International Financial Institutions and European Economic and Monetary Union

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SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

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International Business Finance

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Key international financial institutions

- International financial institutions are integral part of the international monetary system as they built up the institutional framework
- Several institutions with global or remarkably international influence
  - International Monetary Fund
  - World Bank and World Bank Group
  - Central banks of major economic centers (Federal Reserve System, European Central Bank, Bank of Japan, Bank of England)
  - Regional development banks
  - Bank for International Settlements
  - European Investment Bank
- Listed institutions differ in size as well as objective

Basic facts about the IMF

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- Conceived on Bretton Woods conference in July 1944
- Established in 1945 with headquarters in Washington, D.C.
- 189 member countries make near-global membership
- Executive management consists of 24 Directors each representing a single country or groups of countries
- Primary aims
  - Promote international monetary cooperation
  - Facilitate the expansion and balanced growth of international trade
  - Promote exchange stability
  - Assist in the establishment of a multilateral system of payments
  - Make resources available to members experiencing balance-of-payments difficulties

Main channels of the IMF activities

- Surveillance = monitoring national, global, and regional economic and financial developments and advising member countries on their economic policies
  - IMF regularly monitors the strength of national financial sectors (around 15 countries undergo in-depth assessments annually)
- Lending = providing members with loans in hard currencies to support policy programs designed to correct balance of payments problems
  - Almost 200 new loans disbursed since 2008
- Capacity Development = offering technical assistance in its areas of expertise, as well as training for government and central bank officials
  - IMF helped establish Central Bank of Kosovo and trained its staff

IMF governance and organization

- Board of Governors
  - Highest decision-making body of the IMF
  - Each member country represented by one governor and one alternate governor
  - Approve quota increases, special drawing right (SDR) allocations, the admittance of new members, compulsory withdrawal of members, and amendments to the Articles of Agreement and By-Laws
  - Elects Executive Directors
- Executive Board
  - 24-member Executive Board conducts the daily business of the IMF
  - 8 Executive Directors nominated by large countries forming single-state constituencies and 16 represent multiple-state constituencies
  - Takes decisions on all aspects of IMF work including conditions on loans, technical assistance, IMF budget, health checks of member countries economies

IMF governance and organization

- Managing Director
  - Chairman of the IMF’s Executive Board and head of IMF staff (approximately 2,700 from 148 countries)
  - Appointed by the Executive Board for a renewable term of five years
  - Based on tradition, the Managing Director is an European citizen
  - **Kristalina Georgieva** (Bulgaria) has been the Managing Director since October 1, 2019.
- Governance Reform
  - Reform package approved in December 2010 and became effective in January 2016
  - Quota increase and shift in shares
  - Protecting voting power of the poorest
  - New version of quota formula
  - New composition and more representative Executive Board

Funding of the IMF

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- Quota system
  - Each member of the IMF is assigned a quota (based on size of its economy)
  - 75% paid in national currency and 25% in world major currencies
  - Regular reviews of quota resources and allocations
  - Latest review (the 14th), concluded in 2010, included an agreement to double quota resources to SDR 477 billion (about USD 649 billion)
- Multilateral and bilateral borrowing
  - General Agreements to Borrow (1962) and New Agreements to Borrow (1997) together comprise lending capacity of 34 billion SDR (47 billion USD)
  - Bilateral borrowing temporarily supplements other resources in periods of uncertainty
- Gold holdings
  - Gold holdings amount to about 90.5 million troy ounces (2,814.1 metric tons)

Special Drawing Rights (SDR)

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- Created by the IMF in 1969 as a supplementary international reserve asset, in the context of the Bretton Woods fixed exchange rate system
- Collapse of the Bretton Woods system and shift to floating exchange rates lessened importance of SDR as a reserve asset
- 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
- IMF may allocate SDRs to member countries in proportion to their IMF quotas
- Has no physical form, used as a unit of account
- Its value is set daily using a basket
  - Effective October 1, 2016 the SDR basket consists of USD, EUR, CNY, JPY, GBP

SDR valuation

Friday, August 04, 2017				
Currency	Currency amount under Rule O-1	Exchange rate [1]	U.S. dollar equivalent	Percent change in exchange rate against U.S. dollar from previous calculation
Chinese Yuan	1.0174	6.72440	0.151300	0.053
Euro	0.38671	1.18705	0.459044	0.287
Japanese Yen	11.900	110.07000	0.108113	0.468
U.K. Pound Sterling	0.085946	1.31410	0.112942	-0.353
U.S. Dollar	0.58252	1.00000	0.582520	
			1.413919	
		U.S.$1.00 = SDR	0.707254 [2]	-0.106 [3]
		SDR1 = US$	1.413920 [4]	

