UNIT 14 INTERNATIONAL FINANCIAL SYSTEM—AN INTRODUCTION

Structure

14.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the need for international finance
- Describe the structure of international finance.
- Discuss the working of the foreign exchange market
- State the nature and working of international mdney and capital markets
- Describe the role of leading international financial institutions.

14.1 INTRODUCTION

International financial system refers to the system for the flow of funds between nations. The need for the flow of funds arises on account of two reasons. First, the trade between the nations often requires international transfer of funds. Since trade rarely assumes the form of barter, there is normally either a surplus or a deficit in the balance of trade of a country. This will require transfer of funds between the countries. A second category of transfer of funds from one country to another involves long-term capital flows. These may be at both the government and the private levels. In this unit you will study the need for international financial flows as well as the institutional arrangement that exists to facilitate such flow of funds. In particular, you will study the functioning of foreign exchange market, international money and capital markets, roles of the International Monetary Fund, and the, World Bank and its affiliates.

14.2 NEED FOR INTERNATIONAL FINANCE

The need for international finance is of two kinds: 1) short-term, and 2) long-term.

The balance of payments of almost all countries are invariably in disequilibrium. This implies that there is either a surplus or a deficit in the balance of payments. This would require flow of short-term funds from a surplus to a deficit country. On the other hand, flow of long-term capital between the countries is guided by two factors: 1) the foreign capital needs of developing countries and 2) the investment opportunities available abroad, Now let us discuss in detail about short-term requirements and long-term requirements separately.

14.2.1 Short Term Flow of Funds

As discussed earlier, the need for short term flow of funds at their international level arises from the disequilibrium in the balance of payments of the various countries. But what does this disequilibrium mean? The balance of payments of a country refers to the net claims of a country against the rest of the world arising from the transactions over a certain period. **When these claims are positive, the balance of payments is said to be favourable, while if these claims are negative the balance of payments is termed as unfavourable.** In order to follow this statement, it is necessary to understand the hook-keeping of the balance of payments. In Table 14.1 given below, accounts of a country's balance of payments have been presented in a summary form.

Table 14.1
Account of a Country's Balance of Payments (An Illustration)

Receipts (Credit)	Amount ($)	Payments (Debit)	Amount ($)
Exports of goods	1,300	Imports of goods	1,400
Exports of services	140	Imports of services	120
Unilateral receipts	160	Unilateral payments	40
Capital receipts	300	Capital payments	400
Exports of gold	100	Imports of gold	40
Total receipts	2,000	Total payments	2,000

The balance of payments of a country involves double entry book keeping and is, thus, always in balance. This implies that total receipts are equal to total payments. If you look at Table 14.1 carefully, you will observe that both credit and debit sides have the same total, that is $2,000. Still the balance of payments of this country may not be in equilibrium and may require flow of short-term funds between this country and the rest of the world. This is really a paradoxical situation and it deserves careful attention. Since this is a somewhat complex situation, it is necessary for us to consider each item of the balance of payments account separately.

1) **Commodity exports and imports** : In the balance of payments accounts of a country the most important item is commodity trade, i.e., exports and imports. While commodity exports from a country create claims on importing countries, commodity imports result in debt obligations to the countries which have exported goods to this country. Unless exports and imports are done by a country strictly on barter basis, they are not equal. Even in cases where foreign trade is planned and regulated by the government of a country, there may be either a deficit or a surplus in the balance of trade of a country. This would lead to flow of short-term funds between the country and its trading partners, provided payments and receipts under the other heads (as shown in Table 14.1) do not eliminate the need for this flow.

2) **Invisibles, exports and imports** : Along with exports of goods a country also exports services in its various forms which create claims against the foreigners. All these claims appear in the balance of payments accounts of a country on the receipt side. In Table 14.1, you will observe that the exports of services appear on the credit side of the balance of payments accounts. Now, the form in which a country exports services requires some explanation. Major services items generally included in the balance of payments accounts are payments for shipping and freight services, payments for banking, insurance and brokerage services, returns on foreign investments', expenditures by the foreign tourists and the residents of the country abroad, and expenditures incurred by government agencies abroad, and the foreign government agencies in the country. Let us

consider the case of some country, say India. Suppose, shipping, banking insurance and such other services are provided by the Indian companies to foreign firms, claims would be created against them and thus these services would appear in India's balance of payments on the receipts side. Conversely when the Indian firms avail the services of foreign shipping corporations, banks and insurance companies, they would have claims against the Indian concerns and these would appear in India's balance of payments on the payments side. The same is true of other receipts and payments items.

3) **Unilateral transfers** : Unilateral transfers, such as personal remittances, gifts, grants, and indemnities, etc., do not involve any claim for repayment, and are, therefore, termed as **unrequired transfers.** These transfers may appear on both credit and debit sides of the balance of payments accounts of a country. Let us first see what unilateral transfers would appear on the credit side of the balance of payments.

