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1. Learning

After reading through this module, you will be able to:

- Define the meaning, objectives, and important functions of two major international economic institutions, namely; International Monetary Fund and World Bank.
- Appreciate the role of International Monetary Fund and World Bank.
- Understand the role of International Monetary Fund and World Bank in regulating international economic environment.

2. Introduction

The global economic integration and even the development strategy of many nations are influenced by several international organizations such as the IMF, the World Bank, and the regional development banks like the Asian Development Bank. The emergence of the international financial institutions marked its way back to the early 1940s when the economic condition of most of the countries were badly hit due to the Second World War (1939-1944). In order to speed up the recovery of all the economies that were devastated as a result of the Second World War and to mitigate the challenges likely to be faced by the emerging economies, the creation of international financial institutions was pronounced by the Bretton Woods Conference held during July 1944 in New Hampshire, USA with delegates from 44 nations. International Monetary Fund (IMF) and the World Bank are the outcomes of Bretton Wood Conference.

The main objectives of the IMF are to mitigate the problems of international liquidity (i.e., to help the member countries meet their balance of payments deficits) and to achieve international monetary and macro-economic stability. The World Bank – the International Bank for Reconstruction and Development (IBRD) was established to help the reconstruction and development of various national economies by providing long-term capital assistance. The World Bank group now consists of five institutions. India is one of the founding members of the World Bank and IMF and is one of the largest beneficiaries of the IBRD-IMF assistance.

3. International Monetary Fund (IMF)

The International Monetary Fund (IMF) is an international organization that was created on July 22, 1944 at the Bretton Woods Conference and came into existence on December 27, 1945. The IMF was established as an outcome of Bretton Woods Conference with an initial membership of 29 countries and has a current strength of 188 member countries. The organization's stated objectives are to promote international economic cooperation, international trade, employment, and exchange rate stability, including by making financial resources available to member countries to meet balance of payments needs.The IMF provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability and reduce poverty.

3.1 Objectives of IMF

IMF seeks to achieve the following objectives:

1. To promote international monetary cooperation through the Fund's machinery for consultation and collaboration on international monetary problems.
2. To facilitate the expansion of international trade in order to augment employment and real income and to develop the productive resources thereby of all members.
3. To ensure stability to foreign exchange rates and avoid competitive exchange depreciation.
4. To reduce disequilibrium in the international balance of payments of member countries.
5. To promote capital investment in backward and underdevelopment countries.
6. To assist in the establishment of a multinational system of payments in respect of current transactions between the member countries.
7. To secure multilateral convertibility (i.e., to convert the currency of any member into the currency of any other member).

8. To provide short term monetary help to members during emergency.
9. To achieve balanced economic growth and high level of employment in member countries.

3.2 Key IMF activities

The IMF supports its membership by providing

1. Policy advice to governments and central banks based on analysis of economic trends and cross-country experiences;
2. Research, statistics, forecasts, and analysis based on tracking of global, regional, and individual economies and markets;
3. Loans to help countries overcome economic difficulties;
4. Concessional loans to help fight poverty in developing countries; and

5. Technical assistance and training to help countries improve the management of their economies.

The IMF's fundamental mission is to help ensure stability in the international system. It does so in three ways: keeping track of the global economy and the economies of member countries; lending to countries with balance of payments difficulties; and giving practical help to members.

- **Surveillance:** The IMF oversees the international monetary system and monitors the financial and economic policies of its members. It keeps track of economic developments on a national, regional, and global basis, consulting regularly with member countries and providing them with macroeconomic and financial policy advice.

- **Lending:** The IMF provides loans to countries that have trouble meeting their international payments and cannot otherwise find sufficient financing on affordable terms. This financial assistance is designed to help countries restore macroeconomic stability by rebuilding their international reserves, stabilizing their currencies, and paying for imports—all necessary conditions for re-launching growth. The IMF also provides concessional loans to low-income countries to help them develop their economies and reduce poverty.

- **Technical Assistance:** To assist mainly low- and middle-income countries in effectively managing their economies, the IMF provides practical guidance and training on how to upgrade institutions, and design appropriate macroeconomic, financial, and structural policies.

