MODULE 4 ASSIGNMENTS

1. How do MNCs come into existence? What steps may an MNC follow in becoming

global?

The existence of an MNC is based on the international mobility of factors of production, MNCs are the main entities to induce competition across the world. They do so by allocating resources globally in an optimal manner. They make decision on the aspects such as ownership, production, financing and marketing with a single aim as to what is best for the corporation as a whole. The emphasis is on group performance rather than the achievements of individual subsidiaries. They do so by allocating resources globally in an optimal manner.

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Companies gradually increase their commitment to international business. The sequence normally involves exporting, setting up an international operations department, establishing a marketing subsidiary, entering into licensing agreements and eventually creating facilities for manufacturing abroad. It is not necessary that all companies follow this evolutionary process.

This process represents a sequence of moving from a relatively low-risk, low-return, export-based strategy to a higher-risk, higher-return, production-based strategy. Starting the internationalization process from exports has certain advantages.

2. Compare licensing agreement with establishment of a subsidiary.

Licensing agreements

MNCs use licensing agreements as an alternative to setting up manufacturing facilities. In return they receive royalties and other forms of payments.

Licensing has the advantage of smaller investment requirement, faster market entry and lower financial risk. But there are disadvantages associated with licensing. The licensee may turn into a competitor in due course. Besides, the licensor gets lower revenue stream and may find it difficult to maintain quality standards.

Establishment of a subsidiary

An MNC is a company engaged in making and selling its products in more than one country. It operates in other countries through subsidiary companies or branches. Unlike earlier days, the factors of production (capital, raw material, technology and labor) tend to move from one place to another within a country as also from country to country in search of higher returns. Natural resources have their value but even more important are new technologies that give rise to genetic engineering and miniaturization. Capital as a resource is no longer monopoly of a nation state bound by geographical borders; it moves around the world.

3. What risks does an international finance manager face?

The financial market with innovative products presents vast opportunities as well as unprecedented risks. Therefore, understanding operations in this market is a must for any finance manager, particularly the one dealing with international operations. Now, more and more companies are venturing into international operations in one form or another. Some may be doing only exports, others may be doing both exports and imports and still others may be doing exports, imports and investments.

In order to be effective in managing the expanding cross-border activities, finance managers are required to have a good command on working of the financial markets, underlying which are sophisticated financial products. Theoretical basis for these products has to be clearly understood. The market dynamics of many of these products is such that a risk management product can turn into a big risk itself, if not understood properly or not dealt with due care.

In addition, risk management involves both financing and investment decision. A finance manager in an MNC faces many challenges that his counterpart in a domestic firm does not encounter. These challenges include political risks leading to expropriation or confiscation of assets, exchange rate risk, control on repatriation of profits, different tax laws, multiple money markets and different interest rates etc. MNCs and their financial managers have to be abreast with the changes taking place all the time and develop ways to take advantages of the changes while reducing risks that these changes create.

They are able to access world's capital markets and thus diversify their funding sources. International finance manager has to analyze and balance international risks and advantages.

Some of the key challenges he must be prepared to face are listed hereunder:

a. To understand the interrelationship between environmental changes and corporate response. For example, how will the credit conditions be impacted by stock market crash? How will defaults by some debtor countries affect funding ability in the international capital market?

b. To understand the development and use of new instruments such as options, forwards futures and swaps for effective management.

c. To develop ways to minimize risks through internal and external techniques.

d. To take a balanced view of successes and failures, treating them as experiences to learn from. Decisions such as taking loan in a currency that has started appreciating fast, taking a fixed rate financing when rates have started going down will have an adverse impact and impel finance manager to contain the damage to the extent possible.

International financial management will involve the study of

a) Exchange rate and currency markets,

b) Theory and practice of estimating future exchange rate,

c) Various risks such as political/country risk, exchange rate risk and interest rate risk,

d) Various risk management techniques,

e) Cost of capital and capital budgeting in international context, (t) working capital management,

f) Balance of payment, and

g) International Financial institutions etc.

4. Describe the different kinds of international financial flows.

Merchandise Trade Flows

Environment Trade may be related to goods. Alternatively, it may be related to services. The merchandise trade has two sides. While one is export, the other is import. If India exports various goods, it will get convertible currencies and that will be an inflow of funds. On the contrary, it has to make payments in convertible currencies for the imports it makes. Thus export and import of goods lead to international financial flows.

