International Financial Institutions

CE 397

Brad Eck

February 28, 2008

Introduction

Water resources projects involving several countries are frequently financed by international financial institutions. This paper provides an overview of the history and operation of those financial institutions formed after World War II. After the war, most of the world’s economies were in shambles. Many counties, especially France, were in very bad shape. One cause (of many) of the war was economic imbalances between countries due to an inability to conduct international trade.

In an effort to address the problem of exchanging currencies, and to develop a plan to rebuild Europe, the Monetary and Financial Conference of the United Nations gathered in Bretton Woods, New Hampshire in July of 1944. The result of this conference was a new system for international monetary and financial operations: the Bretton Woods System. The system created two international financial institutions, each one for a distinct purpose. The International Monetary Fund (IMF) was created to facilitate the exchange of currency between countries. The International Bank for Reconstruction and Development was created to lend money for reconstruction and development efforts.

International Monetary Fund

To stabilize foreign exchange markets, the IMF fixed exchange rates between currencies. The US dollar was the world’s strongest currency and was still linked to gold. Thus, fixing exchange rates effectively put the world on the gold standard. Countries pay money into the IMF in proportion to their standing in the global economy. The IMF maintains liquidity of currencies by acting as a market maker. The fund bought currency when no one else would, and sold currency when needed. This system of fixed exchange rates collapsed in the late 1970s shortly after the USA went off the gold standard.

After the collapse of the Bretton Woods System, the IMF was re-incorporated under a new governing document. Today the IMF has 185 member countries and total resources of about $358 billion. The IMF maintains financial reserves in the form of a variety of currencies as well as its own currency—the SDR. An SDR (Special Drawing Right) is a basket of currencies (euro, dollar, pound, and yen). The point of the currency basket is that the IMF is less exposed to fluctuations in exchange rates like the recently falling dollar. Right now an SDR is worth about $1.59. The IMF also maintains the largest gold reserves in the world.
Understanding the IMF’s place in international finance requires an understanding of Balance of Payments. A country’s balance of payments is the record of transactions between its residents and foreign residents over a specified period of time. The key point is that the accumulated effect of foreign transactions can create a very large obligation for a country. Making good on this obligation could force a country to sell real assets, which would threaten the economy. The IMF makes loans to countries in this type of situation so that assets do not have to be liquidated. IMF money comes with strings. When a country takes an IMF loan, they agree to make changes in their financial system to avoid a recurrence of the problem in the future. Therefore, the IMF is a very important international financial institution but it does not make loans for specific projects, only for balance of payment issues.

**World Bank**

The International Bank for Reconstruction and Development was formed as part of the Bretton Woods Accords to lend money for specific projects. Just after the bank was formed, it loaned $250 million to France for rebuilding after World War II. Today, the bank is one of five organizations in the World Bank Group:

1. The **International Bank for Reconstruction and Development** loans money to the governments of poor countries for specific projects.
2. The **International Development Association** provides interest free loans and grants to the governments of very poor countries.
3. The **International Finance Corporation** loans money to the private sector in developing countries.
4. The **Multilateral Investment Guarantee Agency** insures (with an i) foreign direct investment in developing nations.
5. The **International Centre for Settlement of Investment Disputes** provides arbitration of international investment disputes.

The first two organizations are known collectively as the World Bank. The vast majority of countries belong to all five organizations. Due to its relevance in this course, the remainder of this document focuses on the World Bank.

**Financing & Governance**

Like the IMF, the World Bank is owned by its 185 members, who contribute money to support the bank. This sovereign backing gives the World Bank a very high credit rating (AAA). The bank uses its credit rating to borrow money in international capital markets. The bank then provides these funds to developing countries as low interest loans. The bank does not operate for profit so loan repayments provide operating income for the bank and provide funds for the International Development Association.

The World Bank was established with $10 billion in subscriptions (promises to pay) at the Bretton Woods conference. Since inception, members have paid $11 billion and the bank has loaned about $400 billion. The bank currently expects to loan $10-15 billion per year.
The World Bank is governed by a board of directors. Each member has a director but the
director’s voting power depends on how much World Bank stock his country owns. The
United States is the largest shareholder and has the most voting power (16%).

Operations

Today’s World Bank does much more than loan money—it seeks to reduce global
poverty through achievement of the UN’s Millennium Development goals. In this effort,
the bank provides financial services, advice and information, and knowledge sharing.

Financial services consist of loans and grants to poor countries. Getting a loan from the
World Bank is a complex task. Before the bank provides the loan, it evaluates the project
proposal on economic, financial, social and environmental grounds. The process of
getting a loan approved depends heavily on the opinion of the bank’s staff and
consultants. Without bank approval, there is no money; and approval rests with the bank
staff. The bank supervises the project, but the borrower actually implements it. In
practice this means that a developing country gets a large infusion of cash from the bank
to carry out a project. Large sums of cash attract corruption, and corruption has been a
problem on World Bank projects for some time.

To help make decisions about loans, the World Bank does a great deal of economic and
sector analysis in developing countries. Indeed most statistics about poverty quoted in
the media are from the World Bank. The bank also strives to increase the capacity of
developing nations for dealings with the developed world. The bank provides training
through knowledge sharing networks, webcasting and other conferences.

Other International Financial Institutions

Besides the Bretton Woods Institutions (IMF & World Bank) there are many other
International Financial Institutions. Many such institutions are modeled on the World
Bank—sovereign nations back loans to developing nations. The World Bank is
considered to be one of 5 Multi-Lateral Development Banks:

(1) The African Development Bank
(2) The Asian Development Bank
(3) The European Bank for Reconstruction and Development
(4) The Inter-American Development Bank Group
(5) The World Bank Group

The so called Sub-Regional Development Banks focus on a smaller region than the
Multi-laterals. Some examples are:

- Corporacion Andina de Fomento
- Caribbean Development Bank
- Central American Bank for Economic Integration
• East African Development Bank
• West African Development Bank

Separate from the banks listed above are Multilateral Financial Institutions, which have more narrow ownership, or focus on special sectors or activities. Some examples are the following:

• The European Commission and The European Investment Bank
• International Fund for Agricultural Development
• The Islamic Development Bank
• Nordic Development Fund and Nordic Investment Bank
• The OPEC Fund for International Development

Questions for Discussion

Think about these questions on a personal level:

• When you loan money, what kind of influence do you expect to have?
• How much research would you do before making a big loan to a risky borrower?

Required Reading

World Bank Operations:  http://go.worldbank.org/1YXPMBNDO0

Supplemental Reading

The websites for the IMF and the World Bank have a great deal of information:

www.worldbank.org
www.imf.org