The IMF shares its expertise with member countries by providing technical assistance and training in a wide range of areas, such as central banking, monetary and exchange rate policy, tax policy and administration, and official statistics**.** The objective is to help improve the design and implementation of members' economic policies, including by strengthening skills in institutions such as finance ministries, central banks, and statistical agencies. The IMF has also given advice to countries that have had to reestablish government institutions following severe civil unrest or war. About 80 percent of the IMF's technical assistance goes to low- and lower-middle-income countries, in particular in sub-Saharan Africa and Asia. Post-conflict countries are major beneficiaries. The IMF is also providing technical assistance aimed at strengthening the architecture of the international financial system, building capacity to design and implement poverty-reducing and growth programs, and helping heavily indebted poor countries (HIPC) in debt reduction and management.

In 2008, the IMF embarked on an ambitious reform effort to enhance the impact of its technical assistance. The reforms emphasize better prioritization, enhanced performance measurement, more transparent costing and stronger partnerships with donors.

3.3 Financial Assistance:

Lending to low-income countries:

In order to assist the less developing economies to tackle with the severe financial downturn, the IMF has revamped its concessional lending facilities to make them more flexible and meet increasing demand for financial assistance from countries in need. These changes became effective in January 2010. Once additional loan and subsidy resources are mobilized, these changes will boost available resources for low-income countries to $17 billion by 2014. To ensure resources are available for lending to low-income countries beyond 2014, the IMF approved an additional $2.7 billion in remaining windfall profits from gold sales as part of a strategy to make lending to low-income countries sustainable.

The Extended Credit Facility **(ECF)** provides financial assistance to countries with protracted balance of payments problems. The ECF succeeds the Poverty Reduction and Growth Facility (PRGF) as the Fund's main tool for providing medium-term support LICs, with higher levels of access, more concessional financing terms, more flexible program design features, as well as streamlined and more focused conditionality.

The Rapid Credit Facility **(RCF)** provides rapid financial assistance with limited conditionality to low-income countries (LICs) facing an urgent balance of payments need. The RCF streamlines the Fund's emergency assistance, provides significantly higher levels of concessionality, can be used flexibly in a wide range of circumstances, and places greater emphasis on the country's poverty reduction and growth objectives.

The Standby Credit Facility **(SCF)** provides financial assistance to low-income countries (LICs) with short-term balance of payments needs. It provides support under a wide range of circumstances, allows for high access, carries a low interest rate, can be used on a precautionary basis, and places emphasis on countries' poverty reduction and growth objectives.

The Rapid Financing Instrument **(RFI)** provides rapid and low-access financial assistance to member countries facing an urgent balance of payments need, without the need for a full-fledged program. It can provide support to meet a broad range of urgent needs, including those arising from commodity price shocks, natural disasters, post-conflict situations and emergencies resulting from fragility.

The Extended Fund Facility **(EFF)** is used to help countries address balance of payments difficulties partly to structural problems that may take longer to correct than macroeconomic imbalances. A program supported by an extended arrangement usually includes measures to improve the way markets and institutions function, such as tax and financial sector reforms, privatization of public enterprises.

The Trade Integration Mechanism allows the IMF to provide loans under one of its facilities to a developing country whose balance of payments is suffering because of multilateral trade liberalization, either because its export earnings decline when it loses preferential access to certain markets or because prices for food imports go up when agricultural subsidies are eliminated.

The Flexible Credit Line **(FCL)** is for countries with very strong fundamentals, policies, and track records of policy implementation. It represents a significant shift in how the IMF delivers Fund financial assistance, particularly with recent enhancements, as it has no ongoing (ex post) conditions and no caps on the size of the credit line. There is the flexibility to either treat the credit line as precautionary or draw on it at any time after the FCL is approved. Once a country qualifies (according to pre-set criteria), it can tap all resources available under the credit line at any time, as disbursements would not be phased and conditioned on particular policies as with traditional IMF-supported programs. This is justified by the very strong track records of countries that qualify to the FCL, which give confidence that their economic policies will remain strong or that corrective measures will be taken in the face of shocks.

The Precautionary and Liquidity Line (PLL) builds on the strengths and broadens the scope of the Precautionary Credit Line (PCL). The PLL provides financing to meet actual or potential balance of payments needs of countries with sound policies, and is intended to serve as insurance and help resolve crises. It combines a qualification process (similar to that for the FCL) with focused ex-post conditionality aimed at addressing vulnerabilities identified during qualification. Its qualification requirements signal the strength of qualifying countries' fundamentals and policies, thus contributing to consolidation of market confidence in the country's policy plans. The PLL is designed to provide liquidity to countries with sound policies under broad circumstances, including countries affected by regional or global economic and financial stress.

