



STUDY NOTE - 10

INTERNATIONAL MONETARY FUND AND FINANCIAL SYSTEM

SECTION - 1

UNDERSTANDING INTERNATIONAL MONETARY SYSTEM

This Section includes

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1.1 INTRODUCTION

- 1.1.1 A sound knowledge of international financial systems is a pre-requisite for the following reasons:
- a. Global trade have been on the steady increase
 - b. Global opportunities have to be exploited
 - c. It helps in avoiding delays in handling global trade
 - d. There are a number of financial intermediaries and institutions that facilitate global trade
 - e. Technology is a great enabler in fostering international trade and scaling up of operations



- f. Globally, there is a trend towards elimination of all trade barriers and facilitate uninterrupted global trade
 - g. Loss due to exchange fluctuations if not prevented or unattended immediately would erode the fortunes of the company.
- 1.1.2 The economic change witnessed by the world like the disintegration of soviet union, political and economic freedom in eastern Europe, the emergence of market-oriented economies in Asia, the creation of a single European market, trade liberalization through regional trading blocs, such as European union, the world's joint mechanism, such as the world trade organization, have all impacted and facilitated the growth of international trade.
- 1.1.3 In 1989, Mexico significantly liberalized its foreign direct investment regulations to allow 100% foreign ownership. The North American Free Trade Agreement of 1994 extends the areas of permissible foreign direct investment and protects foreign investors with a dispute settlement mechanism. This is an example of fostering international trade.

1.2 MOTIVES FOR WORLD TRADE AND FOREIGN INVESTMENT

- 1.2.1 The theories of comparative advantage, factor endowments and product life cycle have been suggested as three major motives for foreign trade.

1.2.2 Theory of comparative advantage

This is the classical economic theory which explains why countries exchange their goods and services with each other. The underlying assumption is that some countries can produce some types of goods more efficiently than other countries. Hence, the theory of comparative advantage assumes that all countries are better off when each one specializes in the production of those goods which it can produce more efficiently and buys those goods which other countries produce more efficiently. It neutralizes the cost and benefits more effectively.

1.2.3 The theory of factor endowments

Countries are endowed differently in their economic resources. Columbia is more efficient in the production of coffee and the US is more efficient in the production of computers. Colombia has the oil, weather and abundant supply of unskilled labor necessary to produce coffee more economically than the US. Differences in these national factor endowments explain differences in comparative factor costs between the two countries. Each country has to take advantage of its own strengths and also trade it off against other countries strengths.

1.2.4 Product life cycle

All products have a certain length of life. During this life they go through certain stages. The product life cycle theory explains both world trade and foreign investment patterns on the basis of stages in a product's life. In the context of international trade, the theory assumes that certain products go through four stages: Introduction and export, international production, intense foreign competition and imports.



1.2.5 Trade control

The possibility of a foreign embargo on sales of certain products and the needs of national defense may cause some countries to seek self sufficiency in some strategic commodities. Political and military questions constantly affect international trade and other international business operations. Tariffs, import quotas and other trade barriers are three primary means of protectionism. This is where a country's economic reforms and liberalization really support international trade in a big way.

1.3 WORLD TRADE BODIES

- 1.3.1 In 1947, 23 countries signed the General Agreement on Tariffs and Trade (GATT) in Geneva. To join GATT, countries must adhere to Most Favored Nation (MFN) clause, which requires that if a country grants a tariff reduction to one country, it must grant the same concession to all other countries. This clause applies to quotas also.
- 1.3.2 The new organization, known as the World Trade Organization (WTO), has replaced the GATT since the Uruguay Round accord became effective on January 1, 1995. Today, WTO's 135 members account for more than 95% of world trade. The five major functions of WTO are:
 - a. Administering its trade agreements
 - b. Being a forum for trade negotiations
 - c. Monitoring national trade policies
 - d. Providing technical assistance and training for developing countries
 - e. Cooperating with other international organizations
- 1.3.3 Under the WTO, there is a powerful dispute-resolution system, with three-person arbitration panel. Some of the major features of WTO and GATT are:
 - a. World Trade Organization (WTO), was formed in 1995, head quartered at Geneva, Switzerland
 - b. It has 152 member states
 - c. It is an international organization designed to supervise and liberalize international trade
 - d. It succeeds the General Agreement on Tariffs and Trade
 - e. It deals with the rules of trade between nations at a global level
 - f. It is responsible for negotiating and implementing new trade agreements, and is in charge of policing member countries' adherence to all the WTO agreements, signed by the bulk of the world's trading nations and ratified in their parliaments.
 - g. Most of the WTO's current work comes from the 1986-94 negotiations called the Uruguay Round, and earlier negotiations under the GATT. The organization is currently the host to new negotiations, under the Doha Development Agenda (DDA) launched in 2001.