SDR interest rate

For the week of July 31, 2017 to August 06, 2017				
Currency	Currency amount under Rule O-1 (A)	Exchange rate against the SDR [1] (B)	Interest rate [2] (C)	Product (A) x (B) x (C)
Chinese Yuan	1.0174	0.105519	3.006700	0.3228
Euro	0.38671	0.834483	-0.560723	-0.1809
Japanese Yen	11.900	0.00640733	-0.132000	-0.0101
U.K. Pound Sterling	0.085946	0.93103	0.130000	0.0104
U.S. Dollar	0.58252	0.71147	1.080000	0.4476
			Total	0.5898
			Floor for SDR Interest Rate	0.050
			SDR Interest Rate [3]	**0.590**

IMF lending

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- IMF helps its members tackle balance of payments problems and restore sustainable economic growth
- 25% of a countries quota is deposited with it’s central bank to supplement its international reserves and can be used unconditionally
- Other IMF lending is conditional: the country must adopt policies that promise to correct its balance-of-payments problems
  - Letter of intent (program of economic stabilization); the conditionality hardens with every further credit line
- IMF lending is temporary (6 months – 4 years), repayment periods are 3.5 years – 10 years
- New types of lending facilities during recent global financial crisis

IMF credits outstanding

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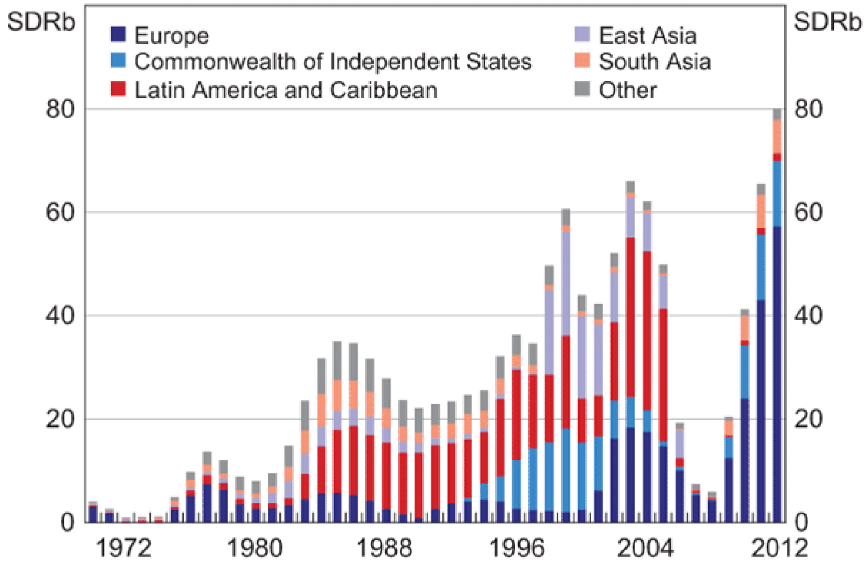