   A country may receive grants and gifts from foreign governments and institutions involving no repayment obligation. In the balance of payments account, these would be shown as the receipts item on the credit side. Over the past three decades the less developed countries have received substantial grants from the developed countries. Remittances are a recent phenomenon. In India's case remittances have constituted the substantial portion of the unilateral transfers on the credit side of the balance of payments account. Indemnities and separations are not normal transfers. These were collected by the USA and its allies from Germany after World War I. These receipts appeared in the balance of payments accounts of the recipient countries of reparations. When these unilateral transfers appear on the debit side of the balance of payments account, then it means that the country has made gifts and grants, has paid reparations, and has permitted remittances.

4) **Capital receipts and payments** : Receipts and payments on account of exports and imports of commodities and services and unilateral transfers constitute the current account of the balance of payments. There is invariably a deficit or a surplus in this account. In the capital account of the balance of payments of a country, all autonomous transactions involving receipts and payments of money capital are registered'. Capital flows between countries take various forms such as borrowings, repayments of loans and foreign private and public investments. When a country receives loans or raises equity capital the amount raised is shown as capital receipts on the credit side. The repayment of loans and repatriation of foreign capital are shown on the debit side of the balance of payments accounts. Like the current account, the capital account of the balance of payments shows either a deficit or a surplus. However, it is only when we take both the current and capital accounts together that we know Whether there is a net deficit or a net surplus in the balance of payments accounts of the country.

5) **Gold movements** : Gold movements between the countries is of two kinds. First, it may be exported or imported like any other commodity. In such a case it is not to be distinguished from other commodities. In the second case gold movements are caused by the need to offset deficits in the balance of payments. When this is done, gold performs the function of the medium of exchange at the international level. In the balance of payments accounts of a country, import and export of gold are treated in the same manner as exports and imports of other goods, i.e., exports of gold are shown on the credit side while imports of gold appear on the debit side. Thus merely from balance of payments accounts one would fail to know the actual reasons for gold movements.

Having discussed the book keeping of the balance of payments, we are now in a position to follow the meaning of disequilibrium in the balance of payments. The difference between the exports and imports of a country is known as the balance of trade. **When exports exceed the imports, the balance of trade is said to be favourable.** Conversely **when imports exceed exports, the balance of trade is considered to be unfavourable.** The deficits in the balance of trade may be offset or accentuated depending upon whether the other heads have a surplus or a deficit. In Table 14.1 the country is shown to have a deficit of $60. If we consider the current account constituting trade of commodities and services and the unilateral transfers, we find that there is a surplus of $40. Since capital receipts are $300 and capital payments are $400, there is a deficit of $100 in the capital account. Considering both the current and capital accounts, we note that there is a net deficit of $60. This has necessitated a net export of gold amounting to $60. This deficit could also be offset by taking short-term loans from capital-surplus developed countries and international financial institutions like the International Monetary Fund.

14.2.2 Long Term Capital Flows

While explaining the book-keeping of the balance of payments a reference has been made to capital flows. You will now learn that the long-term capital flows are caused by the development needs of the various countries. Presently the world can be broadly divided into the capital surplus countries and the capital deficit countries. Most developed countries are the capital surplus countries, while almost all developing countries are the capital deficit countries. Since the countries falling in the latter category have not been able to save adequately for their investment requirements they import foreign capital from the capital surplus countries.

Foreign capital usually takes two main forms : i) private foreign investment, and ii) foreign aid. Before World War 11, private foreign investment was used by the colonial powers to exploit the market of the colonies. Since these colonies have become independent, the penetration of private foreign investment in its earlier form has stopped. Currently private foreign investment assumes two forms : i) direct foreign investment, and ii) indirect foreign investment. **The bulk of the direct foreign investment is now made by the multinational corporations (MNCs),** These MNCs provide substantial amount of financial resources to the countries where they set up branches and subsidiaries. The capital recipient countries thus get substantial help in meeting their needs of capital for growth. But these countries subsequently face problems when repatriation of profits by MNCs starts or the production plans of these companies start causing distortions in their industrial structure, **Indirect foreign investment takes place when nationals of a country make investments in the shares and debentures of the foreign companies.** At present most of the private foreign investment is made in the direct rather than indirect form.