- h. Governed by a Ministerial Conference, which meets every two years; a General Council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the Ministerial Conference.

1.3.4 The General Agreement on Tariffs and Trade (GATT)

- a. GATT was a treaty, not an organization.
- b. Main objective of GATT was the reduction of barriers to international trade through the reduction of tariff barriers, quantitative restrictions and subsidies on trade through a series of agreements.
- c. It is the outcome of the failure of negotiating governments to create the International Trade Organization (ITO).
- d. The Bretton Woods Conference had introduced the idea for an organization to regulate trade as part of a larger plan for economic recovery after World War II. As governments negotiated the ITO, 15 negotiating states began parallel negotiations for the GATT as a way to attain early tariff reductions. Once the ITO failed in 1950, only the GATT agreement was left.
- e. The functions of the GATT were taken over by the World Trade Organization which was established during the final round of negotiations in early 1990s.

1.4 TRADE-RELATED INVESTMENT MEASURES (TRIMS)

- a. TRIMs are the rules a country applies to the domestic regulations to promote foreign investment, often as part of an industrial policy.
- b. It is one of the four principal legal agreements of the WTO trade treaty.
- c. It enables international firms to operate more easily within foreign markets.
- d. In the late 1980's, there was a significant increase in foreign direct investment throughout the world. However, some of the countries receiving foreign investment imposed numerous restrictions on that investment designed to protect and foster domestic industries, and to prevent the outflow of foreign exchange reserves.
- e. Examples of these restrictions include local content requirements (which require that locally-produced goods be purchased or used), manufacturing requirements (which require the domestic manufacturing of certain components), trade balancing requirements, domestic sales requirements, technology transfer requirements, export performance requirements (which require the export of a specified percentage of production volume), local equity restrictions, foreign exchange restrictions, remittance restrictions, licensing requirements, and employment restrictions. These measures can also be used in connection with fiscal incentives. Some of these investment measures distort trade in violation of GATT Article III and XI, and are therefore prohibited.



1.5 TRADE RELATED ASPECTS OF INTELLECTUAL PROPERTY RIGHTS (TRIPS)

- a. **TRIPS** is an international agreement administered for the first time by the World Trade Organization (WTO) into the international trading system.
- b. It sets down minimum standards for many forms of intellectual property (IP) regulation.
- c. Till date, it remains the most comprehensive international agreement on intellectual property.
- d. It was negotiated at the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1994.
- e. TRIPS contains requirements that nations' laws must meet for: copyright rights, including the rights of performers, producers of sound recordings and broadcasting organizations; geographical indications, including appellations of origin; industrial designs; integrated circuit layout-designs; patents; monopolies for the developers of new plant varieties; trademarks; trade dress; and undisclosed or confidential information. TRIPS also specify enforcement procedures, remedies, and dispute resolution procedures.
- f. In 2001, developing countries were concerned that developed countries were insisting on an overly-narrow reading of TRIPS, initiated a round of talks that resulted in the Doha Declaration: a WTO statement that clarifies the scope of TRIPS; stating for example that TRIPS can and should be interpreted in light of the goal "to promote access to medicines for all".

1.6 TRADING BLOCS: TYPES OF ECONOMIC COOPERATION

- 1.6.1 A trading bloc is preferential economic arrangement between a group of countries that reduces intra-regional barriers to trade in goods, services, investment and capital. There are more than 50 such arrangements at the present time. There are five major forms of economic cooperation among countries: Free trade areas, customs unions, common markets, economic unions and political unions.
- 1.6.2 The North American Free Trade Agreement (NAFTA) among US, Canada and Mexico is an example of Free trade areas where member countries remove all trade barriers among themselves.
- 1.6.3 Under the customs union arrangement, member nations not only abolish internal tariffs among themselves but also establish common external tariffs.
- 1.6.4 In a common market type of agreement, member countries abolish internal tariffs among themselves and levy common external tariffs. They also allow the free flow of all factors of production, such as capital, labor and technology.
- 1.6.5 The economic union combines common market characteristics with harmonization of economic policy. Member nations are required to pursue common monetary and fiscal policies.