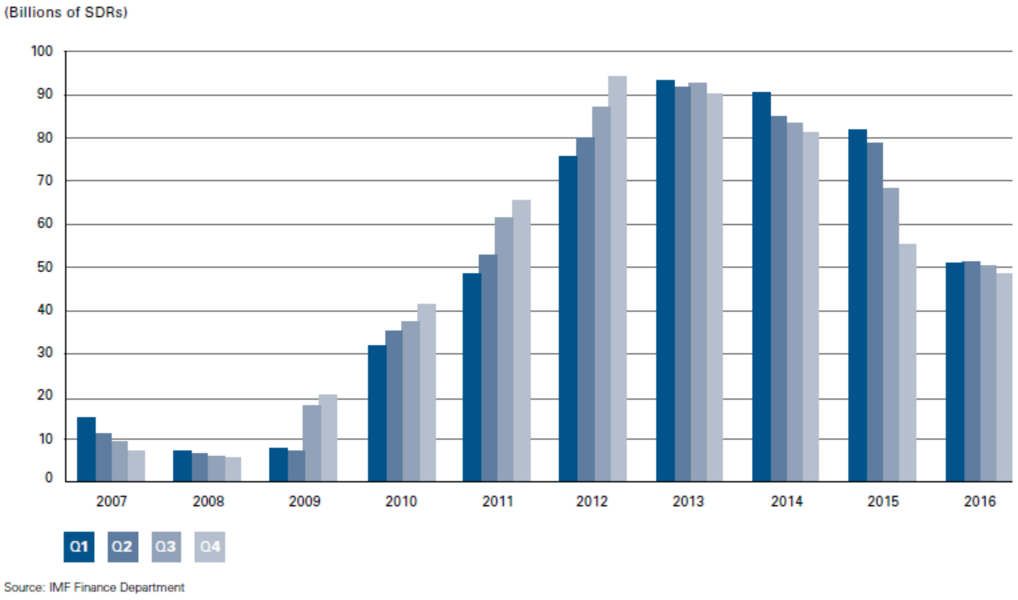

Basic facts about the World Bank

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- Bretton Woods twin to the IMF established in 1945 as the International Bank for Reconstruction and Development
- 189 member countries (membership conditioned by membership in the IMF)
- Executive management consists of 25 Directors appointed from five largest shareholder countries or elected from other member countries
- Devoted to poverty reduction and development in poor countries
- Two goals for the world to achieve by 2030
  - End extreme poverty by decreasing the percentage of people living on less than USD 1.90 a day to no more than 3%
  - Promote shared prosperity by fostering the income growth of the bottom 40% for every country

History of the World Bank

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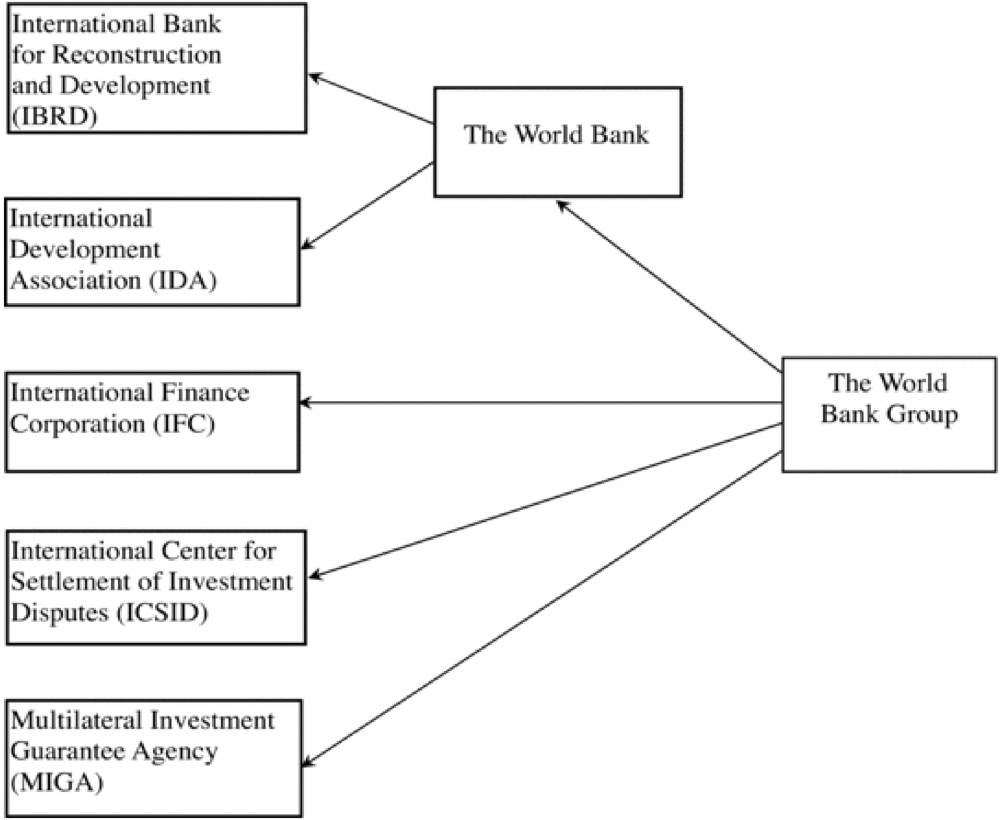
- The IBRD opened in 1946 with the balance between post-war reconstruction and development tilting quickly towards reconstruction
- In 1956, the IBRD Executive Directors created the International Finance Corporation (IFC) to promote private enterprise in developing countries
- In 1960, the Executive Directors created the International Development Association (IDA), a “soft loan” version of the IBRD
- In 1966, the International Center for Settlement of Investment Disputes (ICSID) was introduced to provide arbitration between foreign investors and host country governments
- In 1988, the Multilateral Investment Guarantee Agency (MIGA) was introduced to encourage the flow of FDI to developing countries

