UNIT 18 RISE AND FALL OF BRETTON WOODS INSTITUTIONS

Structure

18.0 Objectives

18.1 Introduction

18.2 World Bank

18.2.1 Lending Operations of World Bank

18.3 International Monetary Fund (IMF)

18.3.1 Special Drawing Rights (SDRs)

18.3.2 IMF – World Bank Harmony

18.4 Achievements or Bretton Woods Institutions

18.5 Failures and Bretton Woods Institutions

18.6 Rationale in Era of Globalisation and Suggestions

18.6.1 Rationale

18.6.2 Suggestions

18.7 International Development Association (IDA) and International Finance Corporation (IFC)

18.7.1 Working of IDA

18.7.2 Working of IFC

18.8 Let Us Sum Up

18.9 Key Words

18.10 Some Useful Books

18.11 Answers/Hints to Check Your Progress Exercises

18.0 OBJECTIVES

After reading this Unit, you will be able to:

- discuss the genesis and rationale of Bretton Woods Institutions;
- describe their operations and working;
- list the objectives and functions of these institutions;
- assess for yourself how far these institutions have achieved their objectives;
- identify the shortcomings of these institutions; and
- give suggestions regarding ways to make these institutions compatible with on-going process of globalisation.

18.1 INTRODUCTION

In 1944, as the Second World War neared its end, a conference was convened by the victorious countries in Bretton Woods, in the United States. It was here that the World Bank and the International Monetary Fund were born – in the hope that they would provide the foundation of a peaceful and prosperous future for the world.

Sixty years later, these two multi-lateral institutions also known as Bretton Woods Institutions (BWIs) occupy a dominant position in the global political economy, but they are the target of powerful attack – both in the streets and in media. And in course of those 60 years, they have been joined by a whole range of other multilateral institutions. In the Course of this period, a great deal had changed. The anniversary of the World Bank and IMF was met with a 'Fifty Years in enough' campaign. While some people see those institutions, and the multilateralism they promote, as important role in the elimination of world poverty others see them not as a solution, but recent years, been greatly increased public attention and criticism of the multi-lateral institutions.

18.2 WORLD BANK

The World Bank group is a partner in opening markets and strengthening economies. Its goal is to improve the quality of life and expand prosperity for people every where, especially the world's poorest.

The World Bank group of institutions includes as follows:

1) **The International Bank for Reconstruction and Development (IBRD)** founded in 1944 in the single developing countries and a major catalyst of similar financing from other sources.

2) **The International Development Association (IDA)** founded in 1960, assists the poorest countries by providing interest free credits with 35 to 40 years maturities.

3) **The International Finance Corporation** supports private enterprise in the developing countries by providing interest free credits with 35 to 40 years maturities.

4) **The Multilateral Investment Guarantee Agency (MIGA)** offers investors insurance against non-commercial risk and helps developing country governments to attract foreign investment.

5) **The International Centre for the Settlement of International Disputes (ICSID)** encourages the flow of foreign investment to developing countries through arbitration and conciliation facilities.

Over the years, the World Bank has made two significant departures in its policy of lending; it changes its policy of lending to government and public sector and concentrated on private sector, and it changed its approach from a project based lending to sector-based lending.

18.2.1 Lending Operations of World Bank

Resources of the Bank consist of the capital and borrowings. The capital of the bank is contributed by its 184 member-countries. Besides, the Bank raided capital by sale of bonds on the World's capital markets where the Bank is the World's largest non-government borrower in the international market.

The Bank leads only to under-developed countries, and even among them it "graduated" its borrowers when per capita income reaches a threshold. The Bank marked or facilitated loans in one or more of the following ways:

- By making or participating in direct loans out of its own funds; or
- Out of funds raided in the market; or

- By guaranteeing the whole or part loans made by private investors through the investment channels.

In recent years, the Bank also moved into "co-financing", with governments and private banks and co-financiers with projects. However, since the mid-1980s when the debt crisis occurred, co-financing has become less popular with commercial banks, but governments have made much use of the Bank's expertise by putting a part of their foreign aid into the projects.