Invisibles

Invisibles include, broadly, trade in services, investment income and unilateral transfers. If an Indian shipping company carries goods of a foreign exporter/importer and gets the freight charges, it will be treated as inflow of funds on account of trade in services. Similarly, if a foreign shipping company carries goods of an Indian exporter, there will be outflow of funds in form of freight charges. There are many examples of international flow of funds on account of trade in services.

Investment income relates to the receipt and payment of dividend, technical service, fees, royalty, interest on loan, etc. A foreign company operating in India remits dividend, etc. to its home country that will represent an outflow of funds. Similarly, an Indian company operating abroad remits to India the dividend and other fees that will represent inflow of funds. Likewise, payment of interest on foreign borrowings represents outflow of funds. Any receipt of interest manifests in inflow of funds.

Unilateral transfers are unidirectional. They represent international financial flows without any services rendered. If an Indian makes a gift to his/her friend in England, it will be a case of outflow of funds on account of unilateral transfer. Similarly, a large number of Indians living abroad remit a part of their income to their family members living in India. This is a case of inflow of funds on account of unilateral transfer.

Foreign Investment

Foreign investment may be of two kinds. While one is direct, the other is portfolio. Foreign direct investment (FDI) occurs when a firm moves abroad for the production of goods or provision of services and participates in the management of that company located abroad. On the contrary, foreign portfolio investment (FPI) is not at all concerned with the production of goods and rendering of services.

The sole purpose of a foreign portfolio investor is to earn a return through investment in foreign securities without any intention of grabbing the voting power in the company whose securities it purchases. In case of FDI too, an investor invests in the shares of a foreign company, but the sole objective is to enjoy the voting power and thereby a say in the management of the foreign company. Thus, it is primarily the voting right that differentiates between FDI and FPI. Whatever the forms may be, inflow of fiends occurs when a foreign investor makes investment in the country. On the contrary, outflow of funds occurs when the domestic investor invests in a foreign country.

External Assistance and External Commercial Borrowings

External assistance and external commercial borrowings are different in the sense that while the former flows normally from an official institution -bilateral or multilateral, the latter flows from international banks or other private lenders. The rate of interest in the former is usually low along with a longer maturity period. The latter carries market rate of interest and a shorter maturity. Last but not least, external assistance is manifest often in outright grant that does not require repayment of principal/interest payment. Whatever may be the difference between the two, any borrowing from abroad is treated as inflow of fiends Lending abroad, on the other hand, represents outflow of funds, However, repayment of loads is treated just the other way,

Short-term Flow of funds

Normally loans and foreign direct investment are meant for a period exceeding one year 8tit there are financial flows that occur for less than a year. Movement of funds relating to banking channels, euro notes, speculative and arbitrage activities, etc. are the examples of short term funds that move across countries.

1. 5. Comment on the structure of balance of payments. What are the basic principles? governing recording of the flows?

There is two norms need to be followed for balance of payment:

1. The structure of the balance of payments is based just on the principles of the double-entry book-keeping. It means that all the inflows of funds are put on the credit side and all the outflows of funds are debited; and ultimately, the two sides are balanced.
2. Since the different forms of the financial flows vary in nature, they are to be entered accordingly in the two compartments of the balance of payments. It may be mentioned that the balance of payments statement is divided into two compartments. One is known as the current account followed by the other known as the capital account. Those transactions that represent earning or spending are recorded in the current account.

6. How can the trade deficit be reduced or eliminated? Give your arguments based on the

elasticity approach,

The elasticity of demand is greater than unity, the import bill will contract and export earnings will increase as a sequel to devaluation. Trade deficit will be removed. However, the problem is that the trade partner may also devalue its own currency as a retaliatory measure. Moreover, there may be a long lapse of time before the quantities adjust sufficiently to changes in price. Till then, trade balance will be even worse than that before devaluation.

In case of full employment, where resources are fully employed, output cannot be expanded. Balance of trade deficit can be remedied through decreasing absorption without equal fall in output. It may be noted that validity of absorption approach depends upon the operation of the multiplier effect that is essential for accelerating output generation, It also depends on the marginal propensity to absorb that determines the rate of absorption.

The process of adjustment varies among the types of exchange rate regime the country has opted for. In a fixed exchange rate regime or in gold standard, if the demand for money that is the amount of money people wish to hold is greater than the supply of money, the excess demand would be met through the inflow of money from abroad. On the contrary, with the supply of money being in excess of the demand for it, the excess supply is eliminated through the outflow of money to other countries. The inflow and the outflow influence the balance of payments. More to lower the excessive cash balances. In the sequel, the balance of payments will turn deficit. Conversely a decrease in domestic credit would lead to an excess demand for money. International reserves will flow in to meet the excess demand. Balance of payments will improve.