Components of the World Bank



Administrative structure of the World Bank

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Body	Composition	Function
Board of Governors	One Governor and one Alternate Governor for each member	Meets annually; highest decision-making body; vision and mission of WB
Executive Board	25 Executive Directors plus President	Day-to-day operations; approve loan and bond issues
President	Traditionally U.S. citizen, **David Malpass** (2019)	Chair of Executive Board; responsible for staffing and general business
Vice President		Assists President
Advisor Council	Appointed by Board of Governors	Advises on general policy matter
Staff	Citizens of members	Run departments of WB

World Bank Administration

- The World Bank has a plethora of Vice Presidencies
- These are structured around
  - Regions (Africa, East Asia and Pacific, Europe and Central Asia, Latin America and the Caribbean, Middle East and North Africa, South Asia)
  - Networks (financial and private sector development, human development, operations policy and country services, poverty reduction and economic management, and sustainable development)
  - Functions (external relations and development economics)
- The World Bank has over 10,000 staff members who work both in the head office in Washington, DC as well as in over 100 country offices around the world

Countries qualified for World Bank activities

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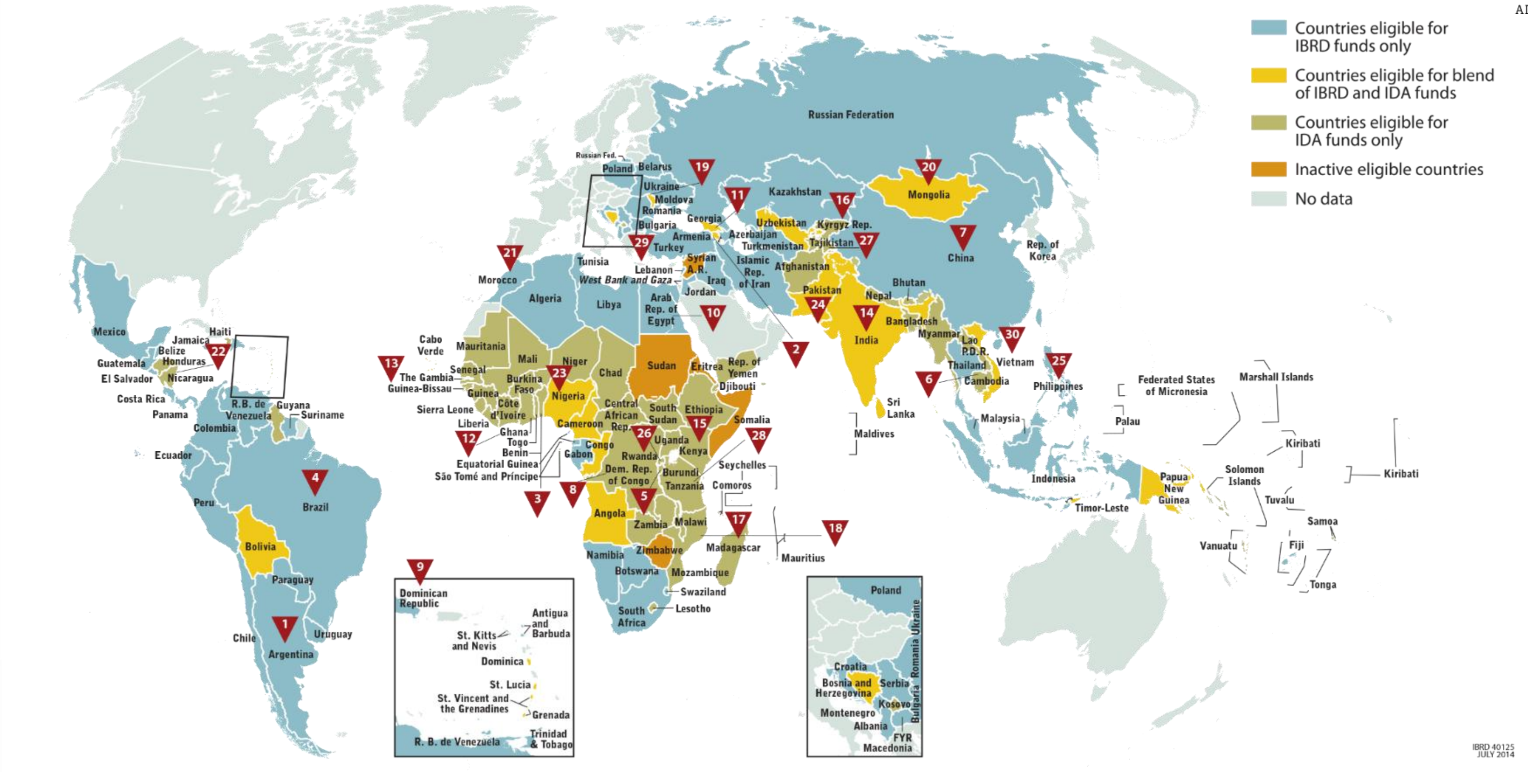