Foreign aid, refers to official loans and grants given in currency or in kind from developed countries and international financial institutions to less developed countries. These loans and grants are provided for development purposes. In international finance only those loans and grants are relevant which are provided in currency. The chief characteristic of such aid is that it is made available on concessional terms implying that the rate of interest is lower and the maturity period is longer. Foreign aid rarely involves any foreign exchange problems when it is provided. Since aid is given by the developed countries in their own currencies and by the international financial institutions in the currencies of the developed countries, it can be used easily to buy capital equipment and technology in the international markets. However, the problem arises when debt servicing obligations are to be met. For this purpose aid recipient countries would need foreign exchange which they can acquire only by having surpluses in their balance of payments. This in most cases is quite difficult to accomplish. As a result most countries inviting foreign capital are now in tight corner. They have either already fallen in the debt trap or are facing the risk of falling into it.

Check Your Progress A

1) State the two main reasons why there is a need for international finance.

....

....

....

....

2) State the two main forms in which inter-country long-term capital flows take place.

....

....

....

....

3) Which of the following statements are True and which are False :

i) Balance of payments of a country is said to'be favourable if its net claims arising from all the transactions with the rest of the world are positive.

ii) Balance of trade refers to the difference between a country's commodity exports and imports.

iii) Balance of payments of a country are always in balance in accounting sense and therefore cannot be in disequilibrium.

iv) Trade deficits or surpluses do not require flow of funds between the countries.

v) Exports and imports of services and the unilateral transfers affect international flow of funds.

vi) Unless capital and current accounts parts of the balance of payments accounts of a country are considered together, 'one cannot know whether there is a deficit or surplus in its balance of payments.

14.3 FOREIGN EXCHANGE MARKET

Most countries in the present day world have open economies which means that some residents of these countries are engaged in international transactions, These transactions can be in the form of commodity exports and imports, services exports and imports inter-country unilateral transfers, capital flows and exports and imports of gold. Most of these international transactions have one special characteristic which distinguishes them from purely domestic transactions. They require use of foreign currency by the participants in the transaction. For example, an Indian firm importing goods from the USA will have to acquire dollars for meeting payments obligations. Similarly, a Canadian visiting India will have to obtain rupees in exchange of dollars which he may be carrying. The international transactions thus require exchange of one currency for another. This buying and selling of currencies take place in the foreign exchange market.

The term foreign exchange in a norrow sense refers to foreign currencies. In broad sense the term foreign exchange includes not only foreign currencies, but also bank deposits denominated in a foreign currency and short-term claims on foreigners expressed in foreign currencies. Most foreign exchange transactions, however, presently involve purchases and sales of foreign currencies and bank deposits denominated in foreign currencies.

14.3.1 Composition of the Foreign Exchange Market

The main participants in the foreign exchange markets are : 1) retail customers, 2) Commercial banks, 3) foreign exchange brokers, and 4) central banks.

1) **Retail customers :** Individuals and business firms are the retail customers. They buy and or sell foreign currencies either for transaction purposes or for adjusting their portfolios. The main transaction purposes for which the retail customers. deal in foreign currencies are commodity exports and imports, services exports and imports and buying and selling of securities. Some retail customers participate in the foreign exchange market on a regular basis only to adjust their portfolios i.e., changing the amounts of the various currencies held. Retail customers normally do not transact directly with each other. Their transactions involving buying and selling of foreign currencies are mostly with the commercial banks.

2) **Commercial banks :** The commercial bank is considered to be the most important institution operating in the foreign exchange market. Commercial* banks hold foreign exchange inventories which enable them to transact in foreign

currencies with the retail customers. If a retail customer buys foreign exchange from the bank, the latter's holding of foreign exchange diminishes. Conversely when the retail customer sells foreign exchange, the bank's foreign exchange holdings increase. The process of buying and selling of foreign exchange by the retail customers to commercial banks goes on continuously. It sometimes results in excess foreign exchange reserves with the commercial banks while at other times there may be shortage of foreign exchange with them. Moreover at any given time while some banks may have excess holdings of foreign exchange, the other banks may be facing shortage of foreign exchange. Under these circumstances commercial banks transact in foreign exchange with one another.

3) Foreign exchange brokers : In certain countries the most notable being the USA, commercial banks do not transact in foreign exchange directly with each other. They usually acquire the services of foreign exchange brokers for this purpose. The brokers themselves do not transact in the foreign exchange. Their main function is to bring together the banks which are wanting to buy foreign exchange with those which are wanting to sell it. Therefore the role of the brokers is that of inter-bank intermediaries. While performing this function, the brokers do not bear any risk arising from exchange rate fluctuations. In fact, this risk is borne by the commercial bank which as dealers of foreign exchange are required to hold foreign exchange inventories.

4) Central banks : A country's central bank is an important participant in the foreign exchange market. Its activity is guided mainly by two purposes : i) to support the domestic currency in the foreign exchange market, and ii) to regulate the amount of the country's foreign exchange reserve. However, to achieve its objectives the central bank generally does not operate in the foreign exchange market directly. It often relies on the services of commercial banks and foreign exchange brokers for its transactions in foreign exchange.

