater security to a bank's customers than separately incorporated banking units. The branches perform all types of banking functions.

Since foreign branches are not incorporated units, they are subject to home country regulations that apply to the companies of which they are parts.

**2.5.7.4 Foreign Banking Subsidiaries**

Opening up of subsidiaries or affiliates is another way of going international. Under this process the parent bank pariticipates in the equity capital of the host country bank. One advantage of this mode is that the parent company has control over the functioning of the subsidiary and is able to implement its policy. Due to the existence of the host-country bank, it comes easily in contact with the local customers. But often, there is a conflict between the parent company and the subsidiary on the issue of implementing a particular policy.

**2.5.7.5 Consortium Bank**

When the volume of business is very large and beyond the means of a particular bank, a few international banks come together to set up a consortium bank in a host country. It represents a separate establishment. The different parent units represent on the board of control according to their investment in the capital stock of the consortium bank. The consortium bank suffers from the disadvantage that sometimes conflict arises among the parent units, which impairs their functioning.

Let us attempt to answer a few questions now:

**SELF-CHECK EXERCISE**

**Q1: Discuss foreign branches as a format for international banking.**

**Q2: Briefly explain direct international lending by commercial banks.**

### 2.5.8 Control of International Banks

Although international banks have several advantages, there is also a need to control their activities. The control involves two issues - why should they be controlled, and secondly, how should they be controlled.

There are four main reasons as to why should these banks be controlled.

(i) International banks encourage inflation because they add to the stock of money through credit creation.

(ii) Sometimes, these are responsible for bank failures because they siphon off suddenly a large amount of cash to other countries and create liquidity problem in the banking sector.

(iii) International banks charge high interest rates causing unmanageable indebtedness among the borrowing governments.

(iv) They do not adhere to the credit allocation policy of the host government, hence do not normally participate in the social objectives of the host country government.

The other issue that arises is the mode of control of international banks. One way to control these is to control their activities by imposing statutory reserve requirements on them. This will ensure equity between them and the domestic banks. It will also help to control the money supply vide the national monetary policy. It may also encourage business to be conducted on-shore, which may be advantageous for the national authorities.

However, imposition of reserve requirements by a few governments cannot be effective as international banks will move their offices to countries with less restrictive regulations. So it is necessary to have a consensus on this issue among the host governments.

Another way of control is to impose some control on the convertibility of currency. It is suggested that payments in foreign currency should be approved by the monetary authorities of the host country, but again, it will be very difficult to monitor thousands of transactions.

Moral persuasion is one way in which international banks should be urged

not to take steps that dilutes the interest of the host country or its banking sector.

Hoever, the best way to control international banks is to raise the operational standard of the domestic banking industry so that it can face the challenges posed by the international banks.

### 2.5.9 Summary

International banks have come a long way and undergone substantial structural changes. Factors responsible for internationalisation of banks have been the tremendous growth in international trade and in the activities of the multinational corporations. International banks operate abroad through various organisational formats. Since the functions of international banks are not stricly regulated, they do not always act in the interest of the host country. Hence there is a need for control on their activities.

### 2.5.10 Suggested Readings

(i) John S. Evans : International Finance: A Markets Approach

(ii) V. Sharan : International Financial Management.

### 2.5.11 Questions for practice

**(A) Long-Answer Questions**

1. Discuss the alternative organisational formats for international banking.
2. Trace the structural changes that have taken place in the development of international banks.

**(B) Short-Answer Questions**

1. Give the scope of international banks.
2. Why should international banks be controlled?
3. Write a brief note on off-shore banking centres.