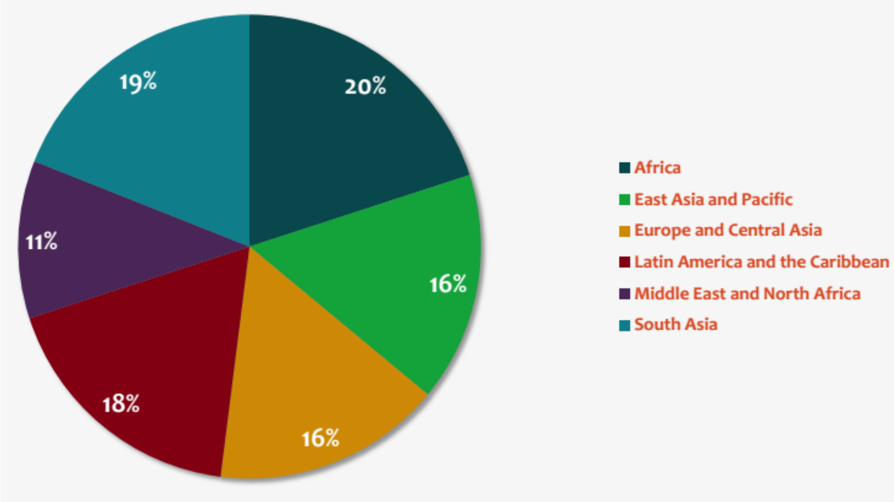
Summary of the World Bank activities

- International Bank for Reconstruction and Development
  - 189 member countries
  - Fiscal year 2016: Commitments of USD 29.7 billion for 114 approved operations
  - Cumulative lending since 1945: USD 658.7 billion

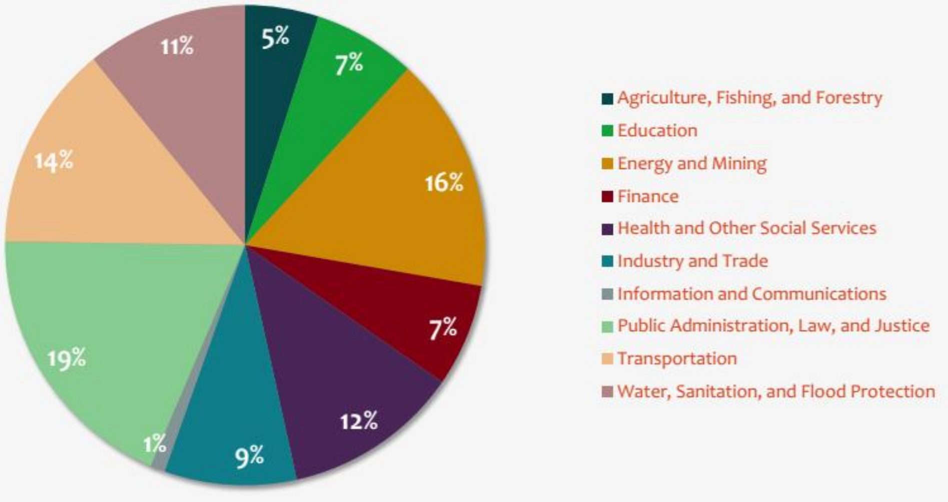
- International Development Association
  - 173 member countries
  - Fiscal year 2016: Commitments of USD 16.2 billion for 161 approved operations (14.4 billion in credits, 1.3 billion in grants, 0.5 billion in guarantees)
  - Cumulative lending since 1960: USD 326.1 billion

Structure of the World Bank lending (last year)