7. Why are MNCs driving investments in South Asian Countries like Thailand, Malaysia

and Indonesia?

The ability of MNCs to use these globally available factors of production makes them competitive rather than the resource endowments of the parent country. The existence of an MNC is based on the international mobility of factors of production. An Indian parent company may raise finances in the US capital market to use it to acquire a company in Malaysia and sell the products of this acquired company in Latin American countries.

Part of the labor force employed in the Malaysian subsidiary may come from other South East Asian countries such as Indonesia, Philippines and Thailand etc. In today's context, development of design and other software can be done in far-off locations and used in other corner of the world as these travel with the speed of light on information networks. Value addition in products takes place at different locations in different countries before they are finally consumed.

(i) A large scale deregulation, cutting down the system of licenses and permits;

(ii) Substantial reduction in public sector enterprises and increase in privatization;

(iii) Increased development and use of information technology: (iv) a large numbers of mergers, takeovers and buyouts of corporate entities to have better structure and control; and

(v) An increasing and more visible adoption of free-market policies in the developing countries

8. Why are China and India emerging as attractive centers of FDI in recent years?

There has been phenomenal growth in FDI in the world following the pursuance of the policy of liberalization and globalization across different countries. FDI by MNCs has now come to be recognized as a powerful means of linking national economies and defining the character of the emerging global economy.

Some of the factors which can explain the growth of FDI in developing countries as china and India are as follows:

1. Intense competitive pressure in domestic economy.

2. Rationalizing of production activities so as to reap economies of scale and lower overall production costs

3. Higher commodity prices have stimulated FDI flows to countries rich in natural resources such as oil and minerals.

4. Increased mergers and amalgamation activities at global level has also acted as stimulant for FDI flows.

FDI outflows increased in 2004 by 18% to $730 billion, with firms based in developed countries accounting for the bulk ($637 billion). In fact almost half of all outward FDI originated from three sources: the United States, the United Kingdom and Luxembourg. Developed countries as a group remained significant net capital exporters through FDI; net outflows exceeded net inflows by $260 billion.

9.. What forces stimulate FDI in a country

FDI decisions depend on a variety of characteristics of the host economy,

Size of the Market

There can be seen a well well-known relationship between FDI and the size of the market and as well as with some of its characteristics (e.g. average income levels and growth rates). When the GDP of a country is relatively small, it is an indicator of low level of national income. As such investors prefer to invest in countries where there is a high growth potential and where there is a large market for their products and services.

Openness

Even though the investors pay attention on the size and the growth of the market as important, all the other domestic market factors are predictably much less relevant in export oriented foreign firms. Wide spread insight is that open economies encourage more foreign investment. One indicator of openness is the relative size of the export sector. Particularly manufacturing exports are a significant determinant of FDI inflows. Investors prefer countries where there are lenient rules and regulations in relation to foreign trade.

Labour costs and productivity

Labour cost is a significant factor for foreign investors specially when making their investments in labour intensive industries and for export oriented subsidiaries. (For an example opening up garment factories, export processing firms where larger number of employees is required) Low wage rates heavily stimulate investors to make their investment decisions in a particular country. How ever when the cost of labour is relatively insignificant (when wage rates vary slightly from country to country) the skills of the labour force are expected to have an impact on decisions about FDI location

Political Risk

High returns in the extractive industries seem to compensate for political instability. In general, as long as the foreign company is confident of being able to operate profitably without undue risk to its capital and personnel, it will continue to invest. Large companies overcome some of the political risks by investing in their own infrastructure maintenance and their own security forces. But these companies are restrained by small local markets and exchange rate risks since they tend to sell exclusively on the international market. If a country is vulnerable to a higher degree of riots, labour disputes, and corruption and if it possesses greater criminal level, those will be the determinants that restrain foreign investments.

Infrastructure Facilities

Infrastructure covers many dimensions ranging from roads, ports, railways and telecommunication systems required to institutional development (e.g. Legal services, accounting etc.) The extent of transport facilities and the proximity to major ports has a significant positive effect on the location of FDI within the country. Poor infrastructure can be seen both as an obstacle and as well as an opportunity for foreign investment.