14.3.2 Spot and Forward Markets

The foreign exchange market is one of the largest markets in the world. You can imagine the size of this market from the fact that its daily trading volume exceeded $100 billion level in recent years. Foreign exchange markets are often classified as spot markets and forward markets. This distinction is essentially in respect of time of delivery of foreign exchange and payment for it. In spot markets, transactions involving the purchase and sale of foreign currencies are done for immediate delivery. In practice; this often takes one or two days' time, but in no case more than this. The exchange rates used for these transactions are the prevailing exchange rates and are characterised as spot exchange rates. Individuals when they wish to go abroad or want to remit their savings to their native countriesbuy foreign exchange in the spot market. However, for trading purposes buying and selling of foreign exchange in the spot markets may not be entirely safe. Since exchange rates are found to fluctuate over time an importer will have to safeguard his interest against these possibilities by buying foreign exchange in the forward market. Suppose, an Indian firm hopes to receive delivery of goods from an American firm after 30 days. This firm has two options for arranging the payment. First, it buys dollars in the spot market at the time of delivery of the goods. Alternatively, it makes a contract today to buy dollars in 30 days. The first option is risky. Suppose, between the time of placing the order and receiving the delivery the rate of exchange changes in an unexpected manner rising from Rs. 18.00 to Rs. 19.00 per dollar. It can inflict heavy losses on the Indian firm if it had decided to buy dollars in the spot market at the time of the delivery of goods. This loss, however, can be avoided if the Indian firm buys dollars in the forward market for future delivery and payment at a rate of exchange determined today. The importance of the forward exchange market in international finance is great, since most transactions in foreign exchange really involve forward transactions.

14.3.3 Exchange Rate Regimes

In the earlier section, we have referred to spot and forward exchange rates. You must be wondering as to how the exchange rates are determined. Further, why do exchange rates change and is there any system whereby the fluctuations in them can be prevented?

Economists generally distinguish among three basic types of exchange rates regimes. A brief description of these-will provide answers'to the questions posed above. You will learn more about them in Unit 15.

1) **Freely flexible (or free-floating) exchange rate regime : A** system of freely flexible exchange rates is characterised by exchange rates **which fluctuate** freely in response to demand for and supply of foreign exchange. This system is the least complex of exchange. rate regimes. **The principal advantage of freely flexible exchange rates is that they adjust automatically to secure equilibrium in the balance of payments.** Since freely flexible exchange rate system does not provide for official intervention to support exchange rates, it freely responds to changes in the factors underlying the demand for and supply of foreign exchange. But this also implies that freely flexible exchange rates are highly volatile. Their principal disadvantage is, therefore, that they transmit price instability and thereby discourage trade and reduce economic welfare.

2. **Fixed (or pegged) exchange rate regime : A** fixed exchange rate regime is characterised by a stable exchange rate within well defined narrow limits through official intervention. Under this system exchange rates are not permanently fixed. They can be changed (though not frequently) in response to structural changes which result in persistent balance of payments deficits or surpluses. To begin with, an exchange rate under the **fixed** exchange rate regime is determined keeping in view the balance of payments positions of the countries in question. In fact, it is balance of payments position of a country which decisively determines the demand for and supply of its currency and in turn its value in terms of other currencies. **The main advantage of a fixed exchange rate system is that by providing stability to exchange rate it eliminates a source of uncertainty in international trade.** The main disadvantage of the system is that it makes restoration of equilibrium in balance of payments difficult.

3) **Managed (or controlled) floating exchange rate regime :** Managed floating exchange rate regime refers to a system in which rate of exchange is adjusted through government intervention quite frequently in response to changes in the foreign exchange market. The government, however, does not commit itself to maintaining a certain fixed exchange rate. Its attempt is limited to preventing wild fluctuations in the exchange rate. This policy results in orderly changes in the exchange rate. **The main advantage of this system is that it does not result in large deficits or surpluses in the balance of payments of any country unless it has some structural problems.** It also avoids the uncertainty and volatility of the freely flexible exchange rate system and instability associated with the infrequent adjustments characterising the fixed exchange rates regime.

Check Your Progress B

1) Distinguish between spot and forward exchange markets.

....

....

....

....

2) List the main participants in the foreign exchange markets.

i) ....

ii) ....

iii) ....

iv) ....

3) Name the three basic types of exchange rate regimes.

....

....

....