Lending by region in fiscal year 2016

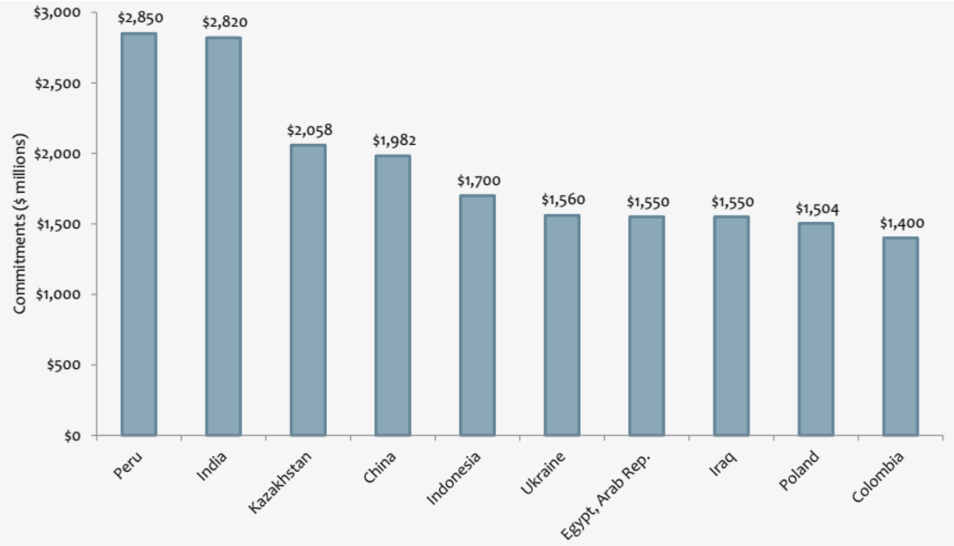


Lending by sector in fiscal year 2016

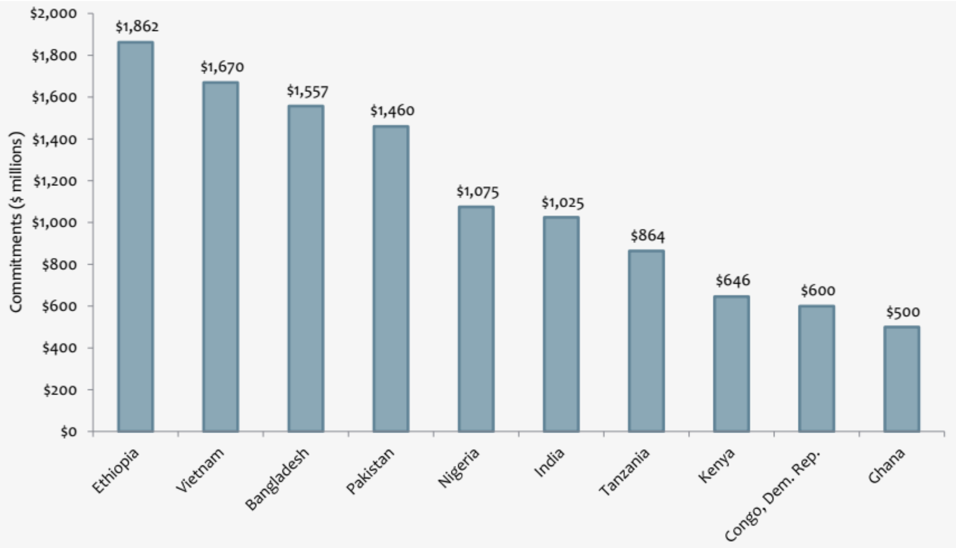


World Bank top borrowers

IBRD top borrowers in fiscal year 2016



IDA top borrowers in fiscal year 2016



Final comparison of the IMF and World Bank

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International Monetary Fund	World Bank
Oversees the international monetary system	Seeks to promote the economic development of the world's poorer countries
Promotes exchange stability and orderly exchange relations among its member countries	Assists developing countries through long-term financing of development projects and programs
Assists all members that find themselves in temporary balance of payments difficulties by providing short- to medium-term credits	Provides to the poorest countries whose per capita GNP is less than USD 865 a year special financial assistance through IDA
Supplements the currency reserves of its members through the allocation of SDRs	Encourages private enterprises in developing countries through its affiliate IFC
Draws its financial resources principally from the quota subscriptions of its member countries	Acquires most of its financial resources by borrowing on the international bond market
Has at its disposal fully paid-in quotas now totaling SDR 145 billion (about USD 215 billion)	Has an authorized capital of USD 184 billion, of which members pay in about 10 percent
Has a staff of 2,700 drawn from 150 member countries	Has a staff of 7,000 drawn from 180 member countries

Economic and monetary union (EMU)

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- Final stage of long-lasting process of economic integration in Europe
- EMU has been a long standing objective since late 1960s
- Euro area with single currency and monetary policy emerged in 1999
- Economic and monetary union involves
  - Policy harmonization to remove obstacles to factor mobility
  - A more marked and wider range of common policies, especially in relation to macroeconomic policy
  - Irrevocably fixed exchange rates or, as in the case of the EU, a single currency
  - A common monetary policy – that is, one interest rate and exchange rate policy determined by a single Central Bank
  - Some pooling of foreign exchange reserves
  - Possible inter-state transfers to offset economic distortions arising from EMU

European Union and Euro Area (Eurozone)

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Why some EU members do not have the euro?