- 1.6.6 Political union combines economic union characteristics with political harmony among the member countries.

1.7 MOTIVES FOR FOREIGN INVESTMENT

- 1.7.1 The product life cycle theory, the portfolio theory and the oligopoly model have been suggested as bases for explaining and justifying foreign investment.
- 1.7.2 Product life cycle theory explains changes in the location of production. After successful launch of new products, companies shift the manufacturing base to other countries for lowering costs and retain the margin. This is what is witnessed in India today, which has become the destination for low cost outsourcing. For eg. South India is called Detroit of US due to many MNC automobile companies setting up their production facilities there.
- 1.7.3 Portfolio theory indicates that a company is often able to improve its risk-return performance by holding a diversified portfolio of assets. This theory represents another rationale for foreign investment. The diversified portfolio will include foreign assets.
- 1.7.4 Under the oligopoly model, the assumption is that business firms attract foreign investments to exploit their quasi monopoly advantages. The advantage of an MNC over a local company may include technology, access to capital, differentiated products built on advertising, superior management and organizational scale.

1.8 BALANCE OF PAYMENTS

- 1.8.1 A country's balance of payments is defined as the record of transactions between its residents and foreign residents over a specified period, which includes exports and imports of goods and services, cash receipts and payments, gifts, loans, and investments. Residents may include business firms, individuals and government agencies. The balance of payments helps business managers and government officials to analyze a country's competitive position and to forecast the direction of pressure on exchange rates. Government's export import policies also mainly depend on this.
- 1.8.2 The balance of payments is a sources-and-uses-of-funds statement reflecting changes in assets, liabilities and net worth during a specified period. Transactions between domestic and foreign residents are entered in the balance of payments as either debits or credits. Transactions that earn foreign exchange are often called credit transactions and represent sources of funds. Transactions that expend foreign exchange are called debit transactions and represent use of funds. A country incurs a 'surplus' in its balance of payments if credit transactions exceed debit transactions or if it earns more abroad than it spends. On the other hand, a country incurs a 'deficit' in its balance of payments if debit transactions are greater than credit transactions or if it spends more abroad than it earns. Surpluses and deficits in the balance of payments are of considerable interest to banks, companies, portfolio managers and governments.
- 1.8.3 They are used to:
- a. Predict pressure on foreign exchange rates



- b. Anticipate government policy actions
- c. Assess a country's credit and political risk
- d. Evaluate country's economic health

1.8.4 Balance of payments accounts

The international monetary fund (IMF) classifies balance of payments transactions into five major groups:

- a. Current account: merchandise, services, income and current transfers
- b. Capital account: Capital transfers, non-produced assets, non financial assets
- c. Financial account: Direct investments, portfolio investments and other investments
- d. Net errors and omissions
- e. Reserves and related items: These are government owned assets which include monetary gold, convertible foreign currencies, deposits, and securities. The principle convertible currencies are the US dollar, the British pound, the euro, and the Japanese Yen for most countries. Credit and loans from the IMF are usually denominated in special drawing rights (SDRs). Sometimes called 'paper gold' SDRs can be used as means of international payment.

INTERNATIONAL ORGANISATIONS AND ACCOUNTING STANDARDS

Many accounting professionals perceive standardization to be too strict and inflexible to provide the information users need;

Harmonisation is necessary as so many MNCs are doing business in numerous countries;

Several international organizations dealing with the harmonization challenge:

- IASC: Founded in 1973 by agreement among professional accounting organizations in 9 countries; now grown to over 70 countries; over 100 professional accounting organizations;

IASC develops and publishes IASs. IASC also promotes these standards for wide international acceptance;

Some countries use IASs as their national accounting rules and others use them as basis for their own accounting rules; MNCs voluntarily use IASs for secondary set of financial statements;

- European Union (EU): Founded on 25/3/57, is the Association of European States, when Belgium, France, West Germany, Italy, Luxembourg and Netherlands signed the Treaty of Rome. Treaty was free movement of labour, capital and goods among member countries by 1992, without any tariff or barrier.