Incentives and operating conditions

Removal of boundaries and provision of a healthy environment for businesses that consists of better operating conditions, lower tax rates or tax holidays are generally believed to have a positive impact on stimulating FDI. Further incentives such as the granting of equal treatment to foreign investors in relation to local counterparts and the opening up of new markets (e.g. air transport, retailing, banking) have been reported as important factors of encouraging FDI flows to a particular country.

Privatization

Through privatization it has attracted some foreign investment inflows in recent years. But when moving on to most of the developing, low income countries progress is still low due to divestments of state assets. This has become political issue that demotivate investors. For an example employee resistance and their aggressive actions over privatization or other moves which threaten their existing jobs and worker rights may act as a deterring factor of FDI.

10.. What is internationalization theory of FDI? Discuss strengths and weaknesses of the

theory?

The internalization theory of foreign direct investment is tested by comparing gains from foreign direct investment (FDI) and non-FDI modes of expansion. The proponents of internalization theory argue that FD1 modes of expansion are better since the risk of dissemination of information monopoly is less when firms expand using these modes. However, critics argue that non- FDI modes of expansion are preferable because of the high agency costs of decentralization associated with FDI modes. This slightly sheds some light on the debate by comparing the gains from FDI and non-FDI modes of expansion. The results show that abnormal returns to the shareholders are significantly higher when firms expand using non-FDI modes of expansion (e.g., sales, contracts, ant1 licensing) relative to FDI modes of expansion (e.g., subsidiaries, acquisitions, and joint-ventures).

The theory of internalization does provide an explanation of certain types of FDI activities by MNEs. In particular, there are three areas where internalization appears to provide an explanation of FDI as a specific form of international involvement by the MNE: these entail vertical integration, transfer pricing and quality control [Buckley, Casson, 1976; Casson, 1983].

11. Gold standard provided domestic price stability and automatic adjustment in balance of

payments and in exchange rate. Discuss.

The process of adjustment varies among the types of exchange rate regime the country has opted for. In a fixed exchange rate regime or in gold standard, if the demand for money that is the amount of money people wish to hold is greater than the supply of money, the excess demand would be met through the inflow of money from abroad. On the contrary, with the supply of money being in excess of the demand for it, the excess supply is eliminated through the outflow of money to other countries. The inflow and the outflow influence the balance of payments.

To explain it further, with constant prices and income and thus constant demand for money, any increase in domestic credit will lead to outflow of foreign exchange as the people will import more to lower the excessive cash balances. In the sequel, the balance of payments will turn deficit.

Conversely a decrease in domestic credit would lead to an excess demand for money. International reserves will flow in to meet the excess demand. Balance of payments will improve.

However, in a floating-rate regime, the demand for money is adjusted to the supply of money via changes in exchange rate. Especially in a situation when the central bank makes no market intervention, the international reserves component of the monetary base remains unchanged. The balance of payments remains in equilibrium with neither surplus nor deficit. The spot exchange rate is determined by the quantity of money supplied and the quantity of money demanded.

When the central bank increases domestic credit through open market operations, supply of money is greater than the demand for it. The households increase their imports. With increased demand for imports, the domestic currency will depreciate and it will continue depreciating until supply of money equals the demand for money. Conversely, with decrease in domestic credit, the households reduce their import.

Domestic currency will appreciate and it will continue appreciating until supply of money equals demand for money. In case of managed floating, the central bank often intervenes to peg the rates at some desired level. And so this case is a mix of fixed and floating rate regimes. It means that changes in the monetary supply and demand do influence the exchange rate but also the quantum of international reserves.

The nature of exchange rate arrangement has undergone changes over past couple of centuries. There was a time when costly metal was' used as medium of international exchange of commodities under a specific arrangement, known as commodity specie standard, It was followed by gold standard that was a more sophisticated version of the exchange rate arrangement and that had set rules.

It enjoyed merits, but at the same time, there were some limitations to that system that led to its suspension for some time and subsequently to its abandonment. The abandonment of the gold standard led to upheavals in the exchange rates and then to check it, the-IMF was established.

12. Mention the features of the fixed parity system of exchange rate. What were the causes

behind its collapse?

The exchange rate regime was known as the fixed parity system with adjustable pegs. In fact, it was designed at Bretton Woods and so it was also known as the Bretton Woods exchange rate system. 31 System In the fixed parity system, each member country was to set a fixed value-called the par value -of its currency in terms of gold or US dollar. It was the par value that determined the rate of exchange between two currencies.