- United Kingdom (GBP)
  - Before Brexit: „opt-out“ clause and five economic tests by Gordon Brown
  - Brexit will leave United Kingdom outside the EU
- Denmark (DKK)
  - „Opt-out“ clause
  - Adoption of Euro refused by referendum
- Sweden (SEK)
  - Referendum + political decision to not fulfill one criterion
- BG, CZ, HR, HU, PL, RO
  - Convergence criteria must be fulfilled first
  - Political will to accept the euro must exist

Historic plans to create monetary union

- 1960-1970s
  - Alternative plans proposed by France and Germany
  - Final „compromise“ version approved in 1970
  - Dismal global economic outlook and lack of specification of the plan's practical implementation made the plan unsuccessful

- 1980s
  - Delors Committee prepared a new plan
  - Schedule, institutions, implementation procedures set up
  - Basis for the Maastricht treaty

Three stages for the EMU implementation

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- Stage One (July 1, 1990 – December 31, 1993)
  - Exchange controls were abolished, capital movements liberalized
  - Set up of formal convergence
- Stage Two (January 1, 1994 – December 31, 1998)
  - Name of the new currency decided
  - Practical framework for the euro adoption defined
  - European Central Bank established
- Stage Three (January 1, 1999 – continuing)
  - 11 countries joined Euro Area (Greece two years later)
  - Single monetary policy came into effect
  - Euro coins and notes introduced in early 2002

Convergence is key in the EMU

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- Nominal convergence
  - Five convergence criteria (Maastricht criteria) for countries joining the Euro Area
- Real convergence
  - Economic cycle, structure of economy
  - Real exchange rates, productivity, labor costs
  - International trade, international investments
- Institutional convergence
  - Legal institutions and legal acts
  - Shareholders‘ and creditors‘ rights, investor protection
  - Market regulations
  - State capacity on enforcing contracts and tax collection

Maastricht convergence criteria

What is measured	Price stability	Sound public finances	Sustainable public finances	Durability of convergence	Exchange rate stability
How it is measured	Consumer price inflation rate	Government deficit as % of GDP	Government debt as % of GDP	Long-term interest rate	Deviation from a central rate
Convergence criteria	Not more than 1.5 percentage points above the rate of the three best performing Member States	Reference value: not more than 3%	Reference value: not more than 60%	Not more than 2 percentage points above the rate of the three best performing Member States in terms of price stability	Participation in ERM II for at least 2 years without severe tensions