Debt relief

In addition to concessional loans, some low-income countries are also eligible for debts to be written off under two key initiatives. The Heavily Indebted Poor Countries (HIPC) Initiative, introduced in 1996 and enhanced in 1999, whereby creditors provide debt relief, in a coordinated manner, with a view to restoring debt sustainability; and The Multilateral Debt Relief Initiative (MDRI), under which the IMF, the International Development Association (IDA) of the World Bank, and the African Development Fund (AfDF) canceled 100 percent of their debt claims on certain countries to help them advance toward the Millennium Development Goals.

3.4 Surveillance

When a country joins the IMF, it agrees to subject its economic and financial policies to the scrutiny of the international community. It also makes a commitment to pursue policies that are conducive to orderly economic growth and reasonable price stability, to avoid manipulating exchange rates for unfair competitive advantage, and to provide the IMF with data about its economy. The IMF's regular monitoring of economies and associated provision of policy advice is intended to identify weaknesses that are causing or could lead to financial or economic instability. This process is known as surveillance.

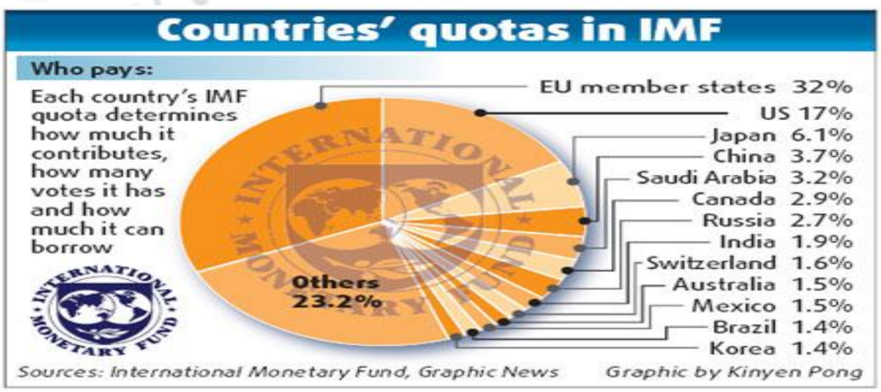
- **Country surveillance:** Country surveillance is an ongoing process that culminates in regular (usually annual) comprehensive consultations with individual member countries, with discussions in between as needed. The consultations are known as "Article IV consultations" because they are required by Article IV of the IMF's Articles of Agreement. During an Article IV consultation, an IMF team of economists visits a country to assess economic and financial developments and discuss the country's economic and financial policies with government and central bank officials. IMF staff missions also often meet with parliamentarians and representatives of business, labor unions, and civil society.

- **Regional surveillance:** Regional surveillance involves examination by the IMF of policies pursued under currency unions—including the euro area, the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the Eastern Caribbean Currency Union. Regional economic outlook reports are also prepared to discuss economic developments and key policy issues in Asia Pacific, Europe, Middle East and Central Asia, Sub-Saharan Africa, and the Western Hemisphere.

- **Global surveillance:** Global surveillance entails reviews by the IMF's Executive Board of global economic trends and developments. The main reviews are based on theWorld Economic Outlook reports, the Global Financial Stability Report, which covers developments, prospects, and policy issues in international financial markets, and the Fiscal Monitor, which analyzes the latest developments in public finance. All three reports are published twice a year, with updates being provided on a quarterly basis. In addition, the Executive Board holds more frequent informal discussions on world economic and market developments.

3.5 India and Increasing IMF Quotas:

- India strongly supports efforts to increase quotas for developing countries in the IMF. The current Indian Finance Minister, ShriPranab Mukherjee, said "resistance to the overdue change will only detract from the legitimacy, credibility and effectiveness of these institutions."
- At the G20's Pittsburgh meeting in September 2009, India proposed a seven percent shift in voting rights to developing nations.Countries agreed on a five percent raise, an accomplishment that has been heralded as a significant step in the right direction. This move was approved by the IMF's International Monetary and Financial Committee (IMFC).
- This recent move is in addition to changes made by the 2008 Quota and Voice Reforms. This reform must be approved by 112 IMF member countries that hold at least 85 percent of the total votes. By early March 2010, 65 members that hold about 70 percent of the IMF's votes had accepted these reforms.
- India has suggested that it could give additional financial resources if its quota was increased and it was given greater voice at the IMF. This next round of quota reforms is already underway, and should be completed by January 2011.