4) Which of the following statements are 'True and which are False

i) Retail customers generally transact in foreign exchange directly.

ii) Commercial bank is the most important participant in the foreign exchange market.

iii) Spot foreign exchange transactions involve immediate delivery of foreign exchange and payment.

iv) In a forward market the price at which currency is traded is set concurrently with the payment and delivery of the currency.

v) A freely flexible exchange rate regime exists whenever exchange rates are freely detennined by the demand for and supply of currencies by private parties.

vi) In a system of fixed exchange rates under no circumstances rates of exchange arc allowed to change.

vii) The system of managed floating is an attempt to combine the advantages of fixed exchange rates with the flexibility of freely floating exchange rates.

14.4 INTERNATIONAL MONEY AND CAPITAL MARKETS

Money and capital markets are an integral part of any financial system. Their role is quite important in international finance. You rnust be aware that well-developed money and capital markets exist in many world cities, but in major international financial centres like London and New York, they attract funds from all over the world. Therefore, the financial capabilities of the major money and capital markets are great and the funds available with them are used by a variety of domestic and foreign groups on an extensive scale.

14.4.1 Money Markets

A money market refers to a market for transacting in financial assets of relatively short-term maturity. These include demand and time deposits, treasury bills, trade bills, acceptances and a variety of other short-term claims. A **money market provides an outlet for funds to those lenders who wish to keep their financial resources liquid.** For example, people rnaking deposits with the commercial banks can withdraw their money any time. Similarly investments in treasury bills are highly liquid due to their easy marketability. In the absence of a money market, all funds kept in liquid position will remain idle. The money market is of great importance for the borrowers who need funds for a relatively short period, particularly for self-liquidating projects.

Short-term funds are made available in the money market by a variety of domestic and foreign groups among which the most notable are commercial banks, non-bank financial institutions, corporations and other business firms, the central banks, governments and individuals. The demand for short-term funds also comes from these institutions and individuals. Major money markets which have emerged as the international financial centres, are closely integrated with the foreign exchange markets. In these centres a large share of the funds is used for financing the foreign trade and movement of services between the countries.

In the absence of strong exchange control measures, a **money market would be highly sensitive to international differences in interest rates.** If the interest rate is higher abroad, there will be an outflow of short--term funds. However, the extent of such an inter-country flow of short-term funds largely depends on interest rate differentials which should be large enough to offset the cost of currency conversion and forward contracts. A **second factor having considerable bearing on the flow of short-term funds is the degree of external disequilibrium.** Generally short-term funds have a tendency to move from a country with a weak or depreciating currency due to its chronic balance of payments problem to a country with a strong currency. During the post-World War II period, governments of many less developed countries had prevented this flow of funds by resorting to stringent exchange control measures. Finally, domestic disturbance and political instability also results in large outflow of funds. The flight of capital from many less developed countries in recent year's can be explained only in these terms.

Mobility of short-term funds is generally desirable and is normally stabilising in nature. However, it may not always be so. In case of a country faced with persistent deficit in its balance of payments a large outflow of its funds may prove destabilising. That is why the governments often do not permit sudden international shifting of short-term funds.

A money market acquires international character when there is a worldwide general acceptability and use of the domestic currency of that country to which this market belongs. This confidence in the currency of a particular country results in a situation where these money markets develop as major centres of foreign exchange reserve. Before World War II the London money market was a leading reserve centre. However, its importance as an.international financial centre was weakened due to UK's decline as an economic pbwer. After World War II the New York money market emerged as the leading reserve centre. This was natural due to dollar's convertibility into gold and the supremacy of the USA as an economic power. It is interesting that since many countries hold their reserves in a particular country, the transfer of short-term funds from the former makes the latter a net debtor on the short-term capital account. This in course of time creates the confidence problem in the reserve currency. It actually happened during the early 1970s when the confidence was shaken in dollar and it was exchanged for other strong currencies in huge amounts.

Apart from the central banks of the various countries which hold their foreign exchange reserves in the international reserve centres, commercial banks and business firms also hold short-term claims as working balance against the major reserve centres. The financial institutions at these centres are, well organised and thus always find profitable investment outlets for these funds.

14.4.2 Capital Markets

In contrast to the money market which covers dealings in short-term claims to assets, **the capital market deals in long-term claims to** assets, **such** as **government bonds, and corporate shares and debentures.** In any capital market there are four broad categories of the suppliers of long-term funds : 1) individuals, 2) commercial banks, 3) non-bank financial intermediaries (like insurance companies, investment trusts, unit trusts and pension and provident funds, and 4) development banks. The demand for long-term funds in most countries comes from individuals, unincorporated concerns, business corporations, public corporations and the governments.

Capital markets now exist practically in all those countries where some industrialisation has taken place. However, the major capital markets in the leading industrialised countries have acquired international character. From this point of view the New York capital market now enjoys a unique position. London was the principal capital market in the late eighteenth and the nineteenth centuries. Its importance vis-a-vis the New York capital market has been less in the twentieth century due to the decline of the UK as an economic power.