Indicators of real convergence in the EMU

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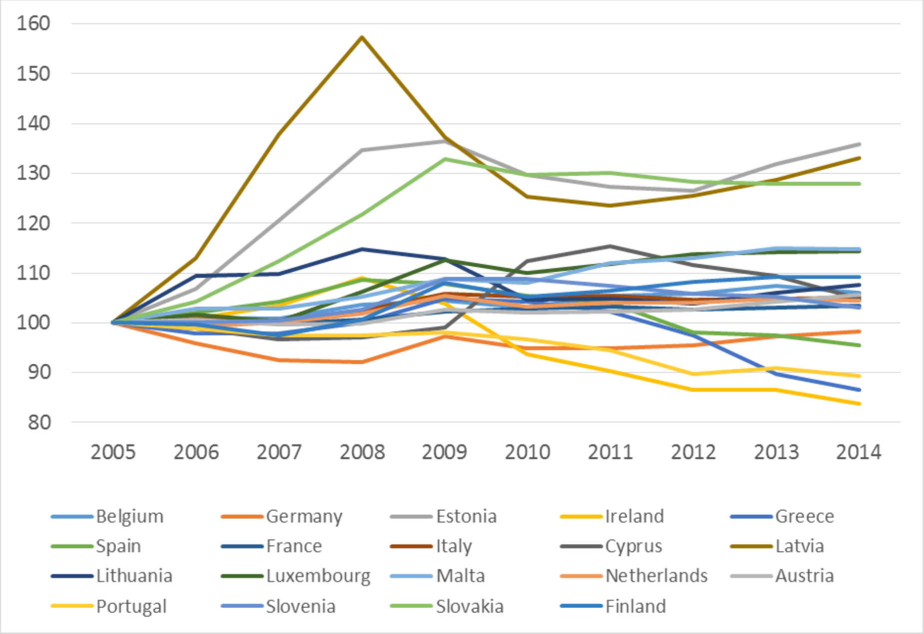
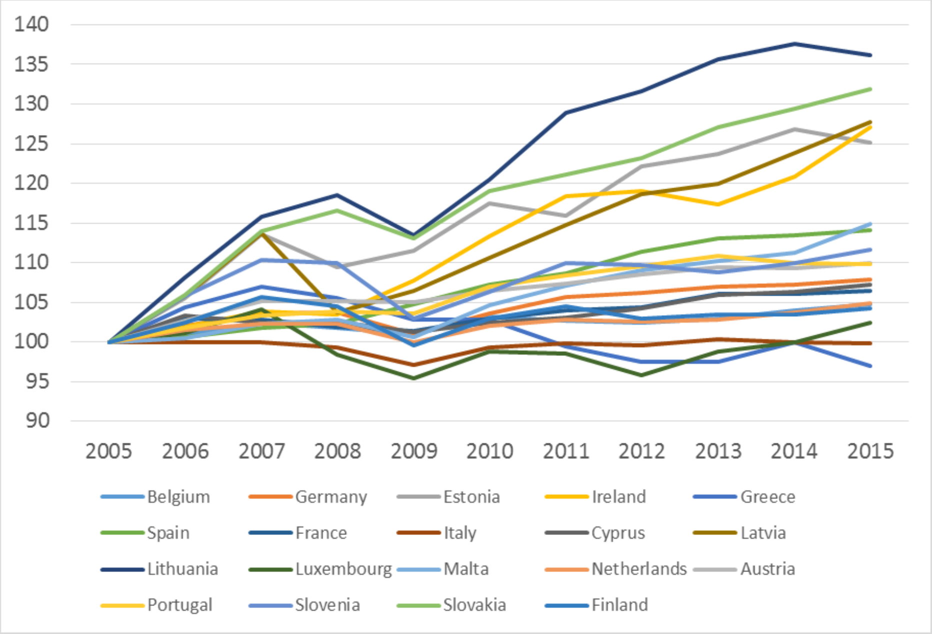
Real effective exchange rate



Real labor productivity



Costs and benefits of EMU

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- Benefits
  - elimination of intra-EU transaction costs lower interest rates
  - uniform interest rates
  - removal of exchange rate uncertainty in intra-EMU trade
  - removes the option of competitive devaluations between EU states
  - financial integration
  - economic cushioning from domestic political instability
  - creates a new international currency to represent the EU's combined economic weight
- Costs
  - short term deflation
  - loss of the exchange rate as a tool of national economic policy
  - loss of power to set interest rates and control the supply of money
  - potential problems related to a lack of 'real' convergence and potential policy conflicts
  - the inappropriateness of one monetary policy for so many states

European Central Bank (ECB)

- ECB is the central bank with responsibility for conducting monetary policy for the euro area
- European System of Central Banks (ESCB) comprises the ECB and the national central banks of all EU Member States whether they have adopted the euro or not
- Eurosystem comprises the ECB and the the national central banks of those countries that have adopted the euro
  - The Eurosystem and the ESCB will co-exist as long as there are EU Member States outside the euro area
- Euro area consists of the EU countries that have adopted the euro

European Central Bank administration

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- Governing Council
  - Main decision-making body of the ECB consisting of the six members of the Executive Board and the governors of the national central banks of the 19 euro area countries
  - Responsible for formulation of monetary policy which includes decisions relating to monetary objectives, key interest rates, the supply of reserves in the Eurosystem
  - Responsible also for decisions relating to the general framework under which supervisory decisions are taken
- Executive Board
  - Consists of the President, Vice-President and four other members
  - Responsible for implementation of monetary policy and managing day-to-day business
- General Council
  - Consists of the President, Vice-President and the governors of the national central banks of all EU Member States

Objective and instruments of the ECB monetary policy

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- The primary objective is to maintain price stability in the euro area
- Price stability defined as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2%
- Operational framework consists of the following instruments
  - Open market operations
    - Main refinancing operations
    - Longer-term refinancing operations
    - Fine-tuning operations
    - Structural operations
  - Standing facilities
    - Marginal lending facility
    - Deposit facility
  - Minimum reserve requirements to credit institutions

Inflation and exchange rate development

Inflation rate in euro area (HIPC, 1999-2017)

USD/EUR exchange rate (1999-2017)

THANK YOU FOR YOUR ATTENTION

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