Before granting or guaranteeing a loan the Bank considers the following matters:

i) The project for which the loan is asked has been carefully examined by a competent committee as regard the merit of the proposals.

ii) The borrower has reasonable prospects for repayment;

iii) The loan is meant for productive purposes; and

iv) Except in special circumstances, the loan is meant to finance foreign exchange requirement of specific projects or reconstruction and development.

The amount of the loan granted by the Bank should not exceed 100% of its total subscribed capital and surplus. Rate of interest is determined by adding a spread of '1/2 of %' over the 'pool rate' of outstanding borrowing of the Bank. In lending for development projects in developing countries, the Bank estimates a likely rate of return; this must be above a minimum 10 per cent for the project to go forward.

18.3 INTERNATIONAL MONETARY FUND (IMF)

The important objectives before the Fund presently are as follows:

- To promote international cooperation;
- To facilitate the expansion and balanced growth of international trade;
- To addict in establishing a multilateral systems of payments for current transactions between member countries as well as in eliminating foreign exchange restrictions that hamper the growth of world;
- To make available to the member countries the IMFs general resources on a temporary basis to enable them to correct BOP difficulties without resorting to measures that would harm national or international prosperity;
- To shorten the duration and lessen the degree of disequilibrium in the BOP of member countries.

The basic functions of the IMF are as follows:

i) To lay down ground rules for conduct of international finance;

ii) To provide short and medium-term assistance for overcoming short-term BOP deficits; and

iii) Creation and distribution of reserved in the form of special Drawing Rights (SDRs).

The Fund has 184 member-countries accounting for more than 80 per cent of the total world population and 90 per cent o the world trade. Each member-country contributes a certain sum of money called a quota subscription as a cost of membership fee.

Quota represents the subscription by a member-country to the capital fund of the IMF. Quotas are fixed for each country taking into account such factors as (i) GNP of the country, (ii) current account transactions, (iii) variability of current receipts, and (iv) official reserves.

Each member country contributes 25 % of its quota in the form of SDR or foreign exchange and 75% in the country's own currency. Quoted serve various purposes:

- They determine the member's contribution to the Fund's resources which form a pool of money that the IMF can draw to lend to members in financial difficulty.
- The determine the voting powers of the members (each country has 250 basic votes plus one additional vote for each SDR 1,00,000 of quota).
- They are the basis for determining how much the contributing member can borrow from the IMF.
- They are the basis for determining how much each member receives form the IMF in periodic allocation of SDRs.

Overall, each member's quota is the most fundamental element in its financial relationship with the IMF.

IMF provides temporary assistance to member countries to tide over BOP deficits. When a country requires foreign exchange, its tenders its own currency to the IMF and gets the foreign exchange. This is known as drawing from the Fund. When the BOI condition of the country improved, it should repurchase its currency from the Fund and repay the foreign exchange.

Ordinarily, for a member-country, a first borrowing or drawing is virtually automatic and within string. A country simply called for the return of its original 25 per cent share (called the 'reserve tranche', tranche being French for 'slice') paid in hard currency. After that it may borrow four more credit tranches (each 25 % of its quota) in each of the subsequent four years. Thus, a member can borrow, almost automatically, upto 125% of its quota in a period of five years. Beyond this, if the IMF approves a member's plan for economic reforms, the member can borrow a further 90 per cent of its quota annually for three years under the 'enlarged access' policy. This limit can be raised to 100 per cent of the quota. All told, a member country can seek foreign exchange upto a cumulative upper limit of 400 to 440 per cent of its quota.

The purchase of the first or the reserve tranche is tree of any strings or conditions. But obtaining the second, third and fourth credit tranches and money from the extended access policy involves an ever grater degree of IMF supervisions, including substantial consultation with the officials of the Fund and a visit by the IMF financial teams. Typically, the IMF will require as prerequisites for borrowing cutback in budget deficit including subsidies to various sectors of the economy, reduction in the rate of monetary expansion, measures to restrain wages and prices, devaluation of an overvalued exchange rate, and some action to make the price system reflect costs more accurately and some steps to encourage exports. These are known as 'conditionalties' attached to assistance from the IMF. The conditionalties have proved to be the most controversial aspect of IMF operation in recent years. The major complaints of the borrowers against the IMF conditionalities are that it has become tougher, with stiffer norms towards borrower's domestic policies and that low income groups within a country bear the burnt of the adjustment.