Inter-country movement of long-term capital is considered to be conducive to a high level of investment and production. The major capital markets which have emerged as the international financial centres channelise long-term investment to countries where they have optimal commercial use. In New York and London, investment banking firms play a significant role in promoting the sale of new foreign securities. They often underwrite the foreign issues. In the USA, the UK and the countries of western Europe, apart from the new issue market for foreign securities, a secondary market for foreign securities also exists. Securities issued by foreign corporations are traded in the stock exchanges and over-the-counter markets of the North American and West European countries.

International movements of long-term capital were restricted by the government of many countries in the post-World War II period. There were two reasons for adopting this policy:

1) On account of the inglorious role of the foreign private investment in the past, many countries with their newly-won independence looked at import of foreign capital with suspicion and thus imposed restrictions on it.

2) Since the foreign private capital was more interested in quick yielding sectors, it was expected to create distortions in the economic structure of the host country.

However, in course of time controls on capital flows were relaxed. Consequently, the flow of long-term private funds between the countries has increased. Since capital flows are guided largely by the amount of returns, more private capital has moved between the various developed countries than from the developed to the developing countries. The explanation for this is simple. Because of very low level of income in developing countries, the size of market tends to be small. The inducement to invest in these countries is, therefore, much less than in the developed countries. Perhaps this explains why the substantial portion of long-term capital flows from developed countries to less developed countries are channelled through government and its agencies.

Check Your Progress C

1) Distinguish between a money market and a capital market.

....

....

....

....

2) State which of the following statements are True and which are False:

i) Financial assets of relatively short-term maturity are transacted in a money market.
ii) A money market is generally insensitive to interest rates differentials at the international level.
iii) International mobility of short-term funds is normally stabilising
iv) At present the London money market is the most important reserve centre.
v) In case a country's money market emerges as a leading reserve centre, the country itself will become a net debtor on the short-term capital account.
vi) It is unlikely that the reserve currency will ever face confidence problem.
vii) Long-term claims to assets are transacted in a capital market.
viii) International movement of long-term capital is not conducive to a high level of employment.
ix) Presently the importance of the New York capital market is less.
x) Major capital markets which have emerged as the international financial centres facilitate inter-country movement of long-term capital.

14.5 INTERNATIONAL FINANCIAL INSTITUTIONS

International financial institutions are an important component of the existing international financial system. From this point of view the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), better known as the World Bank, are particularly important. The decision to set up these institutions was taken at the Bretton Woods Conference held in 1944. In the present section you will learn briefly about their objectives and working. The subsequent units (Units 15 and 16) will deal with these institutions in detail. Presently, the World Bank has two affiliates: 1) the International Development Association (IDA) and 2) the International Finance Corporation (IFC). Although these two institutions have separate existence, yet they have some organisational links with the World Bank and in essence play a complementary role.

14.5.1 The International Monetary Fund

The IMF is now about four and a half decades old. Its main objectives as they are listed in the Articles of Agreement are promotion of international monetary co-operation and international trade in order to realise high levels of income and employment. From this point of view the IMF would attempt to promote exchange rate stability, discourage adoption of exchange controls, assist member countries to restore equilibrium in balance of payments and develop a multilateral system of payments.

The architects of the IMF were aware that these objectives were difficult to achieve; these were, therefore, considered mainly as guidelines for the general behaviour of the member countries. Ever since the IMF was set up the members of the IMF have found it difficult to eliminate exchange controls. Some countries persistently had deficits in their balance of payments due to structural factors, such as lack of energy resources, basic raw materials, shortage of food etc. These countries in any case cannot remove exchange controls completely. Attempts were made by the IMF to prevent frequent changes in exchange rates for about two and a half decades by recourse to a system of fixed exchange rates. The system of fixed exchange rate, however, broke down when some leading countries in violation of the rules floated their currencies in the early 1970s. Exchange rate stability is no longer an objective of the IMF. The IMF, however, has helped member countries by granting loans from its resources to the member countries to correct temporary maladjustments in their balance of payments. The IMF does not provide funds to any member country for correcting a fundamental disequilibrium in its balance of payments. The objective of developing a multilateral system of payments has always eluded the IMF.

14.5.2 The World Bank

The International Bank for Reconstruction and Development (IBRD), also known as the World Bank, was set up in 1945 as a twin institution of the IMF. It was in fact the first attempt to regulate long-term capital movements among nations in an orderly manner to accomplish some pre-conceived long range plans. Its objectives are: 1) to assist less developed countries in need of capital, 2) to provide resources' to countries devastated by war, 3) to facilitate flow of private capital among the countries and 4) to create conditions conducive to international trade between the countries. Thus the architects of the World Bank had set noble goals before it. Notwithstanding the useful services which the World Bank has rendered in facilitating international flow of capital, its activities have invited criticism due to its partisan approach in determining terms and conditions of loans, high rates of interest and bias against less developed countries of Asia and Africa. Most experts now agree that the conservative practices of the World Bank are not always appropriate to the more complex situations of some of the developing countries. The World Bank should have shown greater flexibility and dynamism in channelling funds to these countries.