Box 1.1

3.6 India Supports the Purchasing Power Parity (PPP) for Quotas:

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The IMF assigns each country a fixed quota that is roughly based on its relative size in the global economy. Among other things, the quota determines the voting power of member countries.

- India has proposed using the Purchasing Power Parity (PPP) rate to evaluate the size of each country's economy for the purposes of assigning quotas. The PPP is based on the idea that the same basket of goods should have only one price regardless of the countries in question.

- The most common example of the PPP is the "Big Mac Index." This approach, which is imperfect, looks at the price of this sandwich in the 120 countries where it is produced. Using PPP, if $1 is worth 45 Indian rupees, then a $3 Big Mac should cost 135 rupees. The difference between the real cost of the Big Mac and the hypothetical based on the exchange rate indicates whether a currency is overvalued (e.g., a Big Mac costs 130 rupees) or undervalued (e.g., a Big Mac costs 150 rupees).

- Currently, the IMF uses the Market Exchange Rate (MER) to evaluate a member country's economic size. There can be a significant difference between measuring an economy's size using MER as opposed to PPP because the PPP takes into account, among other things, lower costs of living in any particular country.

- Use of the PPP would allocate a larger share of the global economy to developing countries. This would result in larger quotas for these countries and give them more power at the IMF.

- A newly agreed upon quota formula takes into account both the MER and the PPP. This proposal uses 60 percent MER and 40 percent PPP when estimating the size of a country's GDP.

4. World Bank

The World Bank is one of four institutions created at the Bretton Woods Conference in 1944. It is an international financial institution which acts as a vital source of financial and technical assistance to developing countries around the world. The World Bank's official goal is the reduction of poverty. According to the World Bank's Articles of Agreement (as amended effective 16 February 1989), all of its decisions must be guided by a commitment to promote foreign investment, international trade, and facilitate capital investment. Established in 1944, the World Bank is headquartered in Washington, D.C. It functions through five major agencies:

- International Bank for Reconstruction and Development (IBRD)
- International Development Association (IDA)
- International Finance Corporation (IFC)
- Multilateral Investment Guarantee Agency (MIGA)
- International Centre for settlement of Investment Disputes (ICSID)

4.1 Objective of World Bank:

The principal functions of the World Bank set forth in Article 1 of the Agreement are as follows:

1. To assist in the reconstruction and development of the territories of its members by facilitating the investment of capital for productive purposes.
2. To promote foreign private investment by means of (a) guarantees of or through participation in loans and other investments made by private investors; and (b) 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 borrowed by it.
3. To promote the long range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment thereby assisting in raising productivity, the standard of living and condition of labour in the territories of the member countries.
4. To encourage loans made or guaranteed so that more useful and urgent projects, large and small alike will be dealt with first.
5. To conduct its operations so as to bring about a smooth transition from a war-time economy to a peace-time economy.

4.2 Lending Instruments of World Bank:

Some of the specific lending instruments of the World Bank and their respective objectives are discussed below:

1. **Specific Investment Loan (SIL):** Creation of new productive assets, establishment of social, economic and institutional infrastructure, etc. are the primary objectives of the SIL.
2. **Sector Investment and Maintenance Loan (SIML):** The objective of SIML is to bring investments, policies, and performance in specific sector(s) in line with economic priorities, and ensure efficient operation and maintenance of investments in such sector (s).
3. **Financial Intermediary Loan (FIL):** The FIL wants to support the development of financial institutions and provide funds for general credit or for development of sector/specific sub-sectors.
4. **Emergency Recover Loan (ERL):** This loan is given to restore assets and productivity in a member country immediately after a major emergency (such as war, civil disturbance or natural disaster) that seriously disrupts the country's economy.
5. **Technical Assistance Loan (TAL):** This loan is given particularly to strengthen entities concerned with:
   a. Policies, strategies and institutional reforms that promote further development in a sector or in the economy as a whole.
   b. Specific tasks related to the preparation, implementation or operation of investments, and
   c. Public sector management in such areas as reform of public sector enterprises, Government budgetary and financial management and the formulation of economic policies, etc.

6. **Structural Adjustment Loan (SAL):** The objective of the SAL is to support specific policy changes and institutional reforms pertaining to:
   a. Efficient utilization of resources
   b. Meeting balance of payments needs
   c. Growth and sustainable balance of payments position in the medium and long-term, and
   d. Mitigating social costs.
7. **Sector Adjustment Loan (SEAL):** The SEAL is extended to support for Government policy reform programmes targeted towards the private productive sector where foreign exchange is required for urgent rehabilitation of key infrastructure and productive facilities. This loan is used when SAL is not available.