18.3.1 Special Drawing Rights (SDRs)

SDRs are entitlement granted to member countries enabling them to draw from the IMF apart from their quota. It is similar to a bank granting a credit limit to the customer. When SDRs are allocated, the country's Special Drawing Account with the IMF is credited with the amount of the allotment.

SDR is not a currency. It is merely an asset created out of book entries. As such it is an independent reserve asset. The volume of SDRs can be increased or decreased according to the reserve needs of the international liquidity. Initially, the value of one SDR was equal to a specific quantity of gold (which equalled the value of 1 US Dollar) and provided with an absolute gold value guarantee. That is why SDRs were popularly known as 'Paper Gold'. Later, the value of SDR was linked to a basket of five currencies. The basket is reviewed every five years. It currently, consists of the Euro, the Yen, the Pound sterling and the US Dollor. When a member country utilises SDRs in holding would be less than the allocation. SDRs can be used directly among the members. A country may swap SDRs with another country to acquire a currency it desires. SDRs may be utilised to pay charges to IMF. SDR may be utilised to pay charges to IMF. SDR has gained importance both as a reserve asset and as a Unit of settlement of international transactions. Some international banks time deposits designated in SDR. Some countries have pegged their currencies to SDR.

18.3.2 IMF-World Bank Harmony

Bretton Woods institutions work in tandem. World Bank BOP support is not available with a Fund Programme, while a Fund Programme cannot be finalised without the prior negotiation of BOP support from the World Bank and from bilateral donors to fill the programmed resources gap. The bilateral donors do not commit funds until negotiations with the World Bank have been concluded. Whereas the IMF sets the macro-economic guidelines and targets of a programme, the World Bank imposed a list of neo-liberal macro-economic policy reforms on the borrowing country.

How Does the IMF Differ From The World Bank?

Table 18.1 below summarises the basic differences among the two institutions.

Table 18.1: Distinct Roles of the IMF and the World Bank

International Monetary Fund	World Bank
Oversee the international monetary systems and promotes international monetary cooperation.	Seeks to promote economic development and structural reforms in developing countries.
Promote exchange stability and orderly exchange relations among its members.	Assists developing countries by providing long-term financing of development projects and programmes.
Assists members in temporary BOP difficulties by providing them with the opportunity to correct maladjustments in their BOP.	Provides special finance assistance to the poorest developing countries through the IDA.
Supplements the reserves of its members by allocating SDBs if there is a long-term global need.	Stimulates private enterprise in developing countries through its affiliate, the International Finance Corporation.
Draw its financial resources principally from the quota subscriptions of its members.	Acquires most of its financial resources by borrowing on the international bond market.

18.4 ACHIEVEMENTS OF BRETTON WOODS INSTITTUTIONS

Some of the important *achievements* of the BW Institutions can be summarised as follows:

1) International reserves have increased substantially, providing a larger borrowers, halt now hold reserves greater than 150 per cent of maturing short and long-term debt; less than one-sixth had such coverage healing into 1997.

2) There have been improvements in fiscal performance, with some notable cases of governments achieving and sustaining large primary surpluses.

3) External balances have improved, with current accounts in most of the emerging world in surplus or modest deficit. Only 2 of the 20 largest borrowers now are running deficits in excess of 3 per cent.

4) Exchange rate regained are ore resilient and less fragile, and a substantial majority of the largest borrowing countries have moved to flexible, regimes, and away from the fixed-but adjustable pegs that proved so dangerous in the crises of the 1990s.

5) Important progress has been made in building credibility for new monetary policy requires, and inflation is generally moderate.

6) Governments have made major investments in recapitalising and restructuring their troubled financial systems. For example, in Asia, where some of the most severe problems were encountered, governments have spent over $500 billion carving out problem loans and bolstering capital.

7) Growth rates have improved with the restoration of domestic stability and recovery in external demand. Indeed, aggregate growth currently is runni9gn at its highest rate since the on set of the crisis in 1997.