14.5.3 The Affiliates of the World Bank

The International Development Association (IDA) and the International Finance Corporation (IFC) are the two affiliates of the World Bank. Legally and financially their entities are separate from that of the World Bank.

The International Development Association

The IDA was set up in 1960. The need to set up the IDA was felt long ago. In the late 1940s it was recognised that there was a need for establishing an international agency for financing the development of less developed countries on relatively easy terms. The IDA was set up precisely for this purpose, In fact, its creation highlighted three important points: i) It is a step to institutionalise the concessional finance for development purposes; ii) it has made poverty and economic backwardness in underdeveloped countries a matter of concern for the developed countries of the world; and iii) by improving the economic capabilities of the less developed countries, it attempts to promote a system of multilateral trade and payments.

The membershipof the World Bank is a prerequisite for the membership of the IDA, Any member of the World Bank can join the IDA. However, if he ceases to be a member of the World Bank, its membership of the IDA is automatically terminated, The members of the IDA are divided into two groups, viz., Part I and Part II. Part I countries are the developed ones and Part II are the less developed ones. This categorisation has been made to determine the basis for flow of funds from the richer members to the poorer members of the IDA. Presently, **the IDA is usually referred to as the soft loan window of the World Bank. It underlines the fact that its terms**

and conditions of loans are easy and concessional. The idea underlying the concessional terms and long maturities of the loans given by the IDA is that they should not be burdensome on balance of payments of the borrowing countries.

The International Finance Corporation

The IFC was set up in 1956 to help accelerate economic development of its member countries, particularly in less developed areas by encouraging the growth of productive private enterprise. It thus supplements the activities of the World Bank. In order to realise this purpose the IFC assists productive private enterprise in developing countries in association with private investors. It does not seek guarantee of repayment by the governments of these countries. The IFC also attempts to bring together domestic and foreign private capital and management and tries to create conditions conducive to the flow of private capital, both domestic and foreign, into productive investment in member countries.

The role of the IFC is thus to generate private resaurces for development projects. Left to market forces these resources would not be forthcoming. The IFC promotes productive private investment in three ways: a) by direct investment; b) by obtaining additional foreign and domestic capital; and c) by providing technical assistance. Though the IFC's preference is generally for private enterprise, it sometimes invests in enterprises in which both private and public sectors happen to participate. The IFC, however, invests only in those developing countries where sufficient private capital is not available on reasonable terms.

The membership of the IFC is open only to those countries which are members of the World Bank. If a country ceases to be a member of the World Bank, its membership of IFC terminates automatically.

Check Your Progress D

1) Name the two major international financial institutions.

   i) ....

   ii) ....

2) Which are the two affiliates of the World Bank?

   i) ....

   ii) ....

3) State which of the following statements are True and which are False:

   i) The IMF mobilises long-term foreign capital for the development projects of the less developed countries.
   ii) The IMF has succeeded to an extent in helping the member countries to correct temporary mal adjustments in their balance of payments.
   iii) The World Bank provides funds to member countries to correct fundamental disequilibrium in their balance of payments.
   iv) The World Bank assists less developed countries in need of capital for their development projects.
   v) The IDA provides development aid to less developed countries on concessional terms.
   vi) The IFC is usually referred to as the "soft loan window" of the World Bank.
   vii) The IFC was set up to further economic development in less developed countries by encouraging the growth of the productive private enterprise.
   viii) The membership of the IDA is open to only those countries which are the members of the World Bank.

14.6 LET US SUM UP

International financial system refers to the system of flow of financial resources among the nations. The need for international financial flows arises from the disequilibrium in the balance of payments of the various countries, the development needs of less developed countries and the desire of the private capital to take advantage of the investment opportunities abroad. Often transfer of financial resources on account of trade deficits and imbalances in invisible account are short-term. In contrast, capital flows are long-term.

International transfer of financial resources requires use of foreign currency. Currencies of different countries are exchanged for one another with the help of foreign exchange market. The main participants in the foreign exchange markets are retail customers, commercial banks, foreign exchange brokers and central banks. Among these commercial banks are the most important participants. Retail customers do not transact directly. They meet their foreign exchange needs from the commercial banks. The central bank is the overall controller of the foreign exchange market.