Now EU imports and exports more than any single country in the world; with US as major trading partner; there are 15 member countries now;

4th Directive:



7th Directive:

8th Directive:

Mutual Recognition Directive:

Directive of Dec 8, 1986

11th Directive of Feb 13, 1989

EU Cooperation with IASC:

- It is a major step in the direction of international harmonisation;
- It is to facilitate multinational companies to prepare one set of financial statements that would be accepted by stock exchanges worldwide.

ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD):

Established on Dec 14, 1960; formed by 24 most powerful countries; HO at Paris;

It is an international organization for economic research and policy analysis;

It provides reports on financial accounting and reporting and economic development.

In countries such as India, Canada and Australia, Foreign Investments need government approval. In US and Switzerland, even domestic investments need government approval.

OECD guidelines provide for “Disclosure of information” in financial statements. There exists open and cooperative relationship among the various organizations seeking to set international accounting standards such as IASC and EU commission.

INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS (IOSCO)

It is a private organization with the objective of integrating the securities markets worldwide and for developing financial reporting standards and their effects on securities markets.

UNITED NATIONS (UN)

UN studies the impact of multinational corporations on development and international relations and brings out publications on international accounting and reporting issues.

INTERNATIONAL FEDERATION OF ACCOUNTANTS (IFAC)

IFAC established in 1977 for development of accounting profession and works to achieve international technical, ethics and education pronouncements for the profession.

Other organizations are:

ASIA-PACIFIC ECONOMIC COOPERATION

NORDIC FEDERATION OF ACCOUNTANTS

ASSOCIATION OF SOUTHEAST ASIAN NATIONS

1.9 INTERNATIONAL MONETARY SYSTEM

- 1.9.1 The international monetary system consists of laws, rules, institutions, instruments and procedures which involve international transfer of money. These elements affect for-



foreign exchange rates, international trade and capital flows and balance of payment adjustments. Foreign exchange rates determine prices of goods and services across national boundaries. These exchange rates also affect international loans and foreign investment. Hence, the international monetary system plays a critical role in the financial management of multinational business and economic policies of individual countries.

1.9.2 Foreign exchange system

- a. A global company's access to international capital markets and its freedom to move funds across national boundaries are subject to a variety of national constraints.
- b. These constraints are frequently imposed to meet international monetary agreements on determining exchange rates.
- c. Constraints may also be imposed to correct the balance of payments deficit or to promote national economic goals.
- d. A foreign exchange rate is the price of one currency expressed in terms of another currency. A fixed exchange rate is an exchange rate which does not fluctuate or which changes within a predetermined band. The rate at which the currency is fixed or pegged is called 'par value'. A floating or flexible exchange rate fluctuates according to market forces.

1.9.3 Advantages of flexible exchange rate system

- a. Countries can maintain independent monetary and fiscal policies
- b. Permits smooth adjustment to external shocks
- c. Central banks need not maintain large international reserves to defend a fixed exchange rate

1.9.4 Disadvantages of flexible exchange rate system

- a. Unstable exchange rates can prevent free flow of trade
- b. Inherently inflationary because they remove external discipline

1.10 CONCEPTS IN FOREIGN EXCHANGE RATE

- a. An appreciation is a rise in the value of a currency against other currencies under a floating rate system.
- b. A depreciation is a decrease in the value of a currency against other currencies under a floating rate system.
- c. A revaluation is an official increase in the value of a currency by the government of that currency under a fixed rate system.
- d. A devaluation is an official reduction in the par value of a currency by the government of that currency under a fixed rate system.



1.10.1 Currency boards

A currency board is a monetary institution that only issues currency to the extent it is fully backed by foreign reserves. Its major attributes are:

- a. An exchange rate that is fixed not just by policy but by law
- b. A reserve requirement to the extent that a country's reserves are equal to 100 percent of its notes and coins in circulation
- c. A self correcting balance of payments mechanism where a payment deficit automatically contracts the money supply and thus the amount of spending as well
- d. No central bank under a currency board system
- e. In addition to promoting price stability, a currency board also compels the government to follow a responsible fiscal policy.
- f. Countries like Mauritius, Hong Kong, Estonia, Argentina, Lithuania, Bulgaria and Bosnia are countries that have adopted currency board system.