8) With these improvements, and generally accommodative external financial conditions, borrowing costs have fallen, capital market access was restored for many countries, and credit growth resumed. Net credit growth to sovereigns has remained moderate, however, as much of the borrowing has gone to refinancing the existing stock of debt on more favourable terms.

9) The market for emerging market debt has also matured. There has been more differentiation in the response of spreads, both on the way down and credit fundamentals seemed to improve, and during the recent correction.

This progress is indicative of a general increase in the sophistication and skill of economic policy makers in the emerging world, and in the quality of understanding of the benefits of macroeconomic stability and how to achieve it. Many countries benefited from the advice and financial support from the IMF and the World Bank. But the most successful were those with policy makers who were ahead of the Fund and the Bank in diagnosing and addressing their problems, rather than being dragged reluctantly toward a more credible policy stance.

These improvements have left the emerging markets as a group less vulnerable to financial crisis than they were in the id 1990s. The combination of deeper reserve cushions, stronger external positions, improved balance sheets, more flexible exchange rate required, and better inflation performance provide a very different setting from what existed the last time the world faced a transition after a sustained period of benign financial conditions and low interest rates.

18.5 FAILURES OF THE BRETTON WOODS INSTITUTIONS

The aggregate improvements catalogued above mark substantial difference across countries and a number of areas of lingering vulnerability. Some of these are as follows:

1) some of the most daunting challenges are in the fiscal and public debt area, where a number of emerging market economies across different regions face very high, and in some cases still growing public sector debt levels. Average public debt burdens in the emerging world have risen to about 70 per cent of GDP, and among countries rated single B and below, the mean rises above 80 per cent.

2) The challenge of managing debt burden of this size is magnified by the fact that the debt structures in a number of countries are still quite vulnerable to foreign currency, liquidity and interest rate risk. The substantial share of public debt denominated in foreign currency – 70 per cent on average for the lowest rated group of borrowers – and the relatively short maturity of the debt stock mean that a relatively modest shock can produce a substantial increase in debt burdens, raising the amount of fiscal effort needed to keep the debt stock on a stable or declining path, and increasing the economy's vulnerability to a crisis.

3) In some countries, the fiscal trajectory is too weak to place the debt-to-GDP ratio in a sustainable path. In others, the fiscal position is strong enough to stabilise the debt dynamism but provided little buffer against adverse shocks, and very little room for fiscal policy to help cushion the effects of such a shock.

4) Important challenges remain in the financial area as well. In many countries, large public sector debt burdens have left banking systems highly exposed to the sovereign, constraining authorised room for manoeuvre. There are also problems in bank's corporate and consumer loans books, and a number of banking systems have also a large share of foreign currency denominated liabilities, in some cases held by non-residents.

5) The durability of recent improvements in external positions, which reflect weak domestic demand in many countries, is also open to question. As domestic demand strengths, external balances could move to deficit again, which in some cases will reintroduce a greater external risk.

6) And in many cases, the financial exposure of the IMF and World Bank is already high.

These balance sheet challenges took a long time to develop, and they will take a long time to reverse. They are the legacy of years of past fiscal decisions, magnified by the impact of crises on growth, the exchange rate, and the financial sector. They leave an exacting set of policy challenges. They raise the risk that future stocks to domestic confidence or adverse changes in the external environment could lead to new pressures on exchange rates, or interest rates, and on the capacity of countries to fund themselves on sustainable terms. Apart form the risk of crisis, these debt levels are large enough to depress domestic investment and long-term growth prospects. In past because of these balance sheet and debt burdens, many emerging market economies face a protracted transition before they can expect to be comfortably considered stable investment grade credits, with sufficient levels of self-insurance against external and domestic challenges to financial stability. One of the mot pressing challenges for the Bretton Woods institutions is to help assist in this process of reducing vulnerability, by promoting an unwinding of these large balance sheet risks and at the same time, providing a credible form of contingent insurance for those hopefully rare circumstances when their members face extraordinary financing needs.

Check Your Progress 1

1) Explain how World Bank and IMF are different form each other and how they work in close coordination?

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2) State the major achievements of the Bretton Woods Institutions.