Minor fluctuations in the exchange rate within a narrow band of one per cent above and below the established parities could not be ruled out. They were to be corrected through active intervention of the monetary authorities of that country. It may, however, be mentioned that the fixed parity under the Bretton Woods system was not like that of gold standard of 1880-1914. It was a fixed parity with adjustable pegs meaning that any member country could alter the value of its currency or, in other words, could devalue its currency in case of "fundamental disequilibrium" in the balance of payments.

Changes up to five per cent did not require prior approval of the IMF, but beyond it, IMF's approval was necessary. Fundamental disequilibrium was never formally defined; but in practice, it meant continued and chronic balance of payments problem and colossal loss of reserves.

The purpose of the adjustable peg system was, therefore, to establish a balance between the objectives of stable exchange rates and the macro-economic goals of the countries going for such adjustments as also to help avoid any use of exchange control and trade-restrictive measures. In other words, it brought flexibility in the fixed exchange rate system for the purpose of attaining equilibrium in the balance of payments.

The provisions also contained cautions so that there might not be competitive devaluation. It was maintained through supervision and scrutiny over desired exchange rate changes. Again, an important aspect of the Bretton Woods exchange rate system was that the US dollar was convertible into gold at a fixed rate of $ 35 a troy ounce of gold. The other currencies were convertible into gold via US dollar.

This currency was given the position or intervention currency in the system in view of the fact that in the immediate post-War period, it was the strongest currency. This system was, therefore, likened with the gold exchange standard where countries redeemed their currency into gold-convertible currency and not necessarily into gold directly. In the post-War system, the US dollar came to be the intervention currency what was the British pound during the early decades of the twentieth century.

The system performed well during 1940s and till late 1950s. The US dollar did do well as an intervention currency insofar as it was as good as gold in view of the strong position of the US economy. The central bank in many countries held the dollar denominated securities as reserves. But when the US balance of payments began experiencing growing deficits on account of widening trade deficit and outflow of dollar, the real value of dollar turned lower compared to its nominal value.

It shook confidence in dollar and the central banks began converting the US dollar denominated securities into gold. It led to the outflow of gold from the USA that in turn slashed further the real value of dollar. A vicious circle emerged between falling real value of dollar, loss of confidence in dollar, conversion of US dollar denominated securities into gold and the outflow of gold from the USA.

The outflow of gold was so huge in August 1971 that the then President Nixon suspended the convertibility of US dollar into gold. This decision threatened the very fundamentals of the fixed parity system. In order to bring back confidence in US dollar, the Smithsonian Committee resolutions of December 197I devalued dollar and re-valued upwardly some major currencies. At the same time, the normal fluctuation band was widened to +/- 2.25 per cent. But the Smithsonian measures failed to generate confidence. A few currencies came on to float, and finally, the fixed parity system collapsed in February 1973.

13. Do you agree that fixed exchange rate is better than floating rates? Explain.

Floating Rates

Unlike the fixed rate, a floating exchange rate is determined by the private market through supply and demand. A floating rate is often termed "self-correcting," as any differences in supply and demand will automatically be corrected in the market. Look at this simplified model: if demand for a currency is low, its value will decrease, thus making imported goods more expensive and stimulating demand for local goods and services. This, in turn, will generate more jobs, causing an auto-correction in the market. A floating exchange rate is constantly changing.

In reality, no currency is wholly fixed or floating. In a fixed regime, market pressures can also influence changes in the exchange rate. Sometimes, when a local currency reflects its true value against its pegged currency, a "black market" (which is more reflective of actual supply and demand) may develop. A central bank will often then be forced to revalue or devalue the official rate so that the rate is in line with the unofficial one, thereby halting the activity of the black market.

In a floating regime, the central bank may also intervene when it is necessary to ensure stability and to avoid inflation. However, it is less often that the central bank of a floating regime will interfere.

Fixed Rate

A [fixed](https://www.investopedia.com/terms/f/fixedexchangerate.asp), or pegged, rate is a rate the government ([central bank](https://www.investopedia.com/terms/c/centralbank.asp)) sets and maintains as the official exchange rate. A set price will be determined against a major world currency (usually the U.S. dollar, but also other major currencies such as the euro, the yen, or a basket of currencies). In order to maintain the local exchange rate, the central bank buys and sells its own currency on the foreign exchange market in return for the currency to which it is pegged.