1.10.2 History of the international monetary system

The pre-1914 gold standard: a fixed exchange system:

In the pre-1914 era, most of the major trading nations accepted and participated in an international monetary system called the gold standard. Under this regime, countries use gold as a medium of exchange and a store of value. The gold standard had a stable exchange rate.

Monetary disorder: 1914-45: a flexible exchange system:

The gold standard collapsed after the First World War and ended the stability of exchange rates for the major currencies of the world. The value of currencies fluctuated very widely. The great depression of 1929-32 and the international financial crisis of 1931, further prevented the restoration of gold standard. Governments started devaluing their currencies to support exports.

Fixed exchange rates: 1945-73:

- a. The Bretton woods agreement was signed by representatives of 44 countries in 1944 to establish a system of fixed exchange rates.
- b. Under this system, each currency was fixed by government action within a narrow range of values relative to gold or some currency of reference. US dollar was used frequently as a reference currency to establish the relative prices of all other currencies
- c. At this conference, they agreed to establish a new monetary order, which centered on IMF and IBRD (World Bank).
- d. IMF provides short term balance of payment adjustment loans, while the world bank makes long term development and reconstruction loans.
- e. The agreement emphasized the stability of exchange rates by adopting the concept of fixed but adjustable rates.



Breakdown of the Bretton woods system:

- a. The late 1940s marked the beginning of large deficits in the US balance of payments. America's payments deficits resulted in dilution of US gold and other reserves during the 1960s and early 1970s.
- b. In 1971, most major currencies were permitted to fluctuate. US dollars fell in value against a number of major currencies. Several countries caused major concern by imposing some trade and exchange controls which was feared that such protective measures might become widespread to curtail international commerce.
- c. In order to solve these problems, the world's leading trading countries, called the 'Group of Ten', produced the Smithsonian Agreement in 1971.

The post 1973 dirty floating system:

The exchange rate became much more volatile during this period due to a number of events affecting the international monetary order. Oil crisis of 1973, loss of confidence in US dollar between 1977 and 1978, second oil crisis in 1978, formation of European monetary system in 1979, end of Marxist revolution in 1990 and Asian financial crisis in 1997.

1.11 THE INTERNATIONAL MONETARY FUND (IMF)

- a. An international organization created in 1944 with a goal to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty.
- b. Oversees the global financial system by following the macroeconomic policies of its member countries, in particular those with an impact on exchange rates and the balance of payments.
- c. Offers financial and technical assistance to its members, making it an international lender of last resort. Countries contributed to a pool which could be borrowed from, on a temporary basis, by countries with payment imbalances.
- d. It is headquartered in Washington, D.C., USA.
- e. The IMF has 185 member countries

Current actions:

- a. The International Monetary Fund's executive board approved a broad financial overhaul plan that could lead to the eventual sale of a little over 400 tons of its substantial gold supplies.
- b. The board of IMF has proposed a new framework for the fund, designed to close a projected \$400 million budget deficit over the next few years.
- c. The budget proposal includes sharp spending cuts of \$100 million until 2011.

Membership qualifications:

- a. Any country may apply for membership to the IMF. The application will be considered first by the IMF's Executive Board.



- b. After its consideration, the Executive Board will submit a report to the Board of Governors of the IMF with recommendations (the amount of quota in the IMF, the form of payment of the subscription, and other customary terms and conditions of membership) in the form of a “Membership Resolution”.
- c. After the Board of Governors has adopted the “Membership Resolution,” the applicant state needs to take the legal steps required under its own law to enable it to sign the IMF’s Articles of Agreement and to fulfill the obligations of IMF membership.
- d. Similarly, any member country can withdraw from the Fund, although that is rare (Ecuador, Venezuela)
- e. A member’s quota in the IMF determines the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of Special Drawing Rights (SDRs).
- f. A member state cannot unilaterally increase its quota — increases must be approved by the Executive Board and are linked to formulas that include many variables such as the size of a country in the world economy.
- g. IMF established rules and procedures to keep participating countries from going too deeply into balance of payments deficits. Those countries with short term payment difficulties could draw upon their reserves, defined in relation to each member’s quota.

1.12 THE EUROPEAN MONETARY UNION

A monetary union is a formal arrangement in which two or more independent countries agree to fix their exchange rates or employ only one currency to carry out all transactions. Full European monetary union was achieved in 2002, which enabled 15 EU countries to carry out transactions with one currency through one central bank under one monetary policy. A single currency called the EURO was adopted.