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3) Write a note on the failures of the Bretton Woods Institutions

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18.6 RATIONALE IN ERA OF GLOBALISATION AND SUGGESTIONS

In the present era of globalisation where countries have unprecedented access to international capital flows and where those who have borrowed from the Bretton Woods Institutions are doing everything they can to repay their loans, it has been suggested that the Bretton Woods Institutions should closed down, and hence the slogan "sixty is enough". But it would be too radical a suggestions. For the reasons to be detailed below, not only there is a need for further strengthening of these institutions, there is also a new to restructure them.

18.6.1 Rationale

The rationale for the existence of the Bretton Woods institutions can be grouped in three categories as follows:

A) **Dealing with Global Externalities**

i) Global financial stability and episodes of systemic risk. National monetary authorities may address some but not all of these cases. In a world of greater financial integration, less capital controls, more capital mobility, not money and fickle investors, crises in past triggered by sudden reversal of capital flows cannot be ruled out.

ii) "Irrational" international investors' may derive from payoff externalities (leading to runs), information asymmetries and informational cascades leading to herding behaviour.

iii) Contagion from crisis country to other emerging markets and to advanced economies.

iv) Warning against externalities from poor economic policies and possible need for policy coordination.

v) External effects of liquidity runs and insolvency crises that lead to high liquidation costs.

vi) Need for international financial supervision.

vii) Need for mechanisms for orderly debt workouts.

viii) Need to avoid competitive devaluations wars (that may be proxies for trade policy wars) and severe currency (financial crisis that are highly disruptive of global trade.

ix) Ensure success of globalisation in all its forms (fee trade in goods and services FDI and transfer of information and technologies across countries, increased stable capital mobility and integration, appropriate management of labour migration).

B) **Market failures (even when they do not have international external effects)**

i) Self-fulfilling bank runs, government debt runs, currency crises.

ii) Liquidation costs of liquidity or semi-liquidity crises that results in runs.

iii) Excessive liquidation costs (i.e., the avoidable liquidation costs on top of the unavoidable ones) in insolvency crises where there are also runs.

iv) "Conditionality lending" as a way to resolve two coordination issues: need to design appropriate policy changes based on independent and superior information (thousands of creditors cannot do it) cost – when no private creditor is large enough and risk-neutral enough in a crisis to do that (as uncoordinated creditors rush to the exist) conditionality lending is a form on "delegated monitoring and coordination mechanisms" when there are "multiple principles" for the debtor agent.

v) Reducing the adjustment costs (need for how adjustment and stock adjustment and costly macro/structural reforms) for countries with serious underperformance and policy shortcomings.

vi) Need to actively coordinate debtor and creditors action in crisis management (resolution because of collective action problems (rush to exists, such to courthouse, holdout / tree rider problems) between creditors and between the debtors and its creditors including IMF pushing for appropriate policy regime changes.

vii) Possible provision of lender of last resort support to domestic banking systems that are informally or formally 'dollarised'. As more countries 'dollarise', 'euroise',join monetary and currency unions or are informally dollarised, domestic monetary authorities cannot provide such bender or last resort support.

C) **Domestic Policy Failures**

i) There is too much emphasis on "ownership" ownership of bad policies can lead to disasters. So, at times, the Fund and the Bank will need to be "paternalistic" and tell a country that the policies are unsustainable, that its debt is unsustainable and that its exchange rate regime is unsustainable. Subject to the caveat that some basic ownership is necessary to ensure that an IMF Programme is actually implemented, the IMF should not shy away from being paternalistic when necessary.

ii) But the Fund and the Bank should be careful about who are the "reformers" and who are the "vested interests". In countries with very unequal wealth and income distributions, the oligarchic elites may pursue their own private and corrupt interests.

iii) Going against vested interest and supporting reformers may mean to choose socially progressive reformers. Those advocating reforms that might address some inequality and poverty at times are not defined as "reformers" event though they are taking on vested interest. Vested interests that secure their interests in other ways often have not gotten the some security from the institutions.