If, for example, it is determined that the value of a single unit of local currency is equal to US$3, the central bank will have to ensure that it can supply the market with those dollars. In order to maintain the rate, the central bank must keep a high level of [foreign reserves](https://www.investopedia.com/terms/r/reservecurrency.asp). This is a reserved amount of foreign currency held by the central bank that it can use to release (or absorb) extra funds into (or out of) the market. This ensures an appropriate money supply, appropriate fluctuations in the market (inflation/deflation) and ultimately, the exchange rate. The central bank can also adjust the official exchange rate when necessary.

The reasons to peg a currency are linked to stability. Especially in today's developing nations, a country may decide to peg its currency to create a stable atmosphere for foreign investment. With a peg, the investor will always know what his or her investment's value is and will not have to worry about daily fluctuations.

 A pegged currency can help lower inflation rates and generate demand, which results from greater confidence in the stability of the currency.

Fixed regimes, however, can often lead to severe financial crises, since a peg is difficult to maintain in the long run. This was seen in the Mexican (1995), [Asian](https://www.investopedia.com/terms/a/asian-financial-crisis.asp)(1997), and Russian (1997) financial crises, where an attempt to maintain a high value of the local currency to the peg resulted in the currencies eventually becoming [overvalued](https://www.investopedia.com/terms/o/overvalued.asp). This meant that the governments could no longer meet the demands to convert the local currency into the foreign currency at the pegged rate.

With [speculation](https://www.investopedia.com/terms/s/speculation.asp) and panic, investors scrambled to get their money out and convert it into foreign currency before the local currency was devalued against the peg; foreign reserve supplies eventually became depleted. In Mexico's case, the government was forced to devalue the peso by 30 percent. In Thailand, the government eventually had to allow the currency to float, and, by the end of 1997, the Thai bhat had lost 50 percent of its value as the market's demand, and supply readjusted the value of the local currency.

Countries with pegs are often associated with having unsophisticated [capital markets](https://www.investopedia.com/terms/c/capitalmarkets.asp) and weak regulating institutions. The peg is there to help create stability in such an environment. It takes a stronger system as well as a mature market to maintain a float. When a country is forced to devalue its currency, it is also required to proceed with some form of economic reform, like implementing greater transparency, in an effort to strengthen its financial institutions.

Some governments may choose to have a "floating," or "[crawling](https://www.investopedia.com/terms/c/crawlingpeg.asp)" peg, whereby the government reassesses the value of the peg periodically and then changes the peg rate accordingly. Usually, this causes devaluation, but it is controlled to avoid market panic. This method is often used in the transition from a peg to a floating regime, and it allows the government to "save face" by not being forced to devalue in an uncontrollable crisis.

Although the peg has worked in creating global trade and monetary stability, it was used only at a time when all the major economies were a part of it. While a floating regime is not without its flaws, it has proven to be a more efficient means of determining the long-term value of a currency and creating equilibrium in the international market.

14. What do you mean by SDRs? How do they help improve international liquidity?

Special Drawing Right (SDR)

The SDR was created as a supplementary international reserve asset in the context of the Bretton Woods fixed exchange rate system. The collapse of Bretton Woods system in 1973 and the shift of major currencies to floating exchange rate regimes lessened the reliance on the SDR as a global reserve asset. Nonetheless, SDR allocations can play a role in providing liquidity and supplementing member countries’ official reserves, as was the case with the 2009 allocations totaling SDR 182.6 billion to IMF members amid the global financial crisis.

The SDR serves as the unit of account of the IMF and some other international organizations.

The SDR is neither a currency nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. SDRs can be exchanged for these currencies.

 SDRs augment international [liquidity](https://www.investopedia.com/terms/l/liquidity.asp) by supplementing the standard reserve currencies.

An SDR is essentially an artificial currency instrument used by the IMF, and is built from a basket of important [national currencies](https://www.investopedia.com/terms/n/national-currency.asp). The IMF uses SDRs for internal accounting purposes. SDRs are allocated by the IMF to its member countries and are backed by the [full faith and credit](https://www.investopedia.com/terms/f/full-faith-credit.asp) of the member countries' governments. The makeup of the SDR is re-evaluated every five years

IMF, in order to provide international liquidity, maintains a pool of reserves created out of the contribution of the member countries based on their quota. The size of the pool was enlarged through borrowings from the industrialized countries under different schemes; and more importantly, through the creation of an international reserves asset, known as the SDRs.