Foreign exchange market is one of the largest markets. It is broadly classified into the spot and forward foreign exchange markets. In the spot markets the foreign exchange transactions are done for immediate delivery and payment, while in the forward market the foreign exchange transactions are done for future delivery and payment at a pre-determined rate.

The rate at which one currency is exchanged for another currency is called an exchange rate. For an efficient functioning of the foreign exchange market there has to be some well defined exchange rate system. Broadly there are three basic types of exchange rates systems: i) freely flexible (or freely floating) exchange rate regime; ii) fixed (or pegged) exchange rate regime; and iii) managed (or controlled) floating exchange rate regime.

Money and capital markets play an important role in international finance. A money market is a market in which financial assets of relatively short-term maturity are transacted. Some highly developed money markets have emerged as international financial centres. They are very much sensitive to international differences in interest rates. However, flow of short-term funds among the nations is often influenced by the relative strengths of the various currencies. This flow of funds is generally stabilising in nature. The capital market refers to that segment of the financial market in which long-term claims to assets are exchanged. The major capital markets of the industrially advanced countries channelise long-term investment to countries where profitable opportunities exist for them. This is largely true of the private foreign capital. Long-term loans at the government level, often known as foreign aid, are not channelled through capital markets.

International financial institutions constitute an important component of the international financial system. Presently, the two major international financial institutions are: i) The International Monetary Fund (IMF); and ii) The International Bank for Reconstruction and Development, better known as the World Bank. These institutions have existed for the past four and a half decades. The IMF assists the member countries in tackling their balance of payments problems and thereby encourages international trade. The World Bank provides long-term finance to member countries for the reconstruction and development projects. The World Bank has two affiliates, viz., the International Development Association (IDA), and the International Finance Corporation (IFC). The IDA finances the development programmes of less developed countries on easy terms. The IFC generates private resources for the development projects in the private sector.

14.7 KEY WORDS

Balance of Payments: Difference between the receipts and payments of a country, keeping out accommodating transactions.

Balance of Trade: Difference between commodity exports and imports.

Capital Market: A financial market in which long-term claims to assets are exchaqged.

Disequilibrium in Balance of Payments: A surplus or a deficit in balance of payments.—

Exchange Rate: The rate at which one currency is exchanged for another.

Fixed Exchange Rate Regime: A system of stable exchange rate within well-defined limits.

Foreign Aid: Official loans and grants.

Foreign Exchange: Foreign currencies and bank deposits denominated in foreign currencies.

Foreign Exchange Market: Market in which foreign exchange is transacted.

Forward Foreign Exchange Market: The market in which foreign exchange transactions are done for future delivery arid payment at a pre-determined rate.

Freely Flexible Exchange Rate Regime: A system of exchange, rate in which rates of exchange are allowed to fluctuate freely in response to demand for and supply of foreign exchange.

International Financial System: A system for the Bow of funds between the nations.

Managed Floating Exchange Rate Regime: A system in which rate of exchange is adjusted through government intervention quite frequently in response to changes in demand for and supply of foreign exchange.

Money Market: A market in which financial assets of short-term maturity are transacted.

Spot Foreign Exchange Market: A market in which foreign exchange transactions are done for immediate delivery and payment.

14.8 ANSWERS TO CHECK YOUR PROGRESS

A 2) i) Private Foreign Capital ii) Foreign aid
3) i) True ii) True iii) False iv) False v) True vi) True

B 2) i) Retail Customers ii) Commercial Banks
iii) Foreign Exchange Brokers iv) Central Banks
3) i) Freely flexible (or freely floating) exchange rate regime.
ii) Fixed (or pegged) exchange rate regime.
iii) Managed (or controlled) floating exchange rate regime.
4) i) False ii) True iii) True iv) False v) True vi) False vii) True

C 1) i) True ii) False iii) True iv) False v) True vi) False vii) True
viii) False ix) False x) True

D 1) i) The International Monetary Fund
ii) The World Bank
2) i) The International Development Association
ii) The International Finance Corporation
3) i) False ii) True iii) False iv) True v) True vi) False vii) True
viii) True

14.9 TERMINAL QUESTIONS

1) Discuss the factors from which the need for international finance arises,

2) Explain the paradoxical situation that in spite of the fact that the balance of payments accounts of a country are always in balance, the balance of payments itself is most of the time in disequilibrium.

3) Distinguish between the spot and forward foreign exchange markets. Why are transactions in forward foreign exchange markets done?

4) What are the basic types of exchange rates regimes? Which one in your opinion is the most appropriate for the present day conditions?

5) Discuss the role of money and capital markets in the international flow of funds.

6) What purposes arc being served by the International Monetary Fund and the World Bank and its affiliates?

Note: **These questions** will help you Io understand the unit better. Try to **write answers fo**r them. But do not submit your answers to the **University for assessment.** These are for your practice only.