Given these different externalities and market failures. The Bretton woods institutions have many important roles as follows:

- Ensure international monetary and macro stability that is essential for economic growth.
- Ensure global financial stability.
- Provide bilateral and multi-lateral surveillance and tools for crisis prevention.
- Provide lending to countries in financial difficulty or crisis.
- Support macro stability, and thus long run growth, in lower income countries.

18.6.2 Suggestions

For the last 60 years the Bretton Woods institutions have played an essential role in ensuring global financial stability and fostering economic growth and development. Further, as would be clear from the above discussion, these institutions are equally important even now. What is required is a strategic review of their functions and roles to identify the areas where these institutions can be constructively reformed to ensure that they maintain the crucial and essential roles that they have played until now. To this end, following suggestions in brief, have been made.

1) **Facilitating Restructurings**

There has been some progress in the last few years in efforts to improve the framework for sovereign restructurings. In particular, collective action clauses have become the market standard where emerging market governments issue debt under foreign law. The Bretton Woods institutions should be willing to lend to a sovereign that is in default to its private creditors only when two conditions have been established.

One, the country must commit to a credible medium-term adjustment programme, one that offers that prospect of a successful restructuring and a reasonably early return to the capital markets. This has to be established upfront for any restructuring effort to work. Commitment to a credible adjustment path that offers the reasonable prospect of a return to financial visibility and growth is the necessary foundation for engagement by the creditors in a restructuring process. Without that, there is little basis for meaningful engagement.

Two, before an institution can commit its support, the country must develop, in consultation with its advisors, and outline to the institution and its creditors, a credible and monitorable framework for cooperatively achieving a viable debt restructuring, one that leaves the country with a sustainable debt burden. The issues of appropriate adjustment and appropriate broad terms of proposed restructuring are closely intertwined and need to be assessed in tandem. For the BW institution, it should be an essential prerequisite that the country demonstrate at the outset that its approach has credible prospects for enlisting broad credit concurrence, and for being consistent with country's macroeconomic framework and payment prospects.

2) **Strengthening the Financial Instruments**

With this in view, following suggestions can be made:

i) Finance must be conditioned on a policy framework strong enough and timely enough to restore confidence. An institution's resources cannot compensate for a lack of policy credibility, and lending official resources to fund an inadequate policy efforts may make the situation worse.

ii) The scale of finance provided has to be calibrated to the needs, an the needs can we substantial in today's world. The BW institutions can only fill part of the gap, but there have to be able to fill a credible share of the gap if these have to play a successful part in catalysing other resources to flow.

iii) Flexibility to structure programmes appropriate to the circumstances and the borrower's policy effort is essential. The BW institutions need to be able to substantially frontload financial packages, when this is warranted. Making available small trenches of resources over the life of a programme does little to address the realities of open emerging market economies facing liquidity problems. Rather than the classis staircase pattern of disbursements, the institutions should consider, in some cases, providing a larger up front trance that floats and is available it stress materialises and policy is responding appropriately.

iv) The BW institutions should stand ready to support countries in pursuing reasonable restructuring proposals when narrated by the circumstances. Official financial resources in that context an be helpful in meeting some targeted needs.

v) The institutions need a more credible capacity to withstand arrears, so that these do not face the reality or the perception that these can be induced to accept weak programmes only to allow them to refinance their exposure.

3) **Changing the Surveillance Framework**

Part of the challenge entails reorienting surveillance, the process through which the BW institutions policy advice is delivered, to make it more effective. The surveillance features of today has a number of features that make it poorly suited to a small open emerging market economy that fragile credibility, a limited buffer against shocks, and considerable exposure to a rapidly changing economic and financial environment. Surveillance does not provide a meaningful check on *ex ante* policies, and resources are only made available when the financial need to acute. Access to supplemental resources on a precautionary or contingent basis could make a critical difference in preventing short-term liquidity crisis from becoming full-scale solvency problems leading to default. Of course, access to such contingent financing should be limited to countries whose policies were judged reasonably sustainable, and consistent with a reduction in balance sheet risks over time. With an enhanced surveillance framework designed to help keep policy on a stronger path that does reduce risk over time, and with contingent finance that could be mobilised quickly, the institutions would be better positioned to contain the risk of deeper financial crisis.