4.3 Structure of the World Bank:

World Bank has membership strength of 185 countries. All the 185 member countries of the World Bank are its shareholders who are generally represented by the board of governors. Governors in the member countries are mainly finance ministers or development ministers. Board of Governors in the World Bank group and IMF meet once in a year.

The Board of Executive Directors and the President of the World Bank, who serves as a chairman of the board, are responsible for the conduct of the general operations of the Bank, oversee the work of the Bank on a daily basis, and perform their duties under powers delegated to them by the Board of Governors. The directors meet twice a week in Washington, DC, to approve new loans and review bank operations and policies.Governors delegate 24 Executive Directors with specific duties such as approval of loans and investment and new policies. Each director may represent one country or a group of countries. Countries such as France, Japan, Germany, United States and United Kingdom are its largest shareholders.Under the Articles of Agreement of the International Bank for Reconstruction and Development (IBRD), a country must first join the IMF prior to becoming a member of the Bank. Membership in IDA, IFC, and MIGA is conditioned upon membership in IBRD.

Box 1. 2

India Borrowed from the World Bank soon after it was formed:

India signed the charter of the IBRD on December 27, 1945. This was followed by the first Bank mission to India in 1949.

The IBRD lends to middle-income and "creditworthy" lower-income countries. The International Development Association (IDA) makes loans to the world's poorest countries on concessional terms, meaning zero-interest loans that are repaid over a thirty-five to forty-year period.

Box 1. 3

India Uses the World Bank Extensively:

India has dominated the lending from the IDA so extensively that some call it the "Indian Development Association."

In its first 50 years, from 1949 to June 2000, the Bank extended 215 loans and 292 development credits to India, totalling approximately $26.2 billion from the IBRD and $27.2 billion from the IDA.

5. An Evaluation of IMF-World Bank

The IMF and the World Bank are institutions in the United Nations system. They share the same goal of raising living standards in their member countries. Their approaches to this goal are complementary, with the IMF focusing on macroeconomic issues and the World Bank concentrating on long-term economic development and poverty reduction.

The IMF and the World Bank has certainly played a crucial role since its inception during the early 1940s but nonetheless both the organizations have still not been able to deliver as desired. As a result many economies, particularly developing economies across the world have expressed their disappointment on the various key activities that the IMF and the World Bank were supposed to perform. The objective of the Bretton Woods Conference was to establish a global monetary and financial system to promote stable exchange rates, foster the growth of the world trade, and international movement of capital in the desired directions. Many scholars observe that there is a need to rethink on the objectives of the Bretton Woods Conference once again and expedite the various developmental activities and reform process to foster the growth of the world economy.

Over the past decade the IMF has lost most of its power in developing countries and, as a result, Washington has also lost its most important avenue of influence over their policies. The middle-income countries of Asia, most of Latin America, Russia and others all made sure that they would never have to borrow again from the fund.The World Bank has exercised much of its influence in conjunction with the IMF, but this arrangement too has been weakened. So now, the Bretton Woods twins have most of their power in weaker and poorer developing countries. The IMF system has been ironic as far as the developing countries are concerned. The unconditional borrowing rights based on the quota highly discriminate against the developing countries. What is more draconic has been the allocation of the SDRs, the created liquid assets, in proportion to the quota. Joseph Stiglitz very categorically observes that a half century after its founding, it is clear that the IMF has failed in its mission. It has not done what it was supposed to do – provide funds for countries facing an economic downturn, to enable the country to restore itself close to full employment.

Though some of the failures of the two major international institutions have been discussed above but it is to be understood that the increase in the membership of these institutions is a clear evidence of their efficacy. Although the communists in the past had described these institutions as organs of capitalist imperialism, many socialist countries have become members of these institutions.

6. Summary

This chapter provides a brief overview of the international monetary system including the historical evolution of the IMF and the World Bank. It also discusses the objectives, functions, and the major lending facilities of the IMF and the World Bank. It is often criticized that World Bank and IMF, which are dominated by the developed countries, have not been paying adequate attention to the needs of the developing countries. Further, they are accused of making unwarranted interference in the economic policies of the borrowing developing countries. Nevertheless, the IMF and the World Bank have been a boon to many emerging economics of the world. India has been a major recipient of assistance from both the international institution. The World Bank experts call India a "blend" because it receives funding from both the IBRD and IDA.