4) **Market-Friendly Reforms**

One main shortcoming of present development cooperation is that recipients of development cooperation is that recipients of development finance are denied any form of protection usual in all other cases. This shows in cases of violation of membership rights as well as regarding professional best practice. Damage done by grave negligence must always be compensated unless done the contest of development cooperation. Donors and multilateral institutions are totally exempt from any liability. The increased role of the BW institutions in international capital markets since 1982 contrasts sharply with a total lack of financial accountability. They may and often do gain institutionally and financially from crisis or from their own errors and failures, even if they cause damages by grave negligence. Another loan may be granted to repair damages done by he first loan, increasing the institutions income stream – a severe moral hazard problem and an economically totally perverted incentive system.

International financial institutions should be held financially accountable, differentiating between programmes and projects. To increase BW institutions efficiency and to improve their role in capital markets, market incentives must be brought to bear. The international public sector must become financially accountable for their own errors in the same way as consultants are liable to pay damage compensation if / when negligence on their part causes damage.

5) **Emulating the Private Sector**

The principle of corporate governance need be applied to the BW institutions.

IMF

The most important issue to how to reform the countries quotas in the IMF and the chairs in the Executive Board of the fund to provide greater representation to Asia and Africa. Give the growing roles of Asia in the global economies, Asian policy makers have correctly complained about a system of distribution of power within the IMF that does not recognise their growing role and, in part, they have developed institutions for Asian financial cooperation a reaction to their frustration for the lack of recognition of their growing global role. There is room for a creative solution: Unify the Chairs currently held by the Euro members, thus reducing the number of European Executive Directors, reallocate the existing quotas, reduce the quotas of the European countries to reflect the change in important and power of other regions. Thus, there is now room – and meaningful livelihood for some creative reform that will deliver a more representative IMF in the 21st Century.

Check Your Progress 2

1) Explain the need for Bretton Woods Institutions in this age of globalisation.

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2) What should be the role of Bretton Woods Institutions in the present times?

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3) Make suggestions to improve the working of the Bretton Woods Institutions.

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18.7 INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA) AND INTERNATIONAL FINANCE CORPORATION (IFC)

To end this unit on Bretton Woods Institutions, we give a brief profile of the working of the IDA and IFC, two associates institutions under the World Bank umbrella.

18.7.1 Working of IDA

IDA is an associate of IBRD. It was established in 1960 to provide 'soft loans' to economically sound project which creates 'social capital' such as the construction of roads and bridges, slum clearance and urban development. The projects taken by the IDA are such that fall under the category of high development priority due to their benefit to the development of the area concerned, but the returns from the projects are not sufficient to pay the high rates of interest on borrowings. The IDA provides loans for such projects interest-free and for longer periods. Therefore, IDA is often referred to as the 'sot loan window' of the World Bank.

The IDA extended assistance to high priority projects in the member-countries. The finance may we made available to the member-governments or to the private the enterprises. Lending to private enterprises may be made without government guarantees. It also cooperated with other international institutions and member-countries in providing financial and technical assistance to the less-developed countries.

The financial assistance of the IDA has some special features.

- The credit is interest-free. Only a small service charge of 0.75% per annum is payable on amount withdrawn and outstanding to cover administrative expenses.
- Repayment period is long-extending over 50 years. There is an initial moratorium for 10 years and the amount borrowed is repayable in the next 40 years.
- IDA finances not only the foreign exchange component but also a pat of the domestic cost.
- The credit can also be repaid in the local currencies of borrowing countries. Thus, the repayment of loan does not burden the balance of payments of the country.
- Only the poorest among the poor countries are eligible for assistance.

All members of the IBRD are eligible to become members of the IDA. The members are grouped into two. Part I consists of industrially developed countries whose subscription can be freely used or exchange for other currencies by the IDA. Part II lists consists of other countries who are required to contribute 10% of their subscription in the forms of other currencies and the rest of their own currencies. Contributions in the form of national currencies by these countries are not to be used by the IDA for conversion to other currencies or for financing exports form these countries without the consent of the country concerned.

IDA has been a blessing for the developing countries to whom the credit from the IDA has largely gone. The agency brings significant amounts of investment to the poorest countries on much easier terms than would otherwise be attainable. Importantly, it also serves to separate out the worst risk, protecting the World Bank's treasured A bond rating and thus allowing it to borrow in world credit market at the most favourable terms. In keeping with the objectives, most of the assistance has gone to high development priority projects which could not get finance from other sources.

18.7.2 Working of IFC

The IBRD loans are available only to member-country governments or with the guarantee of member-country governments. Further, IBRD can only make a loan but it cannot participate in the equity of the financed project. IFC was established in 1950 with the specific purpose of financing private enterprise. It is an affiliate of the IBRD. The Board of Governors of the IBRD also constitute the Board of Governors of the IBRD also constitute the Board of Governors of the IFC. But it is a separate entity with funds kept separate from those of the IBRD.

The purpose of the IFC is to further economic development by encouraging growth of private enterprise in member-countries, particularly in the less-developed areas, thus supplementing the activities of the IBRD. The IFC, therefore:

- Invests in private enterprise in member countries, in association with private investors and without government guarantee, in cases where sufficient private capital is not available on reasonable terms.
- Seek to bring together investment opportunities, private capital of both foreign and domestic origin, and experienced management; and

The IFC makes advances in the form of long-term loans or invests in the equity shares in a wide variety of productive private enterprises in developing countries. It particularly encourages joint ventures between developed and developing countries, the technical skill available with the former combining with the resources available with the latter. The project which IFC proposes to assist should be economically viable one and beneficial to the economy of the member-country. IFC's investment normally does not exceed 40% of the total investment of the enterprise. In case of its investment by equity contribution, it does not exceed 25% of the share capital. The interest charged on advances varies depending upon the proposal and status of the borrower.

The resources of the IFC consist of capital contributed by its members. It can also borrow from the World Bank for the purpose of lending. It can also float its own loans in world capital markets.

The IFC had a slow beginning and much of its assistance was concentrated in Latin and Central America Countries. But in recent years it has diversified its area of operation and many developing countries stand benefited.

Check Your Progress 3

1) How is IDA different from / related to IBRD?

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2) Examine the Working of the International Development Association.

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3) Examine the working of the International Finance Corporation.

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18.8 LET US SUM UP

For the last 60 years the Bretton Woods institutions have played and still play an essential role in ensuring global financial stability and fostering economic growth and development. A strategic review of their functions and roles is thus important to ensure that they maintain – in the next 60 years – the crucial and essential roles that have played until now.

18.9 KEY WORDS

Externalities : These are variously known as external economies and diseconomies, spill over and neighbour effects. Externalities involve an inter-dependence of utility and / or production functions. A beneficial externality arises where an externality – generating activity raises the production or utility of the externally-affected party. An external diseconomy is where the externality-generating activity lowers the production or utility of the externally – affected party.

Market Failures : The inability of a system of private markets to provide certain goods either at all or at the most desirable or 'optimum' level.

International Payments Systems : A general term referring to the way in which international financial transactions are carried out, that is payments between residents of different countries who hold different domestic currencies.

Special Drawing Rights : It is an accounting creation without any backing, which, subject to a variety of conditions, debtor countries may use to settle debts.

Conditionalties : The terms at which loans are extended by the IMF.

18.10 SOME USEFUL BOOKS

Grabbe, J. Orlin, *International Financial Markets* (Prentice Hall, New Jersey)

Dhingra, Ishwar C (2007) *The Indian Economy: Environment and Policy* (Sultan Chand, New Delhi,).

Soderston B. and Geoffery Read, *International Economics,* (Mac Millan, London).

Salvatore Dominick, *International Economics* (Prentice Hall, New Jersey)

Bhagwati, J.N., *Dependence and Inter-dependence* (Cambridge, M.I.T).

http://www.imf.org

18.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Sub-section 18.3.2.

2) See Section 18.4

3) See Section 18.5

Check Your Progress 2

1) See Section 18.6

2) See Sub-section 18.6.1

3) See Sub-section 18.6.2

Check Your Progress 3

1) See Sub-section 18.7.1

2) See Sub-section 1.8.7.1

3) See Sub-